IBFD002832
IBFD Journals
IBFD Materials
Bulletin for International fiscal documentati
on
1994

CONTENTS

VOL. 49 NO. 1 JANUARY 1994

UNITED STATES:

CALIFORNIA'S NEW "WATER'S EDGE" ELECTION ENHANCES BUSINESS OPPORTUNITIES FOR FOREIGN INVESTORS: THE US SUPREME COURT TO RULE IN *BARCLAYS* CASE 3

Leonard W. Rothschild, Jr.

For many years the State of California has utilized the worldwide unitary method of taxation, a method which was upheld by the US Supreme Court in 1983. The unitary method is now facing another challenge since the Supreme Court has decided to hear two worldwide unitary cases, one dealing with a foreign-based parent owning a US subsidiary doing business in California and the other dealing with a US parent owning foreign subsidiaries. Shortly before the Supreme Court agreed to hear the two cases the California legislature enacted Senate Bill 671, which significantly amends the water's edge method of taxation.

INTERNATIONAL:

CHOOSING THE RIGHT LOCATION FOR POOLED SERVICES OF A GROUP OF COMPANIES 7

Pierre-Jean Douvier

The requirements of group management and coordination have led to the creation of centres responsible for certain predetermined tasks which are pooled according to geographic criteria or the nature of activities conducted – e.g. headquarters, research and development centres and banking and financial services. The choice of location of such centres depends on many factors, including tax factors. This article examines the fiscal regime of several countries, depending on the services offered by the various centres.

QATAR:

TAXATION REGIME FOR FOREIGN ENTITIES FOLLOWING THE FUNDAMENTAL REFORM OF EXISTING INCOME TAX REGULATIONS 14

Finbarr Sexton

In mid-1993 the State of Qatar introduced a comprehensive income tax reform, covering the taxation of profits and capital income of businesses operating in Qatar. This article summarizes the new provisions and is supplemented by comments on relevant practice directives which continue to be effective under the new regulations.

INTERNATIONAL:

IMPROVING THE ACCOUNTANCY CONTEXT OF TAX REFORM IN DEVELOPING COUNTRIES 21

Seth E. Terkper

This article draws attention to the need to strengthen the accounting capacity of tax administrations to enable them to fulfil their function of effectively implementing tax reforms. The importance of accountancy to tax policy and administration review and the influence of professional accounting bodies found in virtually every country are reviewed, and attention is drawn to the impact made on tax policy by the national and international accounting and auditing standards or guidelines issued by these bodies. The article concludes with suggestions for effectively utilizing the skills of accountants as tax practitioners within and outside the tax system.

DOMINICAN REPUBLIC:

TAX AND INVESTMENT IN THE DOMINICAN REPUBLIC 33

Esther L. Aristy and Pedro O. Gamundí

Major changes in the economic legal framework of the Dominican Republic have taken place over the last three years, including a tax reform and the enactment of a tariff code. This article examines the provisions of the new Tax Code and then looks at tax incentives, the value added tax, property and other taxes.

IFA NEWS:

RESOLUTIONS – 47TH IFA CONGRESS, FLORENCE, 1993 41

© 1994 International Bureau of Fiscal Documentation

BIBLIOGRAPHY
- Books 45
- Looseleaf services 49

LIST OF ADDRESSES 51

CONFERENCE DIARY 55

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

UNITED STATES

CALIFORNIA'S NEW "WATER'S EDGE" ELECTION ENHANCES BUSINESS OPPORTUNITIES FOR FOREIGN INVESTORS:

THE US SUPREME COURT TO RULE IN *BARCLAYS* CASE

Leonard W. Rothschild, Jr., Esq.

Leonard W. Rothschild, Jr., Esq. is an attorney with Bancroft & McAlister, a Professional Corporation, in San Francisco. He is the Bulletin correspondent for the United States and has published numerous articles in the Bulletin, as well as in Tax Notes, State Tax Notes, The Journal of State Taxation, The Tax Advisor, and other journals. Mr Rothschild often advises non-residents with respect to pre-immigration tax planning, as well as foreign-based corporations on investing and doing business in the United States. In addition, Mr Rothschild has represented many foreign-based companies before the Franchise Tax Board in disputes involving California's worldwide unitary tax.

I. BACKGROUND

The State of California has for many years utilized the worldwide unitary method of taxation. This method of taxation was upheld in 1983 by the US Supreme Court in *Container Corporation of America v. Franchise Tax Board* [1] ("Container"), a case involving a US parent corporation with foreign subsidiaries. The *Container* decision specifically did not address worldwide unitary taxation in cases where a foreign-based parent corporation owned a US subsidiary doing business in California.

Ever since the *Container* decision, a number of foreign-based parent company cases have been working their way through the California and federal courts. Finally, on 1 November 1993, the US Supreme Court agreed to hear two worldwide unitary tax cases, *Barclays Bank International Ltd. v. Franchise Tax Board* [2] ("Barclays"), and *Colgate-Palmolive Co. v. Franchise Tax Board* [3] ("Colgate"). *Barclays* involves a foreign-based parent company owning a US subsidiary doing business in California, and *Colgate* is a case of a US parent corporation owning foreign subsidiaries.

It is particularly interesting that the US Supreme Court agreed to hear *Colgate*, since the identical issue (worldwide combination of a US parent corporation owning foreign subsidiaries) was decided by *Container* in 1983. There has been speculation that if the US Supreme Court rules in *Barclays* that California's use of the worldwide unitary tax method is unconstitutional with respect to a foreign-based parent company, under the due process clause it may be necessary to reverse the *Container* decision so that US parent corporations are not treated less favourably than foreign parent corporations. Estimates of the revenue loss to California, if *Barclays* is decided against the Franchise Tax Board is $ 900 million. If *Colgate* is also decided against the Franchise Tax Board the revenue loss is estimated at an additional $ 3.1 billion. Clearly, the State of California has a strong interest in the outcome of both of these cases.

One possible scenario is that the US Supreme Court will rule: (i) in *Barclays* favour, triggering tax refunds and abatements of assessed tax (totalling $ 900 million), and (ii) in *Colgate's* favour, but only on a prospective basis (saving California about $ 3.1 billion). The Court could justify its holding on the grounds that since 1983, US-based corporations should have relied on the *Container* decision. Therefore, a reversal of the 1983 *Container* decision by *Colgate* in 1994 is not prejudicial to US-based corporations, and is required by the new constitutional considerations arising at the time the *Barclays* decision reversed the holding in *Container*.

The *Barclays* and *Colgate* cases are now being briefed, and oral arguments in the two cases will most likely be set for late February or March. A decision should be reached by the US Supreme Court before the end of the Court's term in June 1994.

California, as well as the US Solicitor General, urged the US Supreme Court not to hear *Barclays* since California enacted Senate Bill 671 ("SB 671") on 10 September 1993, which was signed by Governor Wilson on 6 October 1993. California argued that the *Barclays* case was moot, due to the newly enacted legislation. *Barclays*, supported by *amicus curiae* briefs from several foreign governments, argued that the Court should hear this case since the new legislation applies on a prospective basis only.

II. CALIFORNIA WATER'S EDGE LEGISLATION PRIOR TO SB 671

As noted above, although California won the *Container* case, that decision did not address worldwide unitary taxation of a foreign-based parent corporation owning a US subsidiary doing business in California. Foreign corporations, supported by their governments, actively campaigned against California's continued use of mandatory worldwide combined reporting. In addition, the United Kingdom enacted retalia-

1. 463 U.S. 159 (1983).
2. No. 92-1384.
3. No. 92-1839.

© 1994 International Bureau of Fiscal Documentation

tory legislation. That legislation, if implemented, would have reduced tax refunds paid to US corporations, if a US corporation received dividends from its UK subsidiary and did specified amounts of business in California.

In response to all of this pressure, in 1986 the California legislature enacted Senate Bill 85, which permitted certain taxpayer's to elect the "water's edge" method of taxation, instead of being subject to worldwide combined reporting. This election was first effective for income years beginning on or after 1 January 1988. In order to understand the changes made last year by SB 671, it is necessary to discuss the provisions of the 1986 water's edge legislation (most of these provisions are still applicable under the new law).

A. Definition of "water's edge" group

If the "water's edge" election is made, the taxpayer whose income is subject to California franchise tax can determine its income derived from California sources, taking into account *only* the income and apportionment factors of certain specified entities. The entities included in the water's edge election are, as follows:

(1) Affiliated banks or corporations eligible for inclusion in a federal consolidated income tax return (generally 80 percent or more owned subsidiaries), except for IRC Section 936 corporations (possessions corporations).
(2) Domestic international sales corporations (DISCs) and foreign sales corporations (FSCs).
(3) Corporations (not banks) with 20 percent or more average apportionment factors (property, payroll and sales) within the United States, regardless where incorporated (so-called "80-20" companies).
(4) Banks and corporations incorporated in the United States and owned or controlled (directly or indirectly) more than 50 percent (this is less than the 80 percent ownership required to file federal consolidated income tax returns) by the same interests. This does not apply to IRC Section 936 corporations.
(5) Export trade corporations defined in IRC Section 971.
(6) Controlled foreign corporations (as defined in IRC Section 957), if they have Subpart F income (as defined in IRC Section 951). Only a portion of the income and apportionment factors is included in the water's edge combined report, that is, the ratio of Subpart F income to earnings and profits for the year.
(7) Foreign incorporated banks and corporations having less than 20 percent of their business (as measured by the average of their property, payroll and sales factors) in the United States, but only to the extent of their actual income and apportionment factors attributable to US business activities.

B. Definition of "qualified taxpayer"

Only a "qualified taxpayer" can make a water's edge election. A qualified taxpayer is defined as a bank or corporation that: (i) consents to the Franchise Tax Board ("FTB") taking depositions of key domestic corporate employees, (ii) consents to the acceptance of a subpoena requiring the production of business documents, and (iii) agrees that "functionally related dividends" received are presumed to be apportionable business income.

C. Duration of the election and annual election fee

The water's edge election is made by contract with the FTB and, under a 1988 amendment to the law, the election period is five years. The election is automatically renewed at the end of each year for an additional one year period. Many taxpayers made an election and then immediately revoked the election, so that the initial election was only for one five year period. Taxpayers that immediately revoked an election made in 1988 should consider making a new election for 1993 (see the section entitled "Transition Rules for Existing Elections," below).

The contract requires the payment of an annual election fee to the California Unitary Fund. The election fee is computed under two alternative methods, and the taxpayer is required to pay the greater fee. Under the first alternative, the fee is equal to .0003 of the sum of: (i) the taxpayer's California property for 1986, (ii) the taxpayer's California payroll for 1986, and (iii) the taxpayer's California sales for the current year. The computed fee is reduced by the cumulative amount spent by the taxpayer for new employees in California, and for certain investments in new plants or facilities in California since 1 January 1987. Under the second alternative, the fee is .0001 of the taxpayer's property, payroll and sales within California for the current year (with no reduction in election fee for new employees or new investments). In any case, no fee is imposed in an income year in which the taxpayer incurs no tax liability under either a worldwide combination or the elective water's edge method.

D. Domestic disclosure spreadsheet

All taxpayers making the water's edge election are required to file a domestic Disclosure Spreadsheet ("DDS") with the FTB. The DDS describes the state reporting methods of the taxpayer and its affiliates doing business in the United States. The purpose of the DDS is to assist the FTB in determining whether transactions between affiliates are at arm's length.

A taxpayer making the water's edge election is required to file a DDS if either: (i) the property, payroll or sales of the taxpayer and its related banks or corporations in foreign countries exceeds $ 10 million, or (ii) the total assets of the taxpayer and its related banks or corporations in foreign countries exceed $ 250 million. In any case, a DDS is not required for any year in which the taxpayer's property, payroll and sales in the United States are each less than $ 500,000. A related party is generally where there is 50 percent or more common ownership.

The DDS is required to be filed within six months after the filing of the California tax return. The DDS is normally filed once every three years, except where there is a substantial change in the taxpayer's business activities.

© 1994 International Bureau of Fiscal Documentation

E. FTB's power to disregard a water's edge election

The FTB has the power to disregard an otherwise validly filed water's edge election, if a taxpayer wilfully fails to file the DDS or furnish certain other information requested by the FTB during an audit.

III. THE NEW WATER'S EDGE ELECTION, PROVISIONS OF SB 671

SB 671 makes significant changes to the water's edge method enacted in 1986 (effective for income years beginning in 1988). These new changes, which are effective for income years beginning in 1994, substantially liberalize the water's edge election, and will encourage many more taxpayer's to utilize the water's edge election. The most significant changes to the existing election are as follows:

- no election fee;
- no domestic disclosure spreadsheet;
- extension of the election period to seven years;[4]
- FTB cannot disregard a water's edge election.

Most of the other provisions of the water's edge election remain in effect, as discussed above. For example: (i) the composition of the water's edge group remains the same, (ii) the election can only be made by a "qualified taxpayer", (iii) the electing taxpayer remains obligated to retain and to make available to the FTB certain information and documents on audit, and (iv) the election and termination procedures remain the same.

A. Information return and information maintenance requirements

The DDS has been replaced by an information return that must be filed by all California taxpayers that allocate and apportion income, if it and its related banks' or corporations' total assets exceed $ 200 million. Banks and corporations are related if more than 50 percent is owned or controlled directly or indirectly by the same interests. There is an exception to filing in any year, if the taxpayer's property, payroll and sales within the United States are each less than $ 500,000.

The information return will identify the corporate parent and generally all 20 percent or more affiliates owned or controlled directly or indirectly by the parent. The information return, like the old DDS, is filed within six months after the due date (including extensions) of the return. The information return is filed the first year in which a water's edge election is made and then every three years thereafter, unless there is a substantial change in the taxpayer's business activities. Penalties are provided for failure to file the information return.

In place of the FTB having the authority to disregard a water's edge election, the new legislation requires electing taxpayers to maintain and provide on request to the FTB information necessary to: (i) determine the amount of income attributable to California, (ii) classify income as business or non-business income, (iii) determine unitary apportionment factors for use within the water's edge, and (iv) make audits of attribution of income to the United States and foreign countries under certain federal provisions.

Failure to comply with the new information requirements will result in substantial penalties. There is a penalty of $ 10,000 for each taxable year for which information is not made available, and an additional $ 10,000 penalty for each 30 days (after an initial 90 day period) if the taxpayer refuses to provide the requested information. Until regulations are adopted the maximum penalty is $ 50,000.

B. Transition rules for existing elections

SB 671 provides that for any income year beginning on or after 1 January 1994, the existing water's edge contracts are rescinded for any periods remaining on the contracts (commencing on the first day of the taxpayer's income year that begins on or after 1 January 1994). This means that a fiscal year taxpayer whose contract is in effect on 31 December 1993, will continue to be bound by that contract (and will pay an election fee) until the close of its income year in 1994.

All taxpayer's that made a water's edge election under the prior law and wish to continue using the water's edge method, must make a new election. This election is made by filing Form 100-WE with the corporation's 1994 California franchise tax return. This return is due by 15 March 1995, but if an extension of time to file is requested by 15 March 1995, the return filing date is extended until 15 October 1995.

It should be noted that many taxpayers made a water's edge election for calendar year 1988 (or fiscal years beginning in 1988) and immediately filed a notice of intent not to renew their contracts. Therefore, these contracts expired in calendar year 1992 (or fiscal years beginning in 1992). If these taxpayers wish to make water's edge elections for 1993, *new* elections (under the old law) will have to be made, in the manner described in the preceding paragraph (except the due dates are in 1994, not 1995).

IV. OTHER PROVISIONS IN SB 671

In addition to significantly modifying the water's edge election, SB 671 contains many other provisions designed to encourage new investments in California. Although a detailed discussion of these provisions is beyond the scope of this article, listed below are some of the more significant changes affecting businesses:

(1) A 6 percent investment tax credit ("ITC") is enacted for purchases of "qualified" business property. The ITC can be used in 1995 for property placed in service in 1994.
(2) Certain new businesses can elect to forgo the ITC and instead claim an exemption from sales and use tax (up to 6 percent). This will be particularly helpful to new businesses that are not currently paying California income tax, since the ITC would carry over and provide no current benefit.

4. The contract is automatically renewed each year for one additional year, unless a filing of a notice of non-renewal is made by the taxpayer.

© 1994 International Bureau of Fiscal Documentation

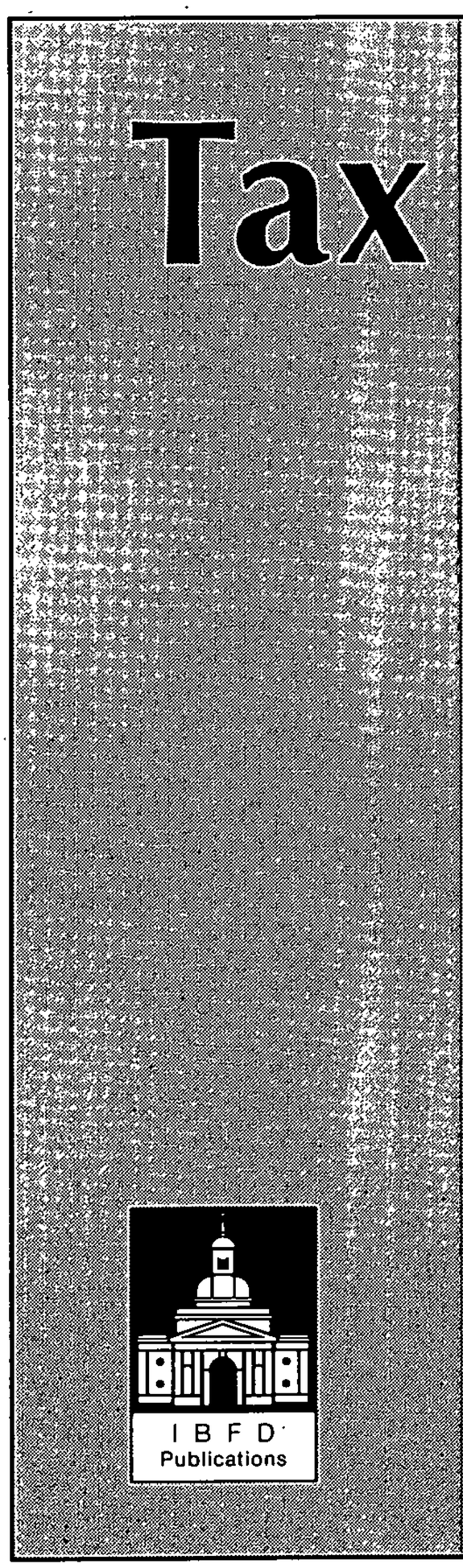
(3) The treatment of net operating losses ("NOL") has been substantially liberalized. Certain new businesses can now carry forward 100 percent of their NOL instead of 50 percent under prior law. In addition, the NOL provisions have been made permanent (the NOL deduction was scheduled to expire in 1996).
(4) The research and development credit is made permanent (it was scheduled to expire in 1998).
(5) In computing the amount of income apportioned to California, the three factor formula is modified by double-weighting the sales factor. This will generally reduce taxes on companies that have large payrolls and property in California, and increase taxes on companies that primarily sell into California.
(6) There are now incentives for individuals to make investments in new small companies. It may be feasible for a foreign-based company to form a California subsidiary, and obtain a portion of the start-up capital having the subsidiary sell minority stock interests to California investors.

V. CONCLUSION

The California legislature has taken a big step forward by enacting SB 671. The estimated revenue loss to California for liberalizing the water's edge provisions is projected to be about $ 80 million per year (due to repeal of the election fee). However, this revenue loss should be at least partially offset by new foreign investments made in California.

For the first time, the legislature has taken affirmative action to create a better tax environment for foreign investors in California. Under the new water's edge election, a foreign-based company doing business in California through a US subsidiary is no longer at a tax disadvantage in competing with California-based businesses.

The California legislature is to be commended for finally addressing the unitary tax concerns of foreign investors. It is hoped that foreign investors will respond positively, by considering making new or additional investments in California.



News Service

Keep track of the latest taxation news from over 150 countries with IBFD's acclaimed weekly newsletter.

Comprehensive coverage of developments of international interest is assured through a network of local correspondents, all experts in their own area. News, trends, proposals and changes in taxation and investment are all reported as they occur.

Tax News Service: there is no better way to keep up with events in international taxation.

NLG 600

Binder, quarterly cumulative indexes and postage by air are included in the subscription. Text includes references for instant updating of IBFD looseleaf services.

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

CHOOSING THE RIGHT LOCATION FOR POOLED SERVICES OF A GROUP OF COMPANIES

Pierre-Jean Douvier
Partner, Bureau Francis Lefebvre

I. INTRODUCTION

The requirements of group management and coordination have led fairly naturally to the creation of centres responsible for a number of predetermined tasks which are pooled according to geographic criteria or the nature of activities conducted. The choice of location of such centres is significant since it will determine the tax and legal regime applicable to the activities. In fact, the decision to locate a services unit in a particular country can only result from a comprehensive reflection embracing many factors – including tax factors – on both the side of the investor's country and the host country. Because operators are so sensitive to the issue of their effective tax burden the tax criterion will be decisive. This article examines the fiscal regime of several countries, depending on the services offered by the various centres.[1] The following comments will not cover active services such as distribution of products, as this would raise major issues (e.g. permanent establishment). Of course, the choice of countries is only for purposes of the examples, each situation having to be scrutinized according to the circumstances and organization of the companies involved.

Although classification is not easy, common services which may be classified in practice as passive can be divided into three categories: headquarters, research and development ("R&D") centres and banking and financial services.

A. Headquarters

A headquarters is a centre located in a particular country which belongs to an enterprise or an international group whose head office is situated in another country. The headquarters acts exclusively, except on rare occasions, on behalf of the group and exercises coordination or control functions in a specific geographic area. The task of the headquarters is, by definition, different from that of the manufacturing, purchasing and operating units which have no decision-making, initiating or coordinating powers over other units of the group.

B. R&D centres

R&D centres focus on activities which aim at the discovery of new processes likely to result in registered patents or know-how. They will therefore deal with creative works systematically undertaken with a view to increasing the number of sources of knowledge as well as utilizing such knowledge for new applications, and this up to the final stage of research, i.e. the operation of experimental development.

R&D activities can be carried out either within a group or under a cooperation agreement among unrelated companies. Given their upstream position in the filing of applications for registration of patents or know-how, they constitute a cost centre.

C. Banking and financial services

This category encompasses various activities such as cash management, invoicing, foreign exchange risk management, transactions involving financial instruments, clearing operations, intercompany financing, as well as insurance and reinsurance.

D. Taxation

Countries which are likely to grant favourable treatment to certain services can be divided into two categories:

- countries whose law does not provide for any particular regime. In such countries ordinary rules apply, although in certain situations, practical rules are implemented by the administration which allow for a modification of the usual corporation tax base. Such is the case for example, in the Netherlands and Luxembourg with financial services. All host countries provide specific tax base rules for headquarters;
- countries where certain services derive their tax regime from the law itself, e.g. Belgium, Ireland and Malta.

II. MODIFICATION OF CORPORATE TAX BASIS

A. Headquarters tax regime

1. Consequences in the host country

Leaving aside the question whether or not the activity of a headquarters may constitute a permanent establishment (PE), host countries deem the activities of headquarters taxable, and part and parcel of the economic process whereby the

1. In all cases it is assumed that double tax treaties apply.

© 1994 International Bureau of Fiscal Documentation

enterprise makes profits; thus headquarters are liable to tax on profits attributable to them.

Headquarters should in principle determine their operating profits and losses according to ordinary rules, i.e. by invoicing their services in the same manner they would invoice unrelated companies. However, it is not always practicable to implement this principle, so their fiscal regime is an adapted regime which makes allowances for the peculiarities of their functioning and attributions. Under such a regime, a determined percentage, generally ranging from 6 to 15 percent depending on the country, is applied to the expenses incurred, the result of which represents the basis assessable to corporate tax (cost plus method). In most cases this regime is granted subject to prior agreement by the tax authorities. In general, it is limited to corporate tax, so all other taxes typical of each country (e.g. registration duties, local taxes, value added tax) are payable under the usual conditions.

Host countries of headquarters generally provide favourable accompanying measures in respect of the liability to income tax of the personnel seconded to the headquarters. Such measures, mainly certain bonuses linked to expatriation or reductions in the taxable basis in favour of alien staff, apply either by right or occasionally subject to agreement.

The situation of headquarters in Luxembourg, the Netherlands, Switzerland and France is illustrative.

(a) Luxembourg

In a Circular Letter dated 12 June 1989, the director for direct taxation of Luxembourg provided a detailed description of the fiscal treatment of administrative activities carried out by coordination companies ("headquarters"). Such companies are defined as resident multinational corporations whose corporate purpose is limited to the following administrative activities: centralized organizational and secretarial services, advertising, marketing and market studies supplies, collecting and processing of technical or administrative data, public relations with national and foreign authorities, centralized accounting, financial and administrative operations, computer-aided data processing, legal evaluation and assistance and any services directly or indirectly related to the above activities. These activities may only be performed for the exclusive benefit of other enterprises belonging to the group.

A Luxembourg headquarters may not engage in centralized financial and re-invoicing operations other than those relating to the clearance of invoices denominated in multiple currencies, nor may it hold patents, licences or other intangibles which may give rise to royalties, nor may it hold shares or interests in resident or non-resident corporations.

Generally speaking a headquarters is subject to tax at the rates applicable under ordinary law. For corporate tax purposes, however, it must generate "such appropriate trading profit as should result from the normal performance of a reasonable administrator dealing with third parties". The profit should be equal to at least 5 percent of deductible expenses which are related to allowable services.[2] The minimum taxable profit is LUF 1,500,000.

(b) The Netherlands

Companies resident in the Netherlands whose corporate purpose is the rendering of services for the benefit of affiliated companies (service sector corporations) may determine their profit according to a percentage ranging from 5 to 25 percent (often discussed in advance with the Dutch Revenue), as the case may be, of local expenditure incurred in respect of the relevant services. This basis is then liable to corporate tax at the usual rate. Generally, such companies may not conclude any commercial agreements since their activities are by their nature ancillary (marketing, advertisement, sales management).

(c) Switzerland

Switzerland has a two-tiered taxation system: one at the federal level and the other at the cantonal level. Swiss headquarters derive their tax regime from a Circular Letter of the Direct Taxes Federal Administration dated 29 June 1959. In practice, the taxpayer must request written confirmation that it is eligible for the regime.

The minimum taxable basis of a Swiss headquarters equals at least 10 percent of expenses incurred locally (or 1/6 th of annual payroll), although the tax authorities may set a minimum return.

The basis is then liable to federal tax under the ordinary rules. Cantons generally determine the taxable basis of activities under the same conditions as the federal government ("cost plus" or 1/6 th) and subject it to cantonal tax at the standard rate (certain cantons, however, apply specific rules depending on the circumstances).

(d) France

In an unpublished note of 13 February 1975, the Direction Générale des Impôts specified that, given the practical difficulties in the application of headquarters taxation rules, it seemed necessary to provide for harmonization of such rules. After defining headquarters, the authorities indicated that headquarters are to be distinguished from liaison offices set up by foreign companies in certain countries. A headquarters is a fixed centre of business, owned by an enterprise or an international group whose head office is abroad, which carries out management, coordination, supervision or auditing activities in a given geographic sector for the sole benefit of the group.[3] The exclusive purpose of liaison offices is to collect information, provide data, place advertisements or conduct scientific research on behalf of foreign companies, and they only perform "auxiliary or preparatory" activities within the meaning of tax treaties.

2. If the headquarters has a clearing activity involving invoices denominated in multiple currencies, the profit generated must correspond to arm's length conditions. To qualify, the remuneration must depend on the foreign exchange risk and be at least 1-1.5% of the total amount of the invoices concerned.

3. Accordingly, a headquarters directly depends on an enterprise or a group of enterprises. A headquarters may be set up as a company or as a branch; it must perform activities exclusively for the companies of the group, so that if it renders services to third parties, the corresponding income is subject to income tax under standard rules. A headquarters may only operate within a limited geographic scope so it cannot carry out activities for the entire group of companies; it constitutes in fact part of the head office of the group for a region of the world.

© 1994 International Bureau of Fiscal Documentation

Normally the headquarters should be in a position to arrange its own accounts and determine the tax base according to the price of the services it renders, as would be the case with unrelated parties. However, due to the peculiarity of such an organization, it is possible, under certain conditions, to determine the tax base of a French headquarters with the prior approval of the French tax administration.

In such a case the French headquarters tax regime is as follows: for corporate tax purposes, the tax base is generally a fixed amount ranging from 6 to 15 percent of expenses incurred. With a few exceptions, the headquarters is liable to other duties and taxes under the usual conditions. The annual flat taxation is payable according to a minimum scale so long as the headquarters does not realize any turnover. If the headquarters is a corporation, intangible services escape French VAT if the corporation for whose benefit the services are provided is established outside the EC or is subject to tax in the EC member state where it is set up. If the headquarters is a branch, expenses borne in France may, subject to certain conditions, benefit from an allowance or a refund.

Subject to prior agreement of the administration, salaried employees of French headquarters also benefit from a particular regime. The regime applicable to the salary and perquisites flowing from expatriate status is generally along the following lines:

- income tax is not levied on certain indemnities (gross up of tax and social security contributions, reimbursement of expenses related to keeping a dwelling in the country of origin), but such indemnities must be included in the tax base of the headquarters;
- certain personal expenses paid for by the headquarters escape tax (education expenses for children, reimbursement of expenses related to the dwelling of the salaried employee in France as well as tax consultation costs, French language lessons for the expatriate, exploratory trip by the salaried employee and spouse, moving and travelling expenses from and to the country of origin, hotel and boarding expenses when arriving and departing from France).

All other indemnities and the expatriate's salary are subject to income tax under the usual conditions.

2. Consequences in the countries financing the headquarters' expenses

Provided the payments committed to finance a headquarters' expenses benefit the investors and are sufficiently documented, their deductibility should not cause any major difficulty.

B. Banking and financial services tax regime

1. Luxembourg

Pursuant to a Circular Letter of 14 July 1989, Luxembourg international group finance companies are defined as Luxembourg resident corporations, which belong to an international group and whose exclusive purpose is making loans to group companies, refinancing these loans with public issues, private credits or bank credits.

The term "international group" refers to a financially linked group of companies at least two of which are established in two countries other than Luxembourg. A company is deemed to form a group with another company if the latter directly or indirectly holds 25 percent or more of the former's share capital or voting rights. A predominant part of the loans made by the finance company must be allocated to the group companies located abroad. Moreover, the parent company of the finance company must be a company of the group and its equity capital (including reserves) must amount to at least LUF 7.5 billion or its corresponding value. Loans issued to foreign group companies must be issued in the same currency and at the same maturity date as the credits in which the relevant funds were collected.

The status of finance company is granted subject to prior approval of the tax authorities upon production of documents setting forth the main financial data of the project.

Such finance companies are subject to taxation under standard rules, allowing for the following peculiarities. For purposes of the tax on profits, loans granted by the finance company to group companies must generate "such appropriate profit as should result from the normal performance of a reasonable administrator dealing with unrelated parties under similar circumstances". The trading profit, meaning a minimum trading profit, is determined by applying a minimum percentage of 1.4 percent to the amount of the loans. Where the financial risk relating to the finance company's intervention is collateralized, the applicable minimum margin is 1.8 percent. If the finance company actually realizes a higher commercial profit than the fixed margin, the taxable base will be derived from this higher base, and assessed to tax at the usual rates.

Financial profits, if any, realized on authorized short-term investments are taxable at the usual rate. Losses may not be deducted from the ¼ or ⅛ percent fixed margin and foreign-sourced withholding on interest paid to the finance company may not, in the presence of a fixed margin, give rise to any tax credit in Luxembourg.

2. Netherlands

Subject to certain conditions, Dutch resident corporations are not liable to tax on profits on dividends received from their resident or non-resident subsidiaries, or on capital gains arising from the disposal of their participation ("participation exemption").[4] However, interest received on loans made to subsidiaries are treated as ordinary income. As such, they are subject to tax under the usual conditions, no favourable regime being applicable, and at the rates currently in effect (40 percent on profits up to NLG 250,000, 35 percent on profits exceeding this amount).

Within the framework of intra-group loans, the managing company (by definition a resident of the Netherlands) secures

4. On 16 July 1993 the Dutch Ministry of Finance published a draft bill concerning an amendment to the participation exemption, as well as a form of earnings stripping provision where interest is paid to affiliated tax haven countries. For a discussion of the bill, see Magnin, E., "Proposed Tax Haven Legislation", 47 *Bulletin for International Fiscal Documentation* (October 1993), at 589.

© 1994 International Bureau of Fiscal Documentation

refinancing from either its parent company, in which case the margin realized in the Netherlands must correspond to arm's length conditions, or from unrelated banking institutions.

Although not mandatory, an application should be filed with the Dutch tax administration for an advance ruling on the determination of the taxable margin in order to avoid any subsequent challenge in case of an audit. Currently, the Dutch administration accepts the following margins:

- ¼ percent of the amount of the loans where the lender is not an affiliated company, where the funds come from financial instruments or where the loans are banking loans exceeding one year;
- ⅛ percent of the amount of the loans where the financing is realized within the group companies or, failing this, where the financial instruments involved are short term, i.e. not exceeding one year provided they are guaranteed by the group.

These rates may be reduced depending on the amount of loans involved.

If the loans are used for the acquisition of participation(s) of subsidiaries, the interest paid thereon is not deductible from the Dutch parent company's taxable results. In this respect, should a tax audit be made, the Dutch inspectors would have recourse to the method commonly known as the "historical method" in order to ascertain that the interest is being paid for the purpose of acquiring a participation (whereby interest paid on loans contracted during the six months preceding the acquisition of a participation are deemed to be related, unless the company proves the contrary). Under this method, the various moves of the loans and interest are retraced over a certain period of time, as compared with the dates at which the participations were acquired by the Dutch holding company.

Intercompany financing may also be routed through a foreign branch (Swiss, United Kingdom or Luxembourg depending on the nature of the loans) of a Dutch company. Such an opportunity is subject to certain conditions, in particular that the investor should inject at least NLG 100 million as share capital in the Dutch corporation; this involves the payment in principle of a 1 percent capital duty, which may be reduced under certain conditions in the event of a reorganization implemented through France (in France the contribution in cash is subject to a flat duty of FRF 500, which is obviously insignificant).

III. TAX STATUS CONFERRED BY DOMESTIC LEGISLATION

This section looks at countries where favourable tax regimes flow from legislation. If the country is an EC member state, it has generally obtained the European Commission's approval. In addition, in most cases, the project is subject to prior approval of the host country's administration.[5] Three regimes are examined which favour certain banking and financial services. Because re-insurance and R&D activities are so specific, they are addressed separately.

A. Fiscal regime in the host country

1. Standard regime

(a) *Belgium*

In Belgium, Royal Decree No. 187 of 30 December 1982 (completed by the Royal Decree of 3 November 1986) established coordination centres, the object of which is to allow the creation of new jobs by promoting private investment in Belgium.[6] The setting up of a coordination centre is subject to the approval of the Belgian Ministry of Finance, Ministry of Economy and Ministry of Employment and Middle Classes and is valid for a renewable ten-year period.

A coordination centre must have as its exclusive purpose one or more of the following activities, which must be carried out for the sole benefit of members of an international group of companies (as defined by Royal Decree of 3 November 1986);

- advertising,
- collection and dissemination of information;
- insurance and re-insurance;
- scientific research;
- relations with national and international authorities;
- centralized accounting, administrative and data processing;
- centralized financial operations and the hedging of risks resulting from fluctuations in foreign exchange rates; and
- all activities of a preparatory or auxiliary nature for the companies of the group.[7]

For corporate tax purposes, coordination centres (whether in the form of a branch or a subsidiary) are not taxed on the income they actually receive but rather on a lump-sum basis, determined as a percentage of certain operating costs and expenses (in the region of 8 percent) borne by the centre. Personnel costs and financial charges are excluded from the base, and the taxable income of the coordination centre may not be less than the aggregate sum of non-deductible expenses, and abnormal and gratuitous advantages granted to the coordination centre by members of the group.

The margin applied by the coordination centre on services rendered to the group companies must correspond to that which would be fixed for similar services between unrelated companies. The taxable basis thus determined will bear:

- corporate tax at the current rate of 39 percent (to be increased by an in principle, temporary 3 percent crisis surtax; effective rate = 40.17 percent) for centres incorporated in Belgium;
- as from fiscal year 1991, the 43 percent tax applicable to non-residents, if the centre was set up as a branch of a foreign company (reduced in certain cases).

5. This internal procedure is justified by the host countries' desire to reserve the right to determine the economic interest of the project's operation, and satisfy themselves that the location is not merely a matter of expediency. The authorities are generally authorized to verify from time to time compliance with the conditions laid down at the time the company was established.
6. Some of the provisions of Royal Decree No. 187 were subsequently amended.
7. The narrowness of the definition of "group" concept in Belgian law should be noted.

© 1994 International Bureau of Fiscal Documentation

A coordination centre also benefits from the following advantages:
- unless otherwise provided by Royal Decree, exemption from any Belgian withholding tax on dividends, interest or royalties paid to resident or non-resident taxpayers;
- exemption from registration duty on contributions to the capital of the centre;
- exemption from the real property withholding tax; and
- at the personnel level, foreign executives and scientists temporarily seconded to the coordination centre benefit from a particularly favourable tax regime.

(b) *Ireland*

In addition to the favourable regime for manufacturing companies and companies located in and carrying out certain activities in Shannon, companies set up in the International Financial Services Centre (IFSC), in the Docks Area of Dublin, may benefit from a favourable regime whereby the corporate tax rate is reduced to 10 percent of the profits they realize (the current standard rate is 40 percent).

This temporary regime, which has the approval of the European Commission is applicable up to 31 December 2005. It is available to companies exporting services, i.e. companies realizing their turnover basically with clients or companies residing outside Ireland, in areas such as banking transactions, loans to trading or industrial companies, leasing, insurance and related activities, etc.

The concession is granted subject to the prior approval of the Irish tax authorities and subject to certain conditions. For instance, the applicant company must prove that it creates new jobs in Ireland. No minimum is required by law – rather approval is contingent on the degree of substance of the project and whether it will benefit the economy. As a general rule, the creation of six to ten jobs (the majority of which are to be reserved for Irish nationals) within a period of three years, is required as a minimum.

When all conditions are satisfied, the Irish tax authorities will issue a certificate in favour of the beneficiary company.

(c) *Malta*

In 1988, Malta passed the International Business Activities Act (IBAA), which established the Malta International Business Authority (MIBA), whose main task is to supervise and regulate, at the administrative level, all offshore activities carried out under the IBAA.

Pursuant to Article 23 (2) of the IBAA, companies registered under Maltese law may conduct any commercial activities within the framework of an international business centre for financial services, notably banking and insurance activities. Creation of such companies is subject to the prior authorization of the MIBA. No resident of Malta may hold shares in such companies. Since such authorization provides for the tax and administrative rules to be complied with, the company by-laws and any other documents must be submitted to the MIBA upon request.[8]

Qualifying companies benefit from a favourable tax regime under which their profits are subject to a reduced rate of corporate tax of 5 percent (standard rate 35 percent). The payment of interest or dividends by an authorized company is exempt from any Maltese withholding tax, and other exemptions are granted from death and gift duties, stamp duties and exchange control regulations.

The company must, of course, keep accounting books and prepare annually a form disclosing its profits and losses, as audited and approved by the Maltese tax administration.

Malta has concluded bilateral tax treaties with several countries such as Australia, Austria, France, the Netherlands, the United Kingdom and the United States. It would, however, be advisable to verify that certain Maltese companies are not excluded from a treaty (or that the right to apply domestic anti-avoidance legislation is not retained by the investor's country).

2. R&D

In addition to financial aid, most countries provide favourable tax treatment for R&D expenditure. It is not intended here to make an exhaustive description of the various regimes. Tax incentives may apply at two levels:
- on the investor's side by tax cuts on the capital invested in an R&D company. In certain countries, capital gains on the subsequent disposal of the company's shares escapes taxation (Australia, Belgium). Such incentives are sometimes reserved for individuals only;
- in favour of the R&D company. Four types of incentives may be distinguished: accelerated depreciation for fixed assets whose acquisition was motivated by R&D operations, tax credits for research, immediate deduction of expenses or a temporary tax exemption on profits.[9]

Once this cost centre stage is completed, the question arises as to where any process discovered should be patented. Leaving aside legal protection regimes, the choice naturally depends on the royalties tax regime and the rate of any withholding tax provided for in the paying country, not losing sight of measures aimed at combating tax evasion. In this respect, most countries have measures to prevent the process from being registered in a low tax third country by reason of royalties received. If the recipient of the royalties is resident of a so-called tax haven, the proceeds are not subject to income tax in this country (or to a nominal corporation tax); however, in this case, the domestic withholding tax, if any, on royalties levied in the country of source, on the gross amount as no treaty will reduce or eliminate it. If the country of residence of the recipient is a treaty country, then the domestic rate of withholding tax in the country of source of the income is reduced or eliminated; correlatively, the proceeds are taxable in the country of the recipient under ordinary rules, i.e. the standard corporate income tax rate is applicable.[10] How-

8. An annual registration duty of MTL 1,000 must also be paid to the MIBA.
9. For example, in France, the General Tax Code generally requires R&D expenses to be deducted, although in certain circumstances the taxpayer may opt to capitalize such costs. In addition, a tax credit is granted for research expenditure on operating expenses incurred on scientific or technical research operations (including software design).
10. Some tax planning is available in certain countries, such as the Netherlands by routing the investment through the Netherlands Antilles.

© 1994 International Bureau of Fiscal Documentation

ever, in such a case, anti-treaty shopping measures (limitation of benefits, beneficial owner concept) or CFC legislation may permit the country of the ultimate shareholder of the royalty company to tax the proceeds received by the latter.

3. Reinsurance

Reinsurance can be defined as the operation whereby, against payment of a premium, a first insurer procures another insurer known as the reinsurer to partially or totally release him from a risk already assumed, i.e. the obligation for him to indemnify an insured third party under an original insurance contract. Within a group of companies, the reinsurance function is, in practice, integrated in an "ad hoc" subsidiary which is then characterized as a "captive reinsurance" company. In most cases, the management of risks is entrusted to a specialized company.

Some countries (Bermuda, Cayman Islands, Guernsey, Luxembourg and, more recently, Ireland) are traditional host countries for reinsurance companies. Madeira (Portugal) recently enacted a law which permits the setting up of reinsurance activities. The captive insurance companies tax regime in tax haven countries (even though some have a long-standing reinsurance tradition, such as Guernsey) will not be addressed here since the countries of residence of the premium debtors retain the right to apply domestic law in the absence of a tax treaty. However, it should be noted that in host countries the profits generated by reinsurance fully escape taxation (at most, a trivial lump-sum annual tax would be payable).

Luxembourg, Ireland and Madeira will illustrate the benefits of locating captive reinsurance companies in Europe.

(a) *Luxembourg*

Any Luxembourg company whose taxable income exceeds LUF 1,312,000 is assessed to corporation tax at the usual rates. However, the tax burden of reinsurance companies setting up in Luxembourg is significantly reduced by specific taxable basis rules intended to adjust to the technical constraints weighing on the activity performed. Luxembourg applies for tax purposes the standard rules provided for in the law. However, as reinsurance is a particular activity, specific reserves may be created which (legally) in practice leads to a reduced tax base.

Luxembourg reinsurance companies may set up a number of technical reserves to the extent of the premiums kept for their own account. Such reserves must show as offset accounts against liabilities existing *vis-à-vis* reinsured companies at the end of the accounting year.

Basically, the reserves are as follows:
- provision for outstanding claims, valued and adjusted on the basis of existing actual data or data discounted at the time the balance sheet is drawn up;
- provision for current risks and exposures which are deductible from tax and deductible provided the annual allocation to the provision account does not represent more than 25 percent by value of the premiums annual increase, or that the provision amount is not higher than 25 percent of the annual amount of premiums.

Both of these reserves qualify as deductible charges in the valuation of the net worth of the company.
- a catastrophe provision which may be tax deductible. It should be noted that the global amount of the provision may not exceed a ceiling equal to a multiple of the average annual premium income over the closed accounting year and four preceding years, net of cancellations and commissions and after deduction of retroceded reinsurance premiums.

(b) *Ireland*

Subject to the rules discussed above, companies set up in the Dublin Financial Centre are liable to corporation tax at the reduced rate of 10 percent over a ten-year period on the profits generated by their reinsurance activities. Reinsurance companies wishing to benefit from this favourable regime must file an application with the Ministry of Finance, through the Industrial Development Authority (IDA). Such application is examined by the Authorizations Consultative Centre, including a sitting representative of the Ministry of Industry and Commerce. As in most countries, no specific provision refers to reinsurance operations, except for an obligation to inform the Minister of Industry and Commerce if a company decides to launch such activities. The central management and control of such companies must be exercised in Ireland, failing which the favourable regime may not be claimed.

(c) *Madeira*

Subject to the prior approval of the Portuguese Minister of Finance, reinsurance activities may currently be carried out in Madeira in the offshore centre in the form of a local branch. However, before authorization is granted, written reports must be submitted to Madeira's Regional Government, and to either the Insurance Institute of Portugal (in the case of insurance) or the Bank of Portugal.[11] Authorization will only be granted if the branch fosters the interests of the economic development of the region and if the applicant institution meets the following tests:
- the branch has adequate minimum deemed capital, which is jointly fixed by order of the Prime Minister and the Minister of Finance, or it guarantees all branch operations by means of its own capital;
- management of the branch is entrusted to at least two managers fully qualified and with full capacity and power to deal with the State, and other entities or persons in respect of all matters relating to the activity of the branch.

The following criteria are taken into account in evaluating the formation of the branch:
- recognized international prestige of the applicant;
- guarantee enjoyed by the Portuguese branch by the applicant;
- technical efficiency and financial resources with respect to the transactions carried out by the branch;

11. Amendment of Decree Law No. 163/86 of 26 July 1986 by Decree Law No. 234/90.

© 1994 International Bureau of Fiscal Documentation

- compatibility between the development of the branch and maintaining good market competitiveness in the branch's activity.

Additional documentation must be presented with the application; e.g. the declaration of guarantee referred to above, the applicant's articles of association, a list of the persons comprising the administrative and the managing board of the applicant, the decision of the shareholders to set up the branch, the programme of operations the branch intends to carry out, together with the attached technical means to operate.[12]

All documentation relating to the application must be duly translated into Portuguese and notarized. A person must be appointed by the applicant to deal with the application *vis-à-vis* the Portuguese authorities. If the authorization is granted, the branch enjoys the favourable regime of the Madeira free trade zone, which provides for a nil taxation until 31 December 2011 for activities developed in the zone.[13]

The branch must pay a licence fee at the time it is set up, as well as an annual fee, the amount of which depends on the activities carried out. The branch accounts must be audited by independent auditors; their report must be sent to the Bank of Portugal or to the Insurance Institute of Portugal, together with the annual financial accounts.

The authorization may be withdrawn in the following situations:
- it was obtained by way of false declarations;
- serious breaches in the management, accounting or internal auditing;
- failure to comply with recommendations of the supervisory institution.

B. Fiscal regime in the investor's country

Two criteria are determinative in the investor's country:
- provisions designed to fight tax evasion which either derive from the country's domestic law or from tax treaties. Most domestic legislation enables countries to combat the artificial or abusive location of profits in countries benefiting from a very favourable tax regime. The provisions may be targeted at structures or at the income of the company;
- financial moves. Considering the tax burden which may result from withholding at source on certain income (dividends, interest, royalties even if they give rise to credits) between host countries and the investor's country, countries whose tax treaties provide for a reduction or abolition of withholding at source will be preferred.[14]

IV. CONCLUSION

What the taxpayer can observe and benefit from is a tax competition between:
- countries providing a particular regime applicable to certain types of services (generally intangible). These tax regimes, usually of a temporary duration, fulfil a need to develop the economy of such countries (Ireland, Belgium, Madeira);
- countries which, more classically, out of respect for their tax tradition, refuse to create any particular status. However, as a result of international competition and in order to better meet investors' needs, they are not reluctant to relax their rules regarding the taxable basis of profits in certain circumstances. In this category, some countries wage internal competition, such as recently in Luxembourg regarding financial companies whose rules are identical to the rules in the Netherlands.

Unquestionably, all of the above countries offer attractive tax advantages, making it possible to implement a tax-optimization policy; however, it is advisable to discount host structures lacking economical reality, and to ascertain on the investor's side whether provisions aimed to combat tax evasion could not apply.

12. In addition, the Regional Government may also request a certificate (dated less than 90 days) issued by the relevant competent authority in the country of the head office, stating that the head office is duly incorporated and authorized to engage in its activity, an explanatory note relating to the operations of the applicant at an international level, in particular referring to commercial, financial and other types of relations maintained with entities established in an EC member state.

13. As part of Portugal Madeira should in principle enjoy the provisions of income tax treaties entered into between Portugal and third countries (e.g. EC member states).

14. Indeed even countries whose domestic law does not make such payments subject to any withholding at source if they are realized for the benefit of non-residents.

© 1994 International Bureau of Fiscal Documentation

STATE OF QATAR

TAXATION REGIME FOR FOREIGN ENTITIES FOLLOWING THE FUNDAMENTAL REFORM OF EXISTING INCOME TAX REGULATIONS

Finbarr Sexton
Manager, Ernst & Young, Doha, State of Qatar

I. INTRODUCTION

The State of Qatar introduced a comprehensive income tax reform on 14 July 1993 with retrospective effect to 1 January 1993. The new law is applicable for accounting periods commencing on or after 1 January 1993. The reform covers the taxation of profits and capital income of businesses operating in the State of Qatar.

Decree Law No. 11 of 1993 relating to Qatar income tax replaces the outdated 1954 income tax regulations which were enacted by Sir Anthony Eden when Qatar was a protectorate of Britain. The 1954 income tax regulations had been subject to various amendments in later years. The underlying intent of the 1954 regulations was to levy income tax on oil related operations. The regulations were in need of significant overhaul to deal with the many contracting and trading operations which characterize the Qatari modern day business environment.

The enactment of the new law comes at a time when the State of Qatar is finalizing the financing for the second phase of the development and production of the gas reserves of the country. This project involves the construction of three liquid natural gas (LNG) plants, specialized transportation fleets and modern day port facilities at Ras Laffan, a desert "green field" location in the north of Qatar. A conservative estimate of the cost is put at US$ 22 billion. The project proffers the potential of lucrative contracts for many foreign companies. The enactment of the new tax law is of concern to many of these companies. With competition for contracts at a cut throat level, the issue of taxation of activities in Qatar has become critical in finalizing the financial bids for these new contracts.

Traditionally, income tax regulations have been supported by practice directives from the Qatar Income Tax Department. This situation will continue under the new regulations. The summary of the new Income Tax Decree which follows is supplemented by comments on relevant practice directives which continue to be effective under the new regulations.

II. TAXATION OF BUSINESS ACTIVITIES

A. Underlying principles

The 1993 Income Tax Decree specifies that income tax will be levied on a business entity which carries out an activity in Qatar. The Decree does not include a definition of a business entity. In practice the term encompasses companies, partnerships or any business arrangement, juristic or natural, which carries on an activity in Qatar.

The term activity has been given a wide definition and includes any occupation, profession, service, trade, industry or contract or any other business with a purpose of making a profit.

B. Scope

Taxation is assessed on the basis of profits arising from activities in Qatar. Business profits include:

- profits on contracts executed in Qatar;
- profits on the sale of any of the company's assets;
- commission on agencies, representation agreements or commercial agencies whether the commission is realized in or outside Qatar;
- fees from consultancy, arbitration or expertise and other related services;
- rent from property;
- the sale, rent or assignment of concessions, trademarks, designs, know-how or copyrights;
- amounts received from debts previously written off;
- profits realized on liquidation.

The decree also specifies that interest and other income from banks realized outside the State of Qatar shall be subject to tax if they relate to amounts arising from a taxpayer's activities in Qatar.

C. Taxable persons

Foreign entities carrying on business activities in Qatar are assessed to taxation. The 1993 Income Tax Decree specifically exempts the profits of wholly-owned Qatari companies from taxation. The Decree also exempts the share of profits of Qatari individuals in business entities operating in Qatar. The exemption of Qatari business interests from taxation is a formal confirmation of a practice which has existed since enactment of tax regulations in Qatar. Qatari business interests were subject to taxation under previous income tax regulations. However, the income tax authorities did not seek to collect tax from Qatari- owned businesses.

© 1994 International Bureau of Fiscal Documentation

D. Rates of taxation

The new rates of taxation are as follows:
Taxable income in Qatari Riyals (QAR)

Exceeding		Not Exceeding	Rate (%)
0	-	100,000	Exempt
100,001	-	500,000	10
500,001	-	1,000,000	15
1,000,001	-	1,500,000	20
1,500,001	-	2,500,000	25
2,500,001	-	5,000,000	30
5,000,000	-	-	35

The new Decree introduces two important changes in the application of tax rates:

- The new rates are progressive. This is a welcome advance as tax rates under the old tax regime were non-progressive.
- The new top tax rate is set at 35 percent, compared to a 50 percent rate under the old regime. This brings the tax rates which would be effective on profits of foreign entities operating in Qatar to rates which approximate to base country rates. This is of particular importance for foreign contractors from France, Italy, Japan, United Kingdom and the United States which traditionally baulked at effective tax rates which were significantly higher than those appropriate in their base countries.

III. ADMINISTRATION AND ASSESSMENT

A. Tax accounting period

The Gregorian calendar year is to be used for Qatar income tax purposes. However, by way of exception a taxpayer may request in writing to prepare and submit tax filings for a year end other than 31 December. In practice an alternative tax accounting period creates administrative problems for the tax authorities and therefore it is granted only in exceptional cases. On commencement of activities, the first accounting period may be more or less than 12 months, but it should not be less than six months or more than 18 months.

When a taxpayer's activity is temporary or is less than a six month period, the taxpayer should submit a declaration when the activity is completed.

B. Filing and tax payment deadlines

Tax declarations should be filed within four months of the end of the financial period. The filing period can be extended at the discretion of the tax administration, but the extension period may not in any case exceed eight months.

Tax shown in the declaration becomes payable on the date the declaration becomes due for filing with the authorities. If the filing date is extended, the payment of taxes can be delayed to a maximum of eight months if the taxpayer provides reasons acceptable to the tax authorities. The tax authorities may also agree that taxes will be paid by instalments during the extended period.

C. Penalties

Penalties for late filing or late payment of taxes will be levied at the rate of QAR 10,000 per month or 2 percent of tax due, whichever is greater. The penalty will be calculated on the number of days delayed but should not exceed 24 percent of the total tax liability.

The new law also includes additional penalties for taxpayers who fail to declare all of their income. An additional penalty equal to 25 percent of the tax liability arising on the undeclared income will be levied when the taxpayer:

- fails to declare all taxable income sources or,
- does not declare all business activities or,
- does not provide full information relating to the tax commitments of the business.

D. Tax submissions

Tax declarations must be supported by audited financial statements where capital or annual profits of the business entity exceeds QAR 100,000. The financial statements must be certified by an accountant in practice in Qatar who is registered with the Ministry of Finance, Economy and Trade. Accounts certified by an auditor not resident and registered in Qatar are rejected by the tax authorities.

On submission of the tax declaration and audited financial statements, the filings of the taxpayer are reviewed by the Income Tax Department. It is normal for the tax department to raise query letters on specific cost categories and the reconciliation of revenues reported with the contract value in the case of principal contractor and subcontractor filings.

As part of the review process, the new law empowers the tax authorities to:

- summon a taxpayer or his representative for an interview regarding information contained in the tax filings and,
- request the submission of additional statements, information or documents and
- request the submission of the books and records of the business for review by tax officials.

E. Appeals procedures

The new law establishes a formal tax appeals procedure against revenue generated assessments.

Provided sufficient reasons exist for the tax authorities to conclude that the filing is not correct, they can issue an assessment on a deemed profits basis. If the taxpayer does not agree with the deemed assessment, he is required to lodge an objection letter within 30 days from the date of assessment stating reasons to support his contentions. If the period expires without an objection, the assessment becomes final and cannot subsequently be appealed. However, if the taxpayer is still not satisfied with the authorities's decision after the objection letter is lodged, he can appeal to a Tax Appeal Committee within 30 days of the date he is notified of the authorities' final decision. Additionally, an appeal may also be presented to the High Court and finally to the Court of Appeal by either the taxpayer or the tax authority.

© 1994 International Bureau of Fiscal Documentation

IV. COMPUTATION OF TAXES

A. Incidence of taxation

Income tax is assessed on profits from income arising or deemed to arise from an activity in Qatar. Income is deemed to arise in Qatar when either of the following are located within the State:

- place of work or service performed; or
- place of delivery of the work done; or
- place of permanent office of the business.

At times it is difficult to make this distinction. The underlying premise is that income and profits therefrom must be deemed to have arisen in Qatar if the profits from the income relate to a contractual agreement negotiated in Qatar. However, this definition does not sufficiently clarify when and under what circumstances income is deemed to arise in Qatar. Many current business transactions demonstrate this point. For example, under current Qatari tax practice directives, a straight supply operation, FOB or CIF port of entry (or delivery to site by independent transporter), is not subject to Qatari tax. Such an operation is considered trade with the State, not trade in the State.

Until 1993, in the case of a supply and installation operation, if the supply element was clearly identifiable in the contract (FOB or CIF), it was not subject to Qatari tax. However, the tax authorities have changed their position and practice in this respect. Whilst not wishing to tax profits earned on out-of State manufacture, they nevertheless wish to ensure that profits attributable to the in-State share of the operation do not escape Qatari taxation.

The Qatari tax authorities now take the position that a taxpayer engaged in supply and installation contracts cannot claim exemption from reporting and accounting for the supply portion of the contract or project. Accordingly, all taxpayers engaged in supply and installation activities in the State will be required to report the gross value of revenues derived from such activities in their tax returns. The authorities permit a deduction for the supply value in accordance with an arm's length price (equivalent to international market value) for the supply operation.

In the front end engineering design and construction sector, much of the highly technical engineering work will of necessity be performed outside the State while the actual construction and implementation is performed within the State. In this case current tax practice is for the tax authorities to examine the contract as a whole and to allow the cost of work done abroad as a charge against the gross income arising in Qatar under the heading of engineering costs.

B. Calculation of taxes

Taxable profits are calculated on the basis of profit disclosed by audited financial statements, adjusted for tax depreciation and any item disallowed for income tax purposes. The recognition of income and expenses should be determined by the accruals basis of accounting.

C. Deductions

Taxable income is ascertained after deduction of all costs and expenses incurred to earn that income. These include:

- interest expenses;
- rent paid;
- salaries and labour costs, end of service benefits and all related costs including charges allocated to end of service benefits, pension funds and other similar charges;
- fees and taxes other than income tax;
- debts written off that are approved by the tax authorities and which are in accordance with standards established for this purpose;
- gifts, donations, advertising and subscriptions for charitable, human, scientific, educational and sporting activities paid to Government departments, or other recognized associations or corporations in Qatar. The allowable cost is subject to a limit of 5 percent of net profits before deduction of the cost.

The following costs and expenses are not considered tax-allowable items under the new tax regulations:

- personal and other expenses not related to taxable activities;
- criminal and tax penalties paid in accordance with the tax law;
- expenses or losses that may be recovered under an insurance policy, or a contract, or by way of a compensation claim;
- depreciation of land;
- depreciation that exceeds cost;
- the branch share of head office expenses that exceed the rate determined by the tax authorities of total branch income.

The tax authorities may request the taxpayer to reconsider expenses which seem to be exaggerated and to submit supporting documents to justify costs stated in the financial statements.

The following additional issues have been subject to practice directives or have been carried forward from the old tax regulations:

1. Head office expenses

The new regulations do not specify the rate appropriate for restriction of head office expenses. The rate has been subject to practice directives from the tax department. The present deduction is subject to a ceiling of 3.5 percent of turnover less sub-contract costs. In the case of banks the limit is 1.5 percent.

The allowable ceiling for head office charges on a project which has income streams arising in Qatar and overseas is set at 3.5 percent of total income after deducting sub-contract costs, the supply value of imported machinery and equipment, revenues arising from work performed overseas, and other income which does not relate to activities in Qatar.

2. Depreciation

Depreciation of assets is allowable for tax in accordance with the following rates, applied to cost on a straight line basis:

© 1994 International Bureau of Fiscal Documentation

ASSET	*Rate (%)*
Buildings such as offices, dwellings, stores, hospitals and clubs	4
Roads and bridges	4
Tanks, pipe-lines, jetties and wharves	5
Office furniture and equipment	15
Plant, machinery and equipment other than that specified	15
Motor cars and motor cycles	25
Lorries and trailers	25
Marine craft	7½
Aeroplanes	25
Drilling and clean-out tools	25
Service replacement plant (including construction and road-making equipment, workshops and equipment, handling equipment and sundry others)	25
Service station buildings and driveways	10
Servicing, greasing and other service station equipment	15
Carts	20
Refining plants, pipe lines (within refinery) and small tanks	10
Intangible assets	10
Airconditioners	25
Electric equipment	20

If rates used in the financial statements are greater, the excess is disallowed. If lower rates are used in the financial statements, an additional claim is not permitted.

3. Provisions

General provisions such as bad debts and stock obsolescence are disallowed. Specific bad debts written off will be deductible to the extent that they are in accordance with the conditions set by the tax authorities. At present, tax officials require that specific provisions for debtor balances are supported by a ruling in the local courts which indicate that the balance is not recoverable.

4. Exchange gains and losses

Exchange gains included in income are assessed to tax. The tax authorities have recently taken the view that unrealized exchange losses are not a tax allowable expense.

D. Loss relief

The new law contains provisions which allow for the carry forward of trading losses for set off against future profits. Losses may be carried forward for a period not exceeding three years from the end of the tax year in which the losses were incurred. Losses cannot be set off against prior year income.

V. INTRODUCTION OF NEW POWERS OF REVENUE ASSESSMENT AND TAX COLLECTION

The new law gives the tax authorities new powers of assessment and tax collection which will have far reaching consequences for taxpayers doing business in Qatar. These are discussed below :

A. Deemed profit tax assessment

The new law allows the tax authorities to issue an assessment for tax on a deemed profit basis. This option may be exercised by the tax authorities in the following instances:

- if they have reasons to believe that the declaration submitted by the taxpayer is not correct or,
- if the taxpayer fails to submit a declaration or,
- if the taxpayer does not maintain proper books and records or,
- if the taxpayer does not provide the information requested by the tax authority.

B. Collection of unpaid taxes from third parties

The new law enables the tax authorities to request a statement from a third party of amounts owed to a taxpayer. The law gives the tax authorities the power to collect these amounts directly from the third party.

C. Power to impound property of a taxpayer

The tax authority is empowered to seek a Ministerial order which would enable it to impound a taxpayer's property for settlement of unpaid taxes.

The new powers described above are aimed at foreign companies which perform contracts in Qatar and which fail to comply with tax reporting requirements. The dual powers of deemed assessment and collection of taxes from third parties represent formidable instruments to force would-be tax defaulters to comply with Qatar income tax regulations.

These powers are supported by new requirements for the withholding of final contract payments to sub-contractors. A practice directive issued by the Director of Income Tax in January 1993 requires all ministries, government departments, public and semi-public establishments and other taxpayers to withhold final payments to sub-contractors until such entities present a tax clearance certificate issued by the Income Tax Department.

The directive also imposes annual disclosure and compliance requirements on the principal contractor. The principal contractor must submit a listing of sub-contractors to the tax department, giving names, addresses, the value of each sub-contract and variations in contract terms.

The tax clearance certificate furnished by the sub-contractor must be submitted as a support for the final tax declaration of the principal contractor. The directive is silent on the ramifications for the taxpayer if sub-contractor costs are not supported by a tax clearance certificate. It is, however, likely from the overall intent of recent directives from the Income

© 1994 International Bureau of Fiscal Documentation

Tax Department that any sub-contractor costs which are unsupported by appropriate certificates may be disallowed in the determination of taxable profits.

VI. TAX EXEMPTION

The new tax law provides for a Committee to be formed to evaluate applications for tax exemption regarding projects executed by foreign or Qatari companies or individuals. The main attributes considered by the Committee when assessing projects for tax exemption are:

- that the projects contribute to the support of industry, agriculture, trade, oil, mineral, tourism, communications or land reform, or any other activities or contracts that the country needs and which are of benefit both economically and socially;
- that the project falls within the planned development and economic objectives of the State and has the approval of the concerned Government department;
- that the project contributes towards the national economy. The following points are considered:
  (a) the commercial profitability of the project,
  (b) the extent the project complements other projects,
  (c) the extent the project utilizes material produced locally,
  (d) the effect of the project on the balance of trade payments.
- that the project uses modern technology;
- that the project creates employment opportunities for citizens.

Any contractor involved in the execution of an exempt project can apply for exemption from income tax.

However, a taxpayer which obtains exemption from taxes is required to maintain proper accounting records and should submit financial statements to the tax authorities within four months from the end of the tax year.

The new tax exemption provisions are aimed at promoting foreign inward investment into Qatar. It is unlikely that contractors undertaking once off projects will benefit from the exemption provisions.

VII. STATUTORY LIMITATIONS PERIODS

Under the new law, the Government forfeits its right to claim taxes from taxpayers after the lapse of a five year limitation period. However, the limitation period is revoked from the date the tax authorities notifies the taxpayer to settle taxes due. On the other hand, a taxpayer forfeits his right to claim taxes overpaid after a three year limitation period from the date of assessment.

The introduction of a statutory limitation period is a welcome development as traditionally a taxpayer's filing obligations in Qatar were open ended. This position had given rise to hardship in recent years for a number of taxpayers who had received requests to submit filings for activities which had taken place a decade ago.

VIII. GENERAL

The provisions of the new tax law do not apply to the following:

- salaries, wages, allowances and related items;
- interest and bank's income due to natural persons;
- corporate societies;
- the religious, charitable, cultural, educational and sports institutions licensed in Qatar;
- natural persons' profits resulting from the purchase and sale of land, real estate, shares or bonds;
- interest on public treasury bonds, development bonds and bonds of the public corporations;
- agricultural activity and fishing;
- inheritance and legacies;
- profits of Qatari natural persons;
- shares of Qatari citizens in the profits of juristic persons.

IX. AVOIDANCE OF DOUBLE TAXATION

Qatari tax regulations do not provide for unilateral relief from double taxation. Several countries, including Japan, Germany, the United States and the United Kingdom, allow some unilateral relief against their own taxes for Qatar income tax paid.

Qatar has concluded a comprehensive double taxation agreement with France covering taxes on income in both countries.

X. TAXATION OF INDIVIDUALS

The new law does not extend to the taxation of the personal income of individuals. There are no personal taxes, social insurance or other statutory deductions from salaries and wages in Qatar. Additionally, there are no estate or gift taxes applicable in Qatar.

XI. SPECIAL TAXATION ASPECTS

Certain issues of significance have not been addressed in the new tax law. It is necessary to rely on accepted revenue practices in these areas when formulating an overall tax planning strategy for business operations in Qatar. Some of the principal concerns are addressed as follows:

A. Transfer pricing practices

Tax regulations in Qatar do not address the issue of allocation of income between related parties operating in different countries. The Qatar tax authorities are unconcerned and remain unconnected with any tax implications that arise from a tax regime outside Qatar. The concept of `allocation' of costs or income is one which is generally not acceptable to the Qatar tax authorities. A taxpayer is allowed to deduct costs which are defined in the tax law. Qatar tax authorities strictly look at the determination, assessment and collection of tax on the business entity based in Qatar in accordance

© 1994 International Bureau of Fiscal Documentation

with Qatar income tax regulations. The new law contains a general statement that the taxpayer may deduct "all costs and expenses incurred to earn business income".

There is tacit acceptance of the arms length pricing approach when appraising the quantum of value attributable to the supply of goods, equipment and other tangible property between related parties.

The performance of services between related parties is subjected to a slightly different approach as it is frequently difficult for the income tax authorities to establish the fairness of the pricing strategy due to the absence of recognized market prices for these services.

The primary instance of related party pricing transactions arise from technical services rendered by a head office or affiliated company for the Qatari business entity. The resulting tax implications for such transactions may be summarized as follows:

1. Services rendered outside Qatar

Technical charges billed by a head office, parent company or affiliated company "A" to the Qatar entity "B" for services performed wholly outside Qatar and for the exclusive benefit of the Qatari project represent deductible costs against Qatari source revenues. Payments received by B are not liable to Qatari taxation.

However, the level of technical charges claimed by A are subject to scrutiny by the Qatar income tax authorities. In particular, the following issues are subject to review:

- work location – staff billed on the project should have worked in the offices of A wholly outside Qatar;
- hourly rates billed must contain no element of administrative charge or profit and must be only the actual direct cost of the individual plus a proportion in respect of direct personnel costs (training, welfare, recruitment, etc.).

The Qatar tax authorities may request certification from A's auditors in support of the allowability of the charges. The certificate requested will generally cover the following issues:

- that the charges billed by A to B are in accordance with the books and records of A; and
- that the staff billed by A to B work solely in the offices of A.

2. Services rendered inside Qatar

Payments made by B to A in connection with services rendered by A inside Qatar are taxable in the hands of the recipient A. The income tax authorities will require A to file an income tax declaration and account for taxation on the profits from the transactions.

B. Taxation of oil and gas operations

The new law does not deal with the issue of the taxation of oil and gas operations. Under the 1954 regulations (as amended) companies deriving their income from the production and export of oil, or from the sale or resale of oil, were liable to income tax at the rate of 85 percent. The taxpayer was allowed to deduct all other taxes, duties and levies from the taxable liability in arriving at the final tax bill. In cases, where the taxpayer was unable to utilize the deductions noted above, it was allowed to pass the credits for these deductions to other taxpayers. The level of credit transfer was allowed only to the extent that the credits exceeded 85 percent of the taxable income of the oil operator.

Royalties paid by a taxpayer on oil produced and exported were allowed as a deduction from profits to a limit of 20 percent of the value of the oil revenues in calculating the taxable income.

It is worthwhile noting that no foreign oil company has had a direct revenue generating interest in Qatar's oil and gas resources since the mid 1970s. The existing tax regulations have remained largely untested.

Exploration and Production Sharing (EPS) agreements relating to concessions granted in recent years in Qatar specify the tax regime appropriate to oil production and sale arising from the concession area. These modern day EPS agreements embody on effective tax rate of 55 percent.

The taxation regime appropriate to present day gas operations has also been embodied in the specific Gas Development and Production Sharing (DPS) agreements.

There continues to be a degree of uncertainty as to whether the old regulations continue to be effective in the absence of specific tax provisions in the EPS/DPS agreements. It is important that the potential investor resolves this uncertainty with the Ministry of Energy and Industry and the Ministry of Finance, Economy and Trade (Tax Department) prior to investment in an old concession right which may not specifically address the taxation regime appropriate to the production and export phase of the oil operations.

C. Tax status of nationals from Gulf Co-operation Council States

Law No. 9 of 1989 provides that nationals of Gulf Co-operation Council States (Bahrain, Kuwait, Oman, Saudi Arabia and United Arab Emirates) are, from 1 March 1989, to be treated as Qatari citizens for income tax purposes. The law effectively exempts foreign companies wholly owned by GCC nationals from income tax in Qatar. Any minority non-GCC shareholding in the GCC registered company will disqualify the company from tax exemption.

D. Military contracts

In recent years, contracts awarded to foreign military equipment suppliers and contractors have enjoyed a special tax-exempt status. This status has been granted at the request of the Ministry of Defence and Ministry of Interior to ensure the confidentiality of the contracts.

© 1994 International Bureau of Fiscal Documentation

XII. SELECTION OF INVESTMENT VEHICLES FOR FOREIGNERS

Qatari Commercial Laws limit the range of foreign participation in business activities in Qatar. Foreign investors generally operate in Qatar by adopting one of the following structures:

- Amiri Decree investment – establish a wholly-owned branch of a foreign company by obtaining an Amiri Decree to carry out a project. The Amiri Decree is awarded for projects which facilitate economic development or the performance of a public service;
- establish a partnership or a company with a Qatari partner to engage in commerce, industry, agriculture and services, provided the foreign investor's share in the capital does not exceed 49 percent and the company is incorporated in a correct manner in accordance with the commercial companies' law;
- establish a partnership or a company to engage in a contracting business with a Qatari partner, with the approval of the Minister of Finance, Economy and Trade, provided the foreign investor's share does not exceed 49 percent of the capital and one of the following conditions is met:
  - that there is a need to establish such a company after consideration is given to factors such as supply and demand;
  - that there is a need for the experience and technology provided by such a company.

The taxation implications for each investment vehicle is similar and may be summarized as follows:

- the Amiri Decree entity does not require a local equity participator. Business profits of the entity accrue solely to the foreign company shareholders. Business profits are taxable in full in accordance with tax rates specified in the regulations;
- the trading partnership or company has a 51 percent local equity participator. The 49 percent element of the business profits accruing to the foreign shareholder is taxable. The 51 percent element of business profit is exempt from tax;
- the contracting partnership or company is also required to have a 51 percent local equity participator. The tax treatment of this entity is the same as the trading entity described above.

XIII. CONCLUSION

The introduction of Decree Law No. 11 of 1993 is seen as a welcome step in attracting new business to Qatar. The lower marginal tax rates applied on a progressive basis will improve the lot of the medium and large sized companies operating in Qatar. The introduction of carry-forward loss relief will benefit many of the smaller taxpayers such as consultants and small contracting businesses.

The new law fails to address the issue of mixed contract activity (supply and installation) and also the recommended tax treatment for engineering design and construction activities. The failure of the law to address these issues will continue to give rise to tax planning headaches and, indeed, put the taxpayer at the mercy of different interpretations from the tax authorities. It is hoped that these issues will receive further clarification in the context of tax practice directives over coming months.

TAXES AND INVESTMENT IN THE MIDDLE EAST

SHED MORE LIGHT ON THE MIDDLE EASTERN MARKET WITH THIS UNIQUE PUBLICATION

- Company and investment law
- Imports and exports
- Full taxation law for businesses and individuals
- Special tax treatment
- Full text of tax treaties (in English)
- PLUS background political and economic information

THE ONLY BOOK available on taxation and investment in the Middle East

CONVENIENT: looseleaf format with per country layout for easy comparisons CURRENT: 2 binders, updated four times a year

INITIAL SUBSCRIPTION ONLY NLG 990

includes binders, 1994 updates, postage by air and packing ◆ Annual renewal fee: NLG 450

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, The Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

IMPROVING THE ACCOUNTANCY CONTENT OF TAX REFORM IN DEVELOPING COUNTRIES

Seth E. Terkper

Mr Terkper is an employee of the National Revenue Secretariat of the Ministry of Finance and a member of the Institute of Chartered Accountants, both in Ghana. *The author expresses his appreciation to Dr Glenn P. Jenkins, institute fellow at HIID and director of the International Tax Program at Harvard University. Dr Jenkins was Mr Terkper's supervisor during his graduate studies at Harvard and when he worked as a research assistant in the summer of 1992.*

I. ACCOUNTANCY AND TAX REFORM PROGRAMMES

A. Introduction

An outstanding feature of economic management in developing countries in the 1980s and possibly for the next decade is the widespread implementation of Structural Adjustment Programmes (SAP) aimed at redressing the declining economic performance in various sectors of their economies. Since the relevant specialist skills required to design and implement these policies are often lacking, the need arises to develop local manpower and attract foreign expertise. A unique opportunity is provided for rationalizing the framework for these programmes from the work of these experts and the involvement of multilateral institutions, such as the International Monetary Fund (IMF) and the World Bank.

The review of tax policy as an important element of the SAP has been undertaken by experts who are mostly consultants in economics and law. A notable gap in applying professional skills to this process is the absence of a consistent agenda for accountancy[1] reform even though auditors in particular have been described as the frontline troops for tax enforcement.[2] For most countries where the tax administration is unable to attract professional accountants because of entrenched civil service working conditions, the need for accountancy review may be lost on policy formulation as well as the implementation process. It is doubtful whether any significant progress can be made towards improving the effectiveness of tax administrations without fully acknowledging the crucial role which accountancy can play in the reform process.

B. Influence of the accountancy profession

There are many reasons why the views represented by the accounting profession ought to be considered as a means of ensuring the effectiveness of tax reform in developing countries. The number of people graduating with majors in accounting from educational institutions and those being admitted to membership of local professional bodies in developing countries have been increasing in recent years. The subject matter of accounting itself has undergone a tremendous transformation from a mechanical structure to an intellectually stimulating framework for management decision making. The scope of training for accountants embraces other fields of discipline such as law, economics, mathematics, finance and information management, making it possible for them to bring a unique perspective to the operations of organizations in both the private and public sectors of any economy. The international network of accounting bodies has also enhanced the impact made by the profession in various sectors of the economy, financial or otherwise.

Accountancy makes an impact on taxation in every country. The professional bodies formulate strict standards of professional practice, regulate qualifying examinations, admission to membership and rules of professional practice. The impact of these regulations is enormous because of the way in which they are harmonized as standards and guidelines across international boundaries.

There are three categories of guidelines for accountants which have contributed to the global standardization of business, accounting and auditing practices. The International Federation of Accountants (IFAC), founded in October 1977 by 63 accounting bodies representing 49 countries, issues the International Accounting and Auditing Standards (IAS); the British Associations issue the Statements of Standard Accounting Practice (SSAP) and the Auditing Standards and Guidelines; the US counterpart associations are responsible for the Generally Accepted Accounting Practices (GAAP) and the Generally Accepted Auditing Standards (GAAS).

All three categories of standards influence practice in many developing countries since most national standards are reproduced from these guidelines. In West Africa, for example, Ghana (which is cited favourably for its economic recovery programmes since the late 1980s) has the British equivalent of the Institute of Chartered Accountants whereas Liberia has the US equivalent of the Institute of Certified Public Accountants. The members of some of these foreign bodies may be admitted to membership of local institutions and permitted to practice in third countries with very little or no formality.

1. The term accountancy is used to include auditing.
2. Gerald H. McCracken, "Preventing Tax Evasion Through Enforcement", *Income Tax Enforcement, Compliance and Administration* (Canadian Tax Foundation, 1988).

© 1994 International Bureau of Fiscal Documentation

This trend is also observable in some Asian countries such as Hong Kong and Singapore. In Singapore (as well as Malawi in Africa), the Chartered Association of Certified Accountants (ACCA) in Britain conducts joint professional examinations with counterpart national associations. Unless specifically stated, further references to standards in this article imply those issued by the British Accountancy Bodies.

Given that accounting and auditing skills are indispensable to the capacity of the administration to implement tax reforms successfully, it is worthwhile to measure their impact at an early stage of the reform process. Whilst these subjects may not always be explicit in defining the theoretical framework for economic reforms, they are instrumental in outlining the process on which implementation must depend. In this context, the renewed interests shown in administration reforms lately[3] would be ineffective without improving their accountancy content.

The focus on policy in this article arises from a conviction that the current coverage of the subject in the design of these programmes is inadequate and sometimes even elusive. A proposal made by the IMF to establish a policy unit in the finance ministries of developing countries, staffed by economists, lawyers and *tax officials* (emphasis added) is an example of what appears to be an evasive reference to the role of accountancy in tax policy reform.[4]

C. The status of tax administration in developing countries

Until recently, the weak administrative capacity in the revenue institutions of third world countries (TWCs) may have been over-emphasized to a point where it threatened to overshadow the more relevant general lessons which could be learned from some of the successful cases emerging from parts of the third world bloc, notably the newly industrializing countries (NICs). The state of helplessness portrayed by the lack of accounting records and illiteracy has persisted in the evaluation of third world tax systems for the best part of 40 years.[5] The consequent strategy which kept the tax process simple whilst imposing a sophisticated structure on a weakening administration may also have ignored the warning against pursuing meticulous policy reviews at the expense of administrative change. In many instances today, Stanley Surrey's time-honoured admonition not to rush the introduction of complex variations of tax structures "without any comprehension of the complex legal and accounting problems which they create" may still be valid.[6] As far as this warning goes, probably a lot more attention may have been paid to legal than accounting reforms in tax institutions in developing countries.

Shalizi and Squire have noted that for most of the developing countries, an administratively feasible set of proposals can be developed for inclusion in adjustment programs.[7] It is doubtful whether some of the complex structures implemented in some countries could have succeeded without significant improvements being made to the capacity of the administration. New Zealand, for example, has been credited with managing the most ideal form of VAT in the world. Similarly, the VAT in Korea, Indonesia and Taiwan have received favourable appraisals in tax reform literature. The major disadvantage of writing about the failures of tax administration *en masse* is to risk ignoring vital lessons which could be taught to sluggish members of the third world bloc. The literature on the Indonesia tax reform still stands out as a good example of detailed administrative analysis.[8] If vigorously promoted, these lessons could counteract the tendency to routinely blame every problem of the tax system on a weak administration, illiteracy and the absence of accountants and business records. It will enhance the administrative content of what Bird and Oldman have described as an explosion of literature on third world tax reforms.[9]

There are reasons other than managing a complex tax structure which define the need for a proper evaluation of the administrative capacity of revenue institutions. The environment around tax administrations in TWCs have become complex with firms in the private sector which apply current business practices, including sophisticated accounting techniques. Furthermore, as the level of education increases in most of these countries, some expertise, including accounting will become increasingly available. The issue facing most tax administrations has been their inability to compete for the scarce physical and human resources made available to the economy. The policy focus ought to be on developing a cadre of tax administrators and practitioners and not on overemphasizing the need for an entire population literate in accounting and record-keeping practices. Given the right employment and working conditions, the tax administration could employ qualified personnel to improve its efficiency. A serious factor affecting change is the legacy in many countries to make the revenue institutions an indispensable part of the core of the civil service. Consequently, at a time when the tax administration is conceived as incapable of handling its major functions, other independent public sector institutions are able to assemble the necessary accounting and legal skills needed to operate complex structures such as banking and stock exchange operations.

Luckily, the literature on tax administration in developing countries has not been pessimistic. The World Bank, for example, observed in a recent study that experience is showing that in the long run tax administration in developing

3. Richard M. Bird, "Tax Administration and Tax Reform: Reflections on Experience" (Tax Policy in Developing Countries, A World Bank Symposium, 1991).
4. IMF, "General Aspects of Tax Administration", IMF Institute, Session No. 37 papers (1981).
5. Richard M. Bird, "The Administrative Dimension of Tax Reform in Developing Countries", in Malcolm Gillis, ed. *Lessons from Fundamental Tax Reform in Developing Countries* (Duke University Press, 1991); also Morag (1957), Gandhi (1966), Bird (1974, 1982), Shalizi and Squire (1989).
6. S.S. Surrey, "Tax Administration in Underdeveloped Countries", in Richard Bird & Oliver Oldman, *Readings on Taxation in Developing Countries* (John Hopkins University Press, 1975); see also Surrey (1958) and Casanegra (1987).
7. Shalizi Z. and Squire L., "Tax Policy in Sub-Saharan Africa", Policy Research Series (2) (The World Bank, 1989).
8. See for example contribution by Hutabarat and Lane on "Computerization in Indonesia", in Gillis, Shoup and Sicat, *VAT in Developing Countries* (The World Bank, 1990).
9. Richard Bird and Oliver Oldman, *Taxation in Developing Countries* (The Johns Hopkins University Press, 1990).

© 1994 International Bureau of Fiscal Documentation

countries can be upgraded and streamlined as part of the adjustment process.[10] Generally, tax administration strategies may be easier to standardize than structural changes because as the IMF notes, "while the solutions to specific tax policy issues may well differ from country to country and within the same country, as the development process evolves, many of the problems and goals of tax administration are similar throughout the world".[11] The relevance of the contribution which is expected to be made by the accounting profession stems from this very fact – accounting principles and practices have been substantially standardized across international boundaries.

The task of improving the accounting content of the tax system should not be confined to the administration. It is necessary to shift part of the emphasis to cultivating tax expertise in the economy, specifically among the growing number of professionals and college and university graduates. There is need to discard certain long-held notions, including those which emphasize that because taxpayers do not keep proper records in TWCs, the steps needed to improve the system must inevitably depend on official action.[12] In even the more sophisticated countries such as the United States, Canada and Australia where literacy rates are high, the success of tax collection and enforcement has been achieved only with the active involvement of tax practitioners who complement the efforts of the administration. It is necessary to outline an official programme in TWCs under which practitioners or agents could be registered and their activities supervised by the tax administration and possibly, the professional accounting bodies. For this reason, apart from proposals made in this article to strengthen accountancy within the tax administration, serious consideration is also given to improving the status of private tax practices in developing countries.

The measures outlined to improve the quality of accounting and auditing are particularly aimed at finding solutions to the problems of ineffective tax systems. In all evaluations of tax systems in TWCs, the problems of inefficiency are traceable to the inability of the administration to exact compliance with accounting regulations. The problems of illiteracy and a large informal sector are not to be underestimated but it is thought that by over-emphasizing these points, many countries may be missing an opportunity to use the tax system itself as the means for transforming the record-keeping base of the economy. It is a well-known fact that no country has yet achieved an appreciable level of record-keeping without strengthening the compliance or reporting requirements of tax and corporate law.

II. ACCOUNTANCY AND TAX STRUCTURE REFORMS

A. Introduction

The multi-disciplinary nature of taxation makes the effectiveness of reforms dependent on a proper evaluation of the impact of all related disciplines at both the formulation and implementation stages. A number of the changes proposed to the legal and accountancy regulations are made at the implementation stage and if not properly coordinated with policy proposals, could result in a major drawback to the overall effectiveness of the reform.

Often what emerges as process difficulties may actually involve fundamental conceptual differences among the disciplines which had better been tackled at the policy formulation stage. These differences need not always be included as part of the practical implementation problems associated with administrative inefficiency. The ensuing sections highlight a few of the areas in which accounting concepts get entangled with certain popular policy initiatives and their subsequent implementation.

B. Broadening the tax base

The two major recommendations made for strengthening the tax base are designing presumptive strategies to reach the "hard-to-tax" sector (mostly self-employed businesses, individuals and professionals) and introducing the VAT.[13] There are major accounting issues which need to be considered in preparing guidelines for implementation of both policies. The compliance problems of hard-to-tax individuals and businesses are similar in all countries but as Bird notes, a larger proportion of the potential tax base of TWCs lies within this group.[14] Apart from withholding schemes, presumptive techniques are perhaps the most popular method advocated for covering this group of taxpayers.

The relevance of accounting to presumptive systems is perhaps best reflected in its objective, which is to eventually encourage taxpayers to keep prescribed books of accounts to facilitate the transition to a superior form of assessment.[15] If this objective is not properly pursued through stringent record-keeping and accounting regulations as part of the tax system, a presumptive system could degenerate into an end in itself, further distorting the schedular tax rates likely to prevail in TWCs. This is because most presumptive systems apply different rates and profit margins to distinguish among various groups of taxpayers. Since the adverse consequences of a distorted tax regime are fraud, evasion and avoidance, accountancy, or more specifically auditing, becomes even more relevant again in checking the excesses of a poorly designed presumptive system. Mexico is cited as an example of the way in which presumptive tax proposals could result in this type of problem because of the explosion of tax shelters and transfer pricing schemes.[16]

The techniques used in connection with presumptive systems rely on accounting ratios and economic indices as the basis

10. *Lessons of Tax Reform* (The World Bank, 1992).
11. IMF Institute (1981).
12. Richard M. Bird, "Income Tax Reform in Developing Countries: The Administrative Dimension", 37 *Bulletin for International Fiscal Documentation* (January 1983), at 3.
13. Wayne Thirsk, "Lessons from Tax Reform: An Overview", in Javad Khalilzadeh-Shirazi and Anwar Shah, *Tax Policy in Developing Countries* (The World Bank 1991).
14. See *supra* note 12.
15. R. Musgrave, "Income Taxation of Hard-to-Tax Groups" in R. Bird and O. Oldman, *Taxation in Developing Countries* (The Johns Hopkins University Press, 1990).
16. Wayne Thirsk (1991).

© 1994 International Bureau of Fiscal Documentation

for assessing taxpayers. The foremost presumptive technique is the net worth approach, described as the difference in wealth at the beginning and end of a tax period, plus consumption during the period. The Israeli *tachshiv* is cited as the best example of the methods which are based on external economic indicators. The theoretical framework for these systems is linking the indices and ratios to turnover, number of employees, value of assets and similar other factors to determine tax liability. Most systems, as in Korea,[17] are based on the relationship between profits and turnover (margins). In their detailed form, ratios may be set for specific industries and other sectors of the economy.[18] For a long time, professional accounting firms have used similar ratios to evaluate client records for audit, investigation and accounting purposes. In auditing, the need for these ratios is emphasized in standards dealing with analytical review techniques used to test the effectiveness of accounting records.[19]

The practical techniques for reconstructing an account to determine the net worth of individuals and businesses, especially in the non-corporate sector, are called incomplete records or single entry in financial accounting studies. Corporations have a better records base because they are required by company law to keep proper books of accounts and file annual financial statements. The incorporation of these techniques in various professional standards may make them indispensable to the training programmes of revenue institutions and to measures taken to re-write manuals for auditing and presumptive systems in developing countries.

The introduction of the VAT in many of these countries has also contributed to the need to upgrade the accounting and auditing capacity of tax administrations. The main advantages of the credit method VAT proposed for most countries are a withholding credit scheme which encourages registered taxpayers to keep proper books of accounts, the elimination of cascading and an inherent audit trail.[20] The experience of countries implementing the VAT has shown that the self-check provided by the incentive to file for a credit may not be enough to minimize the incidence of fraud and evasion associated with all tax systems. Some estimates of revenue loss due to evasion have been put at 2-4 percent and 40 percent for Britain and Italy, respectively and it is likely that this could be higher for many of the developing countries with weak administrations.[21] The success of the VAT therefore depends on the effectiveness of preventive programmes implemented by the revenue institutions. The programmes to strengthen the accounting function ought to include guidelines drawn to coordinate the audit of the VAT and other taxes, especially if the VAT (or domestic and import VAT) is to be implemented by a separate revenue department. The precise nature of these tax audits are discussed below.

Since the structure of the VAT varies across international boundaries, care should be taken in specific country programmes to ensure that not just the laws but accounting standards are made compatible with the particular system to be implemented. A rewriting of accounting standards in consultation with national accounting bodies may be needed to neutralize the influence of international standards such as SSAP 5 (Accounting for Value Added Taxation) which is more compatible with the EC VAT.

C. Rationalization of the rate structure

One of the major objectives of policy review is to re-examine the rate structure so as to remove distortions in the economy, promote fairness, prevent fraud and minimize revenue loss. The following are a few examples which illustrate the need to be mindful of the accounting implications of structural reforms.

First, proposals made in the tariff, excise and sales tax structures to reflect *ad valorem* computations may require knowledge of the rudiments of expenditure allocation and pricing techniques in cost accounting to make a tax audit or examination effective. This may be particularly evident in situations where the bulk of taxes are to be levied at the manufacturing stage of the production cycle. As the economies of TWCs become increasingly liberalized, prices may become evasive for assessing *ad valorem* commodity taxes, especially if raised at a stage of the business cycle other than retailing. The only way to avoid the detailed examination or cope with the absence of records on values, costs and prices is to adopt the presumptive techniques used in connection with customs duties and direct taxes.

The second example is indexation, which is a familiar topic affecting important concepts in both accounting and economics. Among others, it affects the treatment for depreciation allowance, capital gains tax and inventory valuation.[22] Dialogue with the accountancy profession is vital because certain concepts of value (e.g. inflation) may lack the precision guaranteed by actual business transactions and may therefore contradict the historical cost concept which is fundamental to financial accounting worldwide. Periodic revaluations of assets in accounting are acceptable in specific circumstances (e.g. disposals) but to date, all standards issued on general inflation accounting have either been withdrawn or declared non-mandatory.[23] In the instances where some firms may decide to voluntarily comply, the preferred accounting technique may not necessarily be the one favoured by other professions. This is amply demonstrated by the preference of accountants for current cost accounting (CCA) over current purchasing power (CPP) even though the

17. Chang Se Won, "Tax Invoice Cross-Checking System in Korea" (International Conference on the Administrative Aspects of VAT, Washington, October 1990).
18. See *supra* note 12.
19. The definition of net worth is slightly different between accountants and economists because of the emphasis on indexation to ensure the taxation of only consumption. However, prior to this adjustment, the accounting techniques may be useful for determining nominal income or net worth.
20. Alan A. Tait, *VAT: International Practice and Problems* (IMF, 1988).
21. *Id.* See also Cedric Sandford and Michael Godwin, *VAT Administration and Compliance in Britain.*
22. See, for example, R. Conrad, *Dividend Relief and Inflation Adjustments: Possible Options for Tax Systems in Emerging Economies* (Symposium on Directions in Tax Reform in Emerging Economies, Harvard Law School, November 1991).
23. SSAP No. 7, Changes in the Purchasing Power of Money (withdrawn); SSAP No. 16, Current Cost Accounting (non-mandatory); FASB-89: Financial Reporting and Changing Prices (non-mandatory in the United States.

© 1994 International Bureau of Fiscal Documentation

latter uses a general price index favoured by economists.[24] In fact, not only do concepts differ; the meaning attached to certain topics such as depreciation may differ between accountants and other experts; for example, the standard declares that depreciation is fundamentally a cost allocation and not a valuation process.[25]

If tax policies in TWCs are not to be determined in isolation, then policy-makers ought to seriously consider whether any fruitful purpose could be served in confronting the profession over issues which have been intensely debated in developed countries and which have either been rejected or resulted in formidable international standards which influence reporting procedures in almost all countries. Leonard describes the tension created in the United States by the need to revise historical cost accounting to reflect predictive values such as inflation: "As a profession, accountants have generally resisted the pressure to develop measures of financial condition that embody estimates of future events. Accountants, being disposed towards precision and certainty, and worried about their own accountability, are naturally hesitant to assume responsibility for constructing and using uncertain measures."[26] It is proposed that tax policy in developing countries should be designed to reconcile the recommendations of tax studies with generally accepted accounting standards to reduce either the incidence of conflict or the complexity of the administration of the tax regime. Care is needed to avoid establishing other levels of compliance in accounting which may be secondary to the traditional reporting requirements of company and partnership law. At the moment, these laws are heavily influenced by accountancy standards and if they are not simultaneously revised with the tax code, both administration and compliance will be made more complex (and not simplified as expected) as a result of policy reforms.

Another structural issue which has relevance for the future direction of accountancy reform is the necessity of increasing the income tax exemption bracket and VAT registration threshold as means of eliminating a large number of small taxpayers in the informal sector from the tax base.[27] The relevance of this policy to the review of the administrative or accounting process is the possibility of eliminating a large percentage of the informal sector hard-to-tax group from the tax base. Those remaining are likely to comprise non-corporate professional firms of doctors, accountants, lawyers, consultants, etc. and large family businesses, capable of keeping accounting records but sometimes deliberately refusing to comply.

The persistent refusal of this group of privileged taxpayers to keep proper books of accounts is a problem which developing countries share with their industrialized counterparts.[28] But the large concentration of such firms in the urban centres of TWCs reinforces the need to strengthen compliance with accounting regulations in these areas where the infrastructure may be relatively decent, the population fairly literate and practitioners available to provide assistance to taxpayers. The literacy rate is relatively high in urban centres where the United Nations has indicated that over 40 percent of the population of developing countries live.[29] The focus on the urban centres may be the most economically feasible since a large percentage of total revenue is likely to be collected from these centres.

D. Revenue forecasting and monitoring

It is possible to design a financial accounting and budgeting model for monitoring the output and payment of taxes by firms which pay large percentages of specific taxes in small economies. For example, the operations of a few companies could significantly affect the level of revenue from the sales tax or excise duty. In these situations, an accounting spreadsheet showing actual and projected output, prices, tax rates, liabilities and payments may be used to complement the projections derived from statistical and macroeconomic models. The variances from projected and actual revenue could be analysed to provide additional information on industry and tax-specific performances such as determining whether shortfalls in revenue are attributable to non-payment of taxes or physical trends in industry output.

The scale of operations of companies to be targeted for this type of exercise may be such that they already compile detailed management information on their output, cost, price and tax liability. If made available to the administration, this data could alleviate a number of the problems associated with forecasting revenue and monitoring performance for at least some categories of taxes. The negotiations for physical output and financial information from these companies may be held as part of the annual budget process.

It is possible that these companies may feel reluctant to release data which is considered to be strategic to their internal operations. However, this need not prevent the administration from generating the information required from its own data bank, based on corporate tax performances kept by resident tax officers attached to district offices where these firms may be located.

III. ACCOUNTANCY AND ADMINISTRATIVE REFORMS

A. Introduction

The routine administration of the tax system requires guidelines to be issued to regulate the operations of the staff and taxpayers. A large number of these guidelines deal with regulating specific business practices and accounting principles for computing tax liability. They aim at making the computation certain, in view of the flexibility allowed by accounting standards in some cases such as calculating depreciation or inventory cost. Likewise, the regulations attempt to forestall

24. Richard Goode, "Some Economic Aspects of Tax Administration", in R. Bird and O. Oldman, *Taxation in Developing Countries* (The Johns Hopkins University Press, 1990).
25. SSAP 12, Statement of Standard Accounting Practice: Accounting for Depreciation.
26. Herman B. Leonard, *Measuring and Reporting Financial Condition* (Research in Governmental and Non-Profit Accounting, 1985).
27. See *supra* note 20.
28. See *supra* note 15.
29. William Dillinger, *Urban Property Tax Reform – Guidelines and Recommendations* (April 1991).

© 1994 International Bureau of Fiscal Documentation

the fraud, evasion and tax avoidance promoted by dubious accounting and legal practices. To be effective the staff of the administration need to understand both the general principles of accountancy expressed in professional standards and the exceptions made for taxation purposes.

Clearly, the inability of the administration to fulfil these obligations could result in taxpayers moving fast to upset policy changes. The policies required include strengthening the institutional capacity of the administration and formulating model process guidelines which deal with the accounting and audit implications of policy reform and implementation.

B. Institutional and financial autonomy for tax administrations

The status of revenue institutions in the public sector is one of the major factors affecting their inability to specialize and respond adequately to changes in the economy. The constraints are mainly due to the almost universal attachment to the idea that revenue institutions ought to be placed under the strict supervision of the Ministry of Finance because of the political nature of their operations. The resources needed for the effective operations of these institutions are denied primarily because the institutions must compete for funds in ways which do not excite ill-feeling among other government departments in the service.[30]

The inclusion of the revenue institutions in the civil service confuses ministerial oversight with the management of field operations. To restate a point made elsewhere, this policy results in monetary and financial institutions in the economy enjoying a more substantial measure of operational autonomy than fiscal institutions. However, the fact remains that for both fiscal and monetary institutions excessive political interference affects the objective implementation of government policy. There is clear evidence to suggest that this policy has had adverse consequences on the efficiency of tax administration in many countries. The IMF, for example, has observed that some ministries of finance in developing countries, through their so-called research divisions attached to the Minister, devote their time to solving day to day problems rather than paying attention to long-range planning.[31]
The multi-disciplinary nature of taxation requires that the ministry delegate responsibility for the day-to-day operations of revenue institutions to a professionally constituted body. This policy is particularly useful in countries where the ministry itself lacks the expertise in related tax disciplines such as law, accounting and economics. Revenue boards have been established in a number of countries but the policy is not always pushed to the point where the institutions themselves will be granted operational autonomy. Also the potential impact of these boards on policy and implementation could be eroded in cases where the ministry's representation on the board remains excessive.

The entrenched civil service culture has other disadvantages. The frequent transfer of staff to other units of the service disrupts operations and adversely affects specialization. Staff remuneration falls to a point where it becomes virtually impossible to recruit professional staff who are not interested in making money through the corrupt tax practices cited in numerous studies.

An important aspect of institutional independence is the establishment of an accounting department to be responsible for budgetary control and accounting in the organization. It calls for the separation of the finance (and administration) functions from the operations department. The scale of work implied by autonomy for the revenue institutions makes it possible for them to establish professional departments and sections to be responsible for all their financial operations. Consequently, these financial functions are expected to be transferred from the usually overburdened treasury in developing countries.

An independent accounting and budgetary control system with characteristics similar to commercial systems could prescribe an alternative framework for calculating the administration cost of taxation. The typical yearly work schedule for the finance department is expected to begin with the projection of annual revenue and expenditure for the institutions. These projections will form the basis for negotiation by either the management or revenue board with the ministry of finance within the framework of the overall national budgetary process. Once the financial plan is approved, the institutions would be allowed to deduct periodical estimates of their required expenditure at source. These deductions will be made, subject to agreed revenue/expenditure percentage caps (ratios) which define the potential cost of administration. Records of actual expenditure will be maintained, variances between actual costs and projections calculated and analysis made for control and future budgetary or negotiation exercises.

Another potential benefit of a professional finance department may be helping to resolve the frustration of policymakers caused by the failure to sort out the differences between accrual collection reports submitted to the ministry by revenue institutions and the actual cash payments made to the central bank. These differences, which are part of the difficulties arising from the mixture of accrual and cash accounting in government have engaged the attention of public finance economists in recent times.[32] Further confusion is generated by the non-adherence to other routine distinctions made by accountants, such as the difference between capital (non-recurrent) and revenue (recurrent) income and expenditure. The finance department ought to be able to prepare reconciliation statements to explain accrual and cash differences due to time lags and errors between revenue institutions and the central bank. These statements are routinely prepared by firms because of the consistency of applying the accrual concept in financial accounting.[33]

30. See *supra* note 24.
31. IMF Institute (1981).
32. Mario Blejer and Adrienne Chesty, *How to Measure the Fiscal Deficit, Finance & Development* (IMF/World Bank, September 1992).
33. SSAP 2, Disclosure of Accounting Policies.

© 1994 International Bureau of Fiscal Documentation

C. Accountancy and reform of the operations function

It is expected that a significant number of changes proposed to the tax system would require a greater appreciation of generally accepted accounting principles and current business practices by staff of the operations department. The issues discussed in this section are restricted to the examination and audit function, with only occasional references to assessment, investigation or the appeals process. The bulk of tax accountancy work is in auditing and the few examples used here merely demonstrate the need to evaluate the accounting content of the overall administration reforms. The focus is on policies to adopt self-assessment and VAT.

1. Are VAT audits simple in all cases?

In principle, VAT systems assess tax liability on the value added of a firm. The overwhelming choice of the invoice credit method may make the assessment of this liability simple in most instances where very little inventory or work-in-progress is carried. However, the choice of a subtraction method VAT (as in Japan) and strategies to strengthen the audit and examination function may not always be based on a facile policy. This is because audits depend on acceptable levels of transactions verification and in certain cases, the reconstruction of the accounts of business enterprises. The concept of simple VAT audits depends on an underlying assumption that they will be complemented by a comprehensive income tax audit. Therefore, the absence of any such coordination between these two types of audit could easily expose the VAT system to enormous fraud and evasion and warrant the establishment of a system close to what is found in income tax departments.

There are other factors which may contribute to making a VAT audit complicated. The recommendation to implement a high registration threshold could result in the elimination from the tax base of most small-scale retail and traditional manufacturing firms operating in the informal sector. This premise, together with the practical considerations of optimizing resource allocation in TWCs, makes it expedient to concentrate most VAT activities on the manufacturing sector. Therefore, VAT systems in TWCs are likely to take on the characteristics of a manufacturing-based sales tax found in many of these countries. Furthermore, the zero-rating of exports and other VAT multiple rate regimes may inevitably result in the same dubious accounting practices involving expenditure allocation and transfer pricing used to evade income taxes. In a study of indirect tax harmonization in the EC in 1989, the Centre for European Policy Studies estimated that verifications of transactions due principally to multiple rate regimes could delay refunds for up to 38 weeks in some European countries.[34]

It is also possible that the transition to an *ad valorem* basis for computing indirect taxes in general could make the operations function more dependent on understanding basic auditing and accounting techniques. The assessment of a unit tax on production and imports is easier to calculate, compared with an *ad valorem* system based on an evaluation of the cost and pricing structure of a firm. It is when prices of goods and services are widely advertised (e.g. hotels and restaurants) that an *ad valorem* system may be able to avoid anti-tax pricing schemes. The notion that VAT audits are in principle simple is even more curious, considering that the destination and credit principles make it necessary for the system to bend backwards to embrace imports which are already riddled with numerous valuation problems.

It will be against the objectives of streamlining the indirect tax system to allow the traditional distortions of this form of taxation to be compounded by these factors. Even though the VAT is designed to remove these distortions, it requires an effective examination and audit plan to ensure compliance and counteract attempts to corrupt the whole tax system. Therefore, contrary to the opinions of some informed experts, a VAT audit in countries where over 60 percent of total revenue is generated from indirect taxes could assume the same level of sophistication as income tax audits, except in situations where the two forms of audit are either performed by the same institution or well coordinated.[35] Unfortunately, the organization structure for direct and indirect tax administrations do not always contribute to strengthening the coordination of audits. The VAT (and sales tax) is collected by the income tax department in some countries (e.g. Japan and Korea) whereas in others, it is the responsibility of the customs administration (e.g. United Kingdom). The options also include delegating the VAT to a completely new department or contracting it out to private enterprises.[36] Spain, France and Korea are a few of the countries where formal coordination is promoted between the VAT and income taxes.

To be able to implement an effective VAT audit programme, it is important to revise the assertion often made without qualification, that VAT auditors do not need to be qualified accountants. It is not every detail of a professional or income tax audit which is performed by qualified accountants; the obvious lesson for a VAT system is to employ enough qualified accountants to supervise the work of accounts clerks and partly-qualified accountants on the job. To be certain, the audit of VAT could be kept simple but the outcome will not be the best or most efficient system that could have been achieved.

2. Self-assessment and the audit function

Every major tax reform study has emphasized the superiority of the self-assessment system which requires that taxpayers assume more responsibility for raising their own assessment. At the same time, the administration is expected to shift its attention to ensuring compliance with the law, under a system where "there will be more audits, more investigations, more checking and verifying of information in returns".[37] Consequently, there will be a shifting of technically-trained person-

34. Dennis Duverne, *The French & European Rate Systems* (International Conference on Administrative Aspects of VAT, Washington D.C., October 1990).
35. See *supra* note 20.
36. Graham Holland, "Planning the VAT", in Alan Tait, *VAT: Administrative and Policy Issues* (IMF 1991).
37. Trevor Bouchar, "Self-Assessment of Income Tax" *Australian Tax Forum* (1986), at 45.

© 1994 International Bureau of Fiscal Documentation

nel from their role of traditionally assessing taxes to more audit-type work. Where a self-assessment system is recommended as part of the VAT, the same emphasis will be placed on the audit and examination functions.

Under self-assessment systems, the examination of invoices and returns is expected to become the routine activity of the operations department. A reliable plan ought to be in place for field audits to emphasize the need for compliance. The technical issues associated with making a smooth transition ought to be handled in a manner which does not intimidate the administrators.[38] To achieve this objective, the plan for implementation should be made comprehensive enough to cover an outline of all the issues, including availability of financial resources, staff training and re-writing legal, audit and accounting manuals.

The increasing interest shown in examinations, sample selection, field audits, etc. as a result of tax reform policies has given rise to the need to assign proper objectives and meaning to the process of audits in tax administrations.

3. Do tax audits differ from other audits?

The need for auditing reforms within the operations function does not arise solely from introducing VAT systems or making a transition to a self-assessment. The quality and precise nature of audits will be of perpetual interest to taxation because of the need for all systems, financial or otherwise, to implement checks to prevent fraud and errors. It is worthwhile to periodically examine the extent to which tax audit techniques keep pace with changes proposed under the generally accepted standards used by professionals in both the public and private sectors.

There is no doubt that this is an area in which tax administrations in TWCs have lagged behind the private sector and other public sector institutions such as state-owned enterprises. This has resulted in old practices mixed with sporadic innovations mainly from tax reforms. Because such innovations are never comprehensive for lack of resources, manpower, institutional inertia, etc., tax audits are often made to appear different from the practice in the professional mainstream. This trend is more noticeable with indirect taxes, which unlike income tax, have not had a long tradition of probing business malpractice due perhaps to unit taxation and the extensive use of presumptive valuation codes or tariffs.

Thus, a lot of confusion is likely to be generated in reviewing tax systems. This includes the suggestion that VAT audit techniques differ from those used by chartered accountants because of the reliance of the former on preliminary checking of taxpayer systems and records (controls), routine examination of invoices and selective examination of transactions (sampling).[39] VAT audits are also thought to be different because of a previously stated assumption that since they will be coordinated with comprehensive income tax audits, no serious compliance gaps will be created.

All modern day audits rely heavily on systems of control and sampling for efficiency as well as effectiveness. Often in the tax reform literature, the relevance of sampling to audits is limited to selecting taxpayers ("cases") to avoid bias and 100 percent coverage. They do not always extend to its relevance for the actual verification of documents, records and transactions in the course of performing compliance or substantive checks. There is nothing in the tradition of sampling in audits to suggest that once a case is selected for audit it may be possible to check all the underlying business transactions recorded in the books of accounts. The essence of systems audits is making sure that the internal control and accounting systems are adequate enough to support the transactions recorded.

In the absence of such reliable systems, the number of actual records to be substantively audited, variously referred to as vouching or verification, will increase but probably never cover all records of the enterprise. However, it is conceivable that not only the systems but the records maintained will be so inadequate as to call for a reconstruction of the accounts using some of the accounting techniques previously described under presumptive taxation.

It is therefore important to place any discussion of controls and sampling within the wider context of systems auditing as defined in the standards. Generally, auditors do not examine all records and transactions of business enterprises. Rather, they follow a procedure whereby through sampling, only a few records are selected for detailed checking, provided the systems of accounting and internal control are proven by the auditor to be adequate and reliable to prevent fraud or errors. The evaluation of these systems prior to vouching the actual transactions is incidentally referred to as compliance testing, a term relevant to the objective of procedures laid down to enforce adherence to systems such as finance and taxation.

The operational standard states that if the auditor wishes to place reliance on any controls, he should ascertain and evaluate those controls and perform compliance tests on their operation. Therefore, the checks conducted during advisory (or control) visits and prior to substantive audits by VAT officials to ensure "that statutory provisions are being complied with; ... that records of purchases and sales are correctly completed from original documents; that monthly returns for selected months correspond with the totals in the records of purchases and sales"[40] fall within the framework of general auditing standards and need not be represented as unique.

To ensure judicious coverage and optimum allocation of scarce resources to the most useful audits, a stratification strategy is required as part of the sampling programme. The pressure from inadequate resources in particular may place too much emphasis on maximizing the revenue expected from audits.[41] In countries where compliance is already weak, a revenue-yielding objective for audits need not be difficult to justify since the marginal utility of audits may be no where near the optimum. Comparative guidelines on sampling and stratification may be found in most auditing stan-

38. A. Radia and I. Sharkansky, "Tax Reform In Israel", in R. Bird and O. Oldman, *Taxation in Developing Countries* (The Johns Hopkins University Press, 1990).
39. Alan A. Tait, *VAT: International Practice and Problems* (IMF 1990).
40. See *supra* note 20.
41. See *supra* note 24.

© 1994 International Bureau of Fiscal Documentation

dards to assist in drawing up audit manuals. The classification of taxpayers will include broad areas such as types of taxes, form of business organization, geographical location and revenue potential. Even though a revenue-maximizing audit system would focus on major revenue earners within each of these categories, "striking" audits among low-income taxpayers are required to create a sense of vigilance and awareness in the country.

Adequate internal control and accounting systems are preconditions for sample or systems audits. The need to ensure that these systems are effective should place much emphasis (for the efficiency of the VAT system) on ensuring that proper accounting and record-keeping procedures are outlined for registered taxpayers. The audit and examination manual used by officers will therefore include guidelines for establishing and verifying the effectiveness of systems and procedures.

4. The need for uniform terminology

The terminology used in the tax literature is equally confusing[42] because it differs among writers and does not always conform to the language used in auditing standards. Again, the worse cases can be found in VAT research where, as noted earlier, these audits are held out to be unique. It is important to harmonize the terms in accordance with any usage which is fairly standardized across international boundaries.

A number of the audit concepts used in the tax administration literature do not differ radically from the descriptions used in some auditing standards. For example, the elements of a VAT advisory visit (or audit)[43] are similar to most of the techniques described in the operations standard for conducting new and existing audits. Even if it is granted that the language of the professional standards may at times differ from those of tax audits, it seems desirable to adhere to usage which is common to most tax administrations. For example, it is useful to stick to the conventional distinction made between two types of transactions verification used in taxation since such adherence will be important to understanding specific compliance policies, determining the calibre of staff to be engaged and define the training programmes to be pursued by different categories of employees.

(a) *Examination*

This is the familiar term used in the United States in particular to refer to the less tedious but routine check performed on returns and (or invoices for VAT) submitted to the tax administration. It is the routine nature of the examinations function which makes it the most feasible procedure for automation. In general, however, this function will be performed by the reorganized assessment and collection divisions under self-assessment systems by staff who are only moderately qualified in accounting techniques. The examinations or desk (office) audits as they are usually called, reduce the number of site visits made by tax officials to the premises of taxpayers. It would normally involve a comprehensive check of the entries on a return or invoice presented prior to payment of the taxes due. In almost all cases, no attempts will be made to verify the transactions underlying the entries.

(b) *Audits*

This is a relatively rigorous attempt to check or verify the transactions, records and accounting entries underlying a tax return, invoice or books of accounts. It involves field audits of only a small percentage of taxpayers (and their transactions!). It is a relatively more expensive, time-consuming process, undertaken by better qualified groups of accounting officers.

Audits and examinations are inter-related through the fundamental requirements of sound internal control systems and so it helps to consider them as components of a comprehensive system rather than different types of audit. An effective examinations programme, especially where computerized, is technically speaking, a compliance measure to reduce fraud and the number of substantive audits to be performed. Thus, it is used to identify most of the cases selected for field audits even though it is ideal to base the selection process on a separate computerized programme. Given the widespread use of computers in developing countries, a simplified version of a computerized examination model, similar to the discriminant function score system used in the United States, could facilitate the reform of the audit function in most developing countries. Saltzman has stated that the greater taxpayer compliance observed under the US internal revenue laws results from the effectiveness of audits.[44] The distinction between field audits and examinations also helps concentrate field audits at the headquarters and regional offices whilst dispersing the examinations function to district tax offices across the country.

The changes proposed to administration reforms affect the examinations and audit function because of the need to ensure that individuals and businesses comply with the tax laws. Since their dependence on the accountancy and auditing professions is likely to be substantial, it is important to pay attention to the capacity of the tax administration to continuously assess the impact of professional standards and practice on the tax system. Failure to do so would widen the current efficiency gap between tax institutions and the clients they serve.

D. Computerization of the accounting function

A common feature of all tax reform programmes is technical assistance to acquire computers to improve data processing and information management. The responsibility of officials handling tax reforms is to make sure that the design of the management information system is adequate to cover all activities which are potentially feasible for computerization. A broader concept of computerization is therefore needed to allow coverage of viable accounting procedures and techniques. One way of doing this is to integrate changes required

42. Graham Holland, *The Audit of VAT* (IMF/UNDP Seminar on VAT in Asia and Resource Mobilization, Jakarta, Indonesia 1990).
43. Milka Casanegra, Graham Holland and Carlos Silvani, "The Audit of VAT", in Alan Tait, *VAT: Administrative and Policy Issues* (IMF 1991).
44. M. Saltzman, *IRS Practice and Procedure* (1981).

© 1994 International Bureau of Fiscal Documentation

to these functions with the development of application software under computerization projects.

The more obvious promise of the relevance of application software to tax accountancy is improving the examination function. It has been noted already that a simpler version of the US discriminant function score programme could be developed to assist these countries make the transition to self-assessment systems and VAT. This kind of programme is likely to reduce the workload by shedding excessive manual verification of records and also eliminate frivolous audits.

It has been indicated previously that a programme could be written to make the selection of audit cases fair across the objectives established for the sampling and stratification programme. A rational selection programme minimizes expediency and unnecessary politicization of the process. A comprehensive programme may be implemented to link the audit and examination functions to taxpayer identification schemes to provide a more objective basis of analysis for the causes of non-compliance, including fraud, evasion and avoidance.

It may be necessary to plan towards a selected number of sophisticated application of computers to tackle the increasing number of computer-based accounts prepared by a few large business enterprises. In addition to developing its own application software, the administration could base its procedures for auditing computer systems on the standard entitled `Auditing in a Computer Environment' issued by the auditing standards board.

IV. TAX PROFESSIONALISM IN DEVELOPING COUNTRIES

A. Introduction

There is a long history in TWCs for almost all aspects of the tax function to be performed by officials employed by the government. The sole exception is probably corporate taxation which for a long time has been easily recognized as a product of the financial reporting requirements of company law. The commercialization of corporate taxation and external audits is an area in which accounting firms have had virtual monopoly, but surprisingly there is a reluctance to extend the experience to other categories of taxpayers. This may be due to scarcity of professionals, politicization of the process and the unstructured nature of accounting practice by these taxpayers.

Nonetheless, it is useful to extensively defuse the lessons learned from the cooperation and financial relationship between the administration and accounting firms in other sectors of the economy to encourage qualified as well as part-qualified accountants to make a full-time career out of taxation. The global trend is for the share of consulting and tax work performed by these firms to increase at the expense of preparing and auditing financial statements. In the United States, for example, the share of external audits conducted as a percentage of revenue by the "Big Six" accounting firms declined from 62 percent in 1982 to just under 50 percent in 1990 and that consultancy and tax work covered the lost ground.[45] These firms maintain a significant presence in developing countries but it would seem as though the impact of their operations is not felt beyond corporate taxation and audits.

There are two approaches to promoting tax professionalism in developing countries, both of which are used in varying degrees in many countries.

B. Licensing of tax practitioners

It is proposed to consider licensing private tax practitioners as an essential step towards making the transition to self-assessment systems and improving general compliance in developing countries. The basis for this proposal is to further buttress the contention that the high level of tax literacy in most developed countries is made possible by the widespread availability of experts to assist individuals and businesses in meeting their tax obligations. The use of private practitioners should be seen as one of the long term measures needed to solve the numerous problems of implementation in TWCs.

The qualifications of practitioners and the modalities for their operations are important issues to be carefully considered. It is often argued that for most TWCs, the qualifications of tax practitioners need not be the same as professional lawyers or accountants. This argument is expedient in the short-term but given the long-term perspective of this proposal, it may be necessary to place the overall overview of tax practices under professional firms. The limits to be placed on practising qualifications could be determined in consultation with the appropriate professional groups.

The administration will be solely responsible for licensing practitioners, approving a code of conduct and enacting a manual for operations. The manual will contain guidelines relating to the minimum requirements for transactions, accounting records and books and the returns necessary to comply with the law. The administration should be charged with organizing periodic seminars and training for practitioners and their staff. The revenue institutions could tap into their experience in training tax officers to perform this function.

If it is decided to use non-professional accountants, then certain types of tax accounting may be limited to only the professional firms. For example, the non-professional firms may be allowed to file tax returns on behalf of self-employed businesses and wage-earners whose liability fall within a given income range. The computation of taxes for companies and other high income taxpayers could then be restricted to the professional firms. It may be reasonable, at least initially, to restrict the selection of sites for the operations of tax practitioners to the urban centres where professional advice and high-income activities experience are likely to be available.

C. Tax audits by public accountants

The second option is to enter into contracts with professional accountants to perform tax functions for the administration to

45. Rahul Jacob, "Can you Trust that Audit?", *Fortune Magazine* (18 November 1991); source: Bowman's Accounting Report.

© 1994 International Bureau of Fiscal Documentation

make use of their professional skills. Few countries are known to implement this policy even though Indonesia may be planning to implement the scheme. The involvement of those to be engaged should be limited to conducting audits and investigations as opposed to routine examination and assessment. If it is desired to use professional accountants for these types of routine functions, then the previous option of registering them as self-employed businesses may be a better alternative.

The primary objective of chartered accountants is to tackle cases which may be beyond the present capabilities of the administration. This is a useful way of concentrating the resources of the administration on the more routine functions. A secondary aim may be using them to extend the scope of audits in the economy in the event that the revenue institutions lack the capacity to undertake a representative coverage of taxpayers.

The use of public accountants should not be considered as a substitute for strengthening the accounting capacity of the administration. In the first place, the tradition in many countries against using independent accountants to perform routine tax functions may take a long time to overcome. But even if this were possible, the accounting section should be capable of understanding the work of independent auditors in order to evaluate their performance. Another difficulty in using independent accountants may lie in the potential for conflict of interest arising from a tradition in many countries for accountants to represent taxpayers against the administration. Apart from wanting to stay clear of a system which smacks of politicization in many countries, it is doubtful whether accounting firms will get involved with a system which pitches them against potential clients and fellow accountants.

The decision to use independent accountants could be based on a strategy to utilize their services for complex audits whilst exploring options for strengthening the administration. It may be necessary for all firms to be registered to sever any client relationships with groups of taxpayers they are likely to audit. The programme should include periodic seminars similar to what is proposed for keeping tax practitioners abreast with changes in tax law and policy.

D. The benefits of tax professionalism

The two proposals discussed can be expected to succeed because they will be implemented in commercial ventures for the individuals and firms willing to participate. They are deemed to be compatible with current trends in TWCs to purge government from activities which are performed more efficiently by the private sector. Also they could be considered as the foundation for strengthening fiscal intermediation in third world economies. In this instance, parallels may be drawn with financial and monetary intermediation even if in the past, it has been more difficult to pursue the privatization of fiscal functions.

The use of tax practitioners on an extensive scale could reduce administration costs in the long run but probably increase compliance costs. In the short-term, the cost of licensing and training practitioners could increase administration costs but these costs are expected to be eventually recovered from the agents who stand to benefit financially from the program. The administration may shed the huge cost of employing staff on official assessments but these savings may be re-channelled into financing the training staff to cope with the higher volumes of examination and audit required under a self-assessment system.

The fees paid by taxpayers to practitioners need not increase compliance costs in all instances since the appointment of agents could improve the record keeping capacity of taxpayers and thus enable them to benefit from the enhanced financial administration. Also, as an incentive to promote the scheme, the fees paid to agents by all categories of taxpayers should be made tax deductible to minimize the compliance cost.

The appointment of many private tax practitioners is likely to have an adverse effect on the ability of the revenue institutions to retain the qualified staff who will be attracted to the system as agents or employees of the practising firms. The turnover of staff in revenue institutions is observable now but could deteriorate further if steps are not taken to improve employment and working conditions at the time of licensing private firms.

The cooperation expected from national accounting bodies will not necessarily eliminate the perceived adversarial relationship between professionals such as lawyers or accountants and the tax administration.[46] Indeed, a number of these bodies have regulations specifying cautious conduct with revenue institutions on behalf of clients. For instance, the Certified Association of Chartered Accountants (United Kingdom) states, *inter alia*: "Where a member is approached by the Police, the Inland Revenue, the Customs and Excise Authorities ... making enquiries which may lead to the prosecution of a client ....the member should act with caution". Nevertheless, it is in the interest of governments to promote dialogue as well as utilize the professional capabilities of these firms towards achieving national objectives. There is no reason to believe that the current relations between the tax authorities and accountants could be worsened by implementing the proposals advocated in this article.

V. CONCLUSION

The thrust of this article has been strengthening the accounting capacity of tax administrations to enable them fulfil their function of effectively implementing tax reforms. The issues which need to be tackled evolve around employing qualified staff, improving working conditions and revising technical manuals to incorporate up-to-date standards from the professional mainstream. A programme of continuous cooperation with national professional institutions will enhance the quality of this programme. A useful component of the programme

46. Leon Yudkin, *A Legal Structure for Effective Income Tax Administration* (Harvard Law School International Tax Program, 1971).

© 1994 International Bureau of Fiscal Documentation

may be the need for a proper evaluation of the assistance needed to establish private tax agencies to complement this effort.

BIBLIOGRAPHY

– Richard M. Bird and Oliver Oldman, *Readings on Taxation in Developing Countries* (The John Hopkins University Press, 1975).

– Richard M. Bird and Oliver Oldman, *Taxation in Developing Countries*, 4th ed. (The John Hopkins University Press, 1990).

– Canadian Tax Foundation, *Income Tax Enforcement, Compliance & Administration, 1988.*

– Certified Association of Chartered Accountants, *Accountants' Guide, A Handbook of Standards, Statements and Rules of Professional Conduct for Accountants* (Certified Accountants Educational Press, June, 1989).

– William Dillinger, *Urban Property Tax Reform – Guidelines and Recommendations*, April 1991.

– Malcom Gillis, *Lessons from Fundamental Tax Reform in Developing Countries* (Duke University Press).

– Harvard Law School International Tax Program, Symposium on Directions in Tax Reform in Emerging Economies, Harvard 1991).

– IMF, *General Aspects of Tax Administration*, IMF Institute, Session No. 37 Papers, 1981.

–. IMF, *Theoretical Aspects of the Design of Fund-Supported Adjustment Programs*, September 1987.

– IMF/UNDP, Seminar on VAT in Resource Mobilization, Jakarta, Indonesia 1990.

– IMF/The World Bank, *Finance & Development*, September 1992.

– Javad Khalilzadeh-Shirazi and Anwar Shah, *Tax Policy in Developing Countries*, World Bank 1991.

– Herman B. Leonard, "Measuring and Reporting Financial Condition" (Research in Governmental and Non-Profit Accounting, 1985).

– Martin Miller, *Generally Accepted Accounting Principles (GAAP) Guide*, 1991.

– M. Salzman, *IRS Practice and Procedures* 1981.

– Cedric Sandford and Michael Godwin, *VAT Administration & Compliance in Britain.*

– Shalizi M. and Squire L, "Tax Policy in Sub-Saharan Africa", (Policy Research Series 2, The World Bank, 1989).

– Alan Tait, *VAT – International Practice and Problems* (IMF, 1988).

– Alan Tait, *VAT– Administration and Policy Issues*,(IMF, 1991).

– The World Bank, *Lessons of Tax Reform, 1992.*

– Leon Yudkin, *A Legal Structure for Effective Income Tax Administration*, Harvard Law School International Tax Program, Cambridge 1971.

© 1994 International Bureau of Fiscal Documentation

DOMINICAN REPUBLIC

TAX AND INVESTMENT IN THE DOMINICAN REPUBLIC

Esther L. Aristy and Pedro O. Gamundí

Esther L. Aristy: Bachelor of Laws Summa Cum Laude, Pontificia Universidad Católica Madre y Maestra (PUCMM), 1981; admitted to practice in the Dominican Republic in 1981; Master in Public Administration, Syracuse University, 1985; Professor of Law, PUCMM; associate attorney in charge of the Corporate Law Department at Pellerano & Herrera.

Pedro O. Gamundí: Bachelor of Laws Cum Laude, Universidad Nacional Pedro Henríquez Ureña (UNPHU), 1988; admitted to Practice in the Dominican Republic, 1988; Master of Laws in Common Law Studies, Georgetown University Law Center, 1991; Master in Political Sciences, UNPHU, to be awarded in November 1993; Professor of Economic Law, PUCMM; associate attorney at the Foreign Investment Department, Pellerano & Herrera.

I. INTRODUCTION

From 1990 to 1992 the economic legal framework of the Dominican Republic (DR) underwent profound changes aimed at an overall liberalization, modernization and revamp of the economy. Noteworthy among the reforms are 1992 Tax Code[1] and the tariff reform carried out by three Presidential Decrees in 1990 and 1991.[2]

The trend for economic reform is not likely to end in the near future: the Monetary Board of the Central Bank is expected to submit a Monetary and Financial Code bill to the Dominican Congress in the near future which is aimed at harmonizing and improving the monetary and financial system, and the Congress recently enacted a Tariff Code which consolidates into a single law the three decrees of 1990 and 1991.[3]

There is little doubt that the new tariff system and the new Tax Code, which together comprise a comprehensive and far-reaching tax reform, will have a substantial impact on the DR economy, particularly in respect of trade and investment. The Tax Code will not only effect many significant changes to the tax system but may also become one of the main pillars of the government's new economic policy, tending towards a more liberal economy and redefining the role of the State.

From a purely fiscal perspective the reform aims to prevent further erosion of the income tax system, which has been adversely affected by high marginal rates and a narrow base, and which has deteriorated as a result of numerous special incentives, exemptions and deductions. The primary objective of broadening the tax base is to be achieved by a reduction in the marginal income tax rates on individuals and corporations, and elimination of most of the special incentives, exemptions and deductions. The Tax Code also provides inflation adjustment mechanisms and creates a tax on capital gains and a fringe benefits tax. The Code is expected to have other advantages for the taxpayer, notably transparency, efficiency and reduced potential for discrimination among taxpayers.[4]

Analysed from a broader perspective, i.e. from an economic policy perspective, elimination of incentives and reduction of the marginal tax rates point towards a liberalization of the economy, where economic decisions are made for reasons of efficiency and competitiveness, and not because of incentives. The lack of special incentives and exemptions is expected to reduce the intervening role of the State in the market which, together with a lower and more uniform corporate rate, should give the private sector clearer indications on how to place resources in the different sectors of the economy.

The Tax Code is comprised of four titles:
- general provisions;
- income tax;
- value added tax; and
- excise taxes.

The most relevant aspects of the reform are contained in Title II on income tax. The Code repeals the former Income Tax Law (Law No. 5911 of 1962), which contained many outdated tax policy criteria. It also partially or totally repeals a number of laws and regulations that amended Law No. 5911 or which were related in some way to the fiscal system.

This article examines the new income tax system under the Tax Code, and then looks at tax incentives, the value added tax, property and other taxes.

II. INCOME TAX

A. General

Under former Law 5911, only Dominican-source income was taxable in the DR regardless of the nationality or residence of the taxpayer. Income was classified into five categories according to a schedular tax system, under which each type of income was taxed at a different rate. As a general rule, capital gains, income from temporary activities, occasional and gratuitous income were not subject to tax.

1. Enacted by Law No. 11/92.
2. The three decrees will not be discussed in this article.
3. Law No. 14/93 of August 1993.
4. It should be noted, however, that the regulations for application of the Code have not yet been issued.

© 1994 International Bureau of Fiscal Documentation

The schedular system has been abolished under the new Tax Code, and the concept of global income introduced. Under the reform resident individuals, legal entities and permanent establishments of non-residents are subject to tax on Dominican-source income and on income resulting from investments and financial gains sourced outside the DR. Non-residents are taxed only on Dominican-source income.[5] Non-residents who become resident in the DR are subject to tax on Dominican-source income and on income resulting from investments and financial gains sourced outside the DR as from the third taxable year in which they become resident.[6]

B. Taxable income

Article 272 contains an extensive list of income that is deemed to be of Dominican source. The following items are included:

- income from capital, property or rights placed, located or economically used in the DR;
- income from the performance of commercial, industrial, agricultural, mining or similar activities in the DR;
- fees and salaries and other such payments for professional or other services rendered in the DR (whether or not received in the DR);
- income from wages, remuneration or other type of benefits paid by the State to its official representatives or other persons performing a public mission abroad;
- income from loans;
- income from the lease of real or personal property;
- income from tangible or intangible property (or rights attached thereto) located or exploited in the DR;
- income derived from the rendering of technical assistance whether provided abroad or in the DR.

In addition to the concept of Dominican-source income, the new Tax Code extends the scope of taxable income to income from investments and financial gains derived outside the DR.

C. Capital gains

Capital gains which were previously exempt from income tax in the DR are now subject to tax.[7] Capital gains are determined by deducting the purchase price or production cost (adjusted for inflation) from the transfer price or value of the assets. In the case of depreciable property, the purchase price or production cost is the residual value of the property, upon which the inflation adjustment is applied.[8] Once the capital gain has been determined, it is considered taxable income, and then taxed at the rate applicable to corporations or individuals, depending on the case.[9]

Capital losses may only be offset against capital gains; if losses exceed gains, the excess may be set off against capital gains derived in subsequent fiscal years.[10]

D. Fringe benefits tax

Under the new Tax Code, the cost of providing specific non-cash fringe benefits to employees is borne by the employer rather than the employees.[11] The employer is required to pay a monthly tax on fringe benefits at a rate equivalent to the corporate income tax.[12] Thus, the fringe benefits tax does not impose an obligation on the employer to withhold tax on behalf of the employee, as is the case of withholding tax on salaries and wages; rather it may be considered a special tax on the employer who granted the benefit. For the purpose of determining the tax, employers are required to register in a separate account the amount of fringe benefit compensation granted each month.[13]

E. Deductions

As a general rule any expenditure actually incurred in the DR to obtain, maintain or preserve taxable income is deductible, so long as the expense can be supported by documentation.

1. Business activities

The following deductions are allowed from the gross income of a taxpayer carrying out business activities:[14]

- interest on debts and expenses, provided such debts are directly related to the business activity of the taxpayer;
- taxes and rates on income-producing property, with the exception of income tax, charges, fines and interest related to fines, inheritance tax and gift tax, and taxes, rates and rights incurred to obtain, maintain or preserve capital assets;
- insurance premiums paid in respect of income-producing property;
- premiums paid for life and health group insurance, provided the policies are in favour of all personnel;
- extraordinary losses, i.e. losses incurred on assets used to produce taxable income as a result of *force majeure* or offences committed by third parties;
- R & D expenditure;
- bad debts;
- differences in exchange rates derived from adjustments to the rate of exchange (not converted at the end of the

5. Art. 270. Unless otherwise noted, all references are to the new Tax Code.
6. Art. 271.
7. "Capital gain" means the profit from the sale, exchange or other disposal of a capital asset. "Capital assets" encompass all assets owned by the taxpayer whether or not connected to his business. However, excluded from capital assets are commercial stock classified as inventory and goods to be sold to clients.
8. Art. 289.
9. It is not clear from the text of the law whether the capital gains tax applies to both individuals and corporations, nor is the applicable tax rate clear. In the absence of regulations clarifying this point we are inclined to infer that the capital gains tax applies to both corporations and individuals at the regular income tax rates set forth in the Code.
The rate for corporations is the regular corporate rate, gradually reduced to 25%. The rate for individuals is the normal progressive rate, although an exemption is granted in the case of the sale of a personal residence up to RD$ 500,000.
10. Art. 289, Item i. The general rule under Art. 287, Item k (on allowed deductions), is that the carry-forward of losses may not exceed a three year period from the year in which the loss was incurred. However, the provision dealing with the carry-forward of losses in the case of a transfer of capital assets does not impose a limit on the number of years a loss may be carried forward. Upcoming regulations should clarify this point.
11. Fringe benefits include free accommodation, vehicles, education allowances, personal insurance premiums, special discounts on the sale of goods, etc.
12. Art. 319.
13. Art. 320.
14. Arts. 286 and 287.

© 1994 International Bureau of Fiscal Documentation

fiscal year) on the hard currency owned by an enterprise or on obligations in foreign currency, when such differences are unfavourable to the enterprise;[15]
- amortization of intangible property including patents, copyrights, drawings, models, contracts and franchises;
- amortization for wear, depletion and years in use, as well as losses for the justifiable non-use of business property, all of which are only accepted up to 5, 15 or 25 percent depending on the category of property;
- donations to charitable institutions (including educational and religious institutions) up to 5 percent of net taxable income;
- contributions to pension and retirement plans, up to 5 percent of taxable income;

The deductions for most employee fringe benefits have been abolished under the new Tax Code.

2. Other activities

Individuals who carry out activities other than their business (with the exception of dependent personal services) may deduct all expenses incurred in connection with those activities which are necessary to obtain, maintain or preserve taxable income.[16]

A simplified system of deductions has been introduced for resident individuals who derive more than 80 percent of their income from entrepreneurial, professional or similar activities, and whose income does not exceed RD$ 100,000 per year – such individuals may opt for a standard deduction of 30 percent of gross income in determining net taxable income.[17] Deductions granted to individuals for family dependents, life or disability insurance, medical and dental expenses, hospitalization, contributions to political organizations, trade unions and Chambers of Commerce are no longer permitted.

3. Prohibited deductions[18]

The legislation specifically prohibits the deduction of certain expenses:[19]
- personal expenses of an owner, partner or manager of an enterprise;
- salaries and wages paid to, or withdrawals made by an owner, partner or manager of an enterprise, or by his/her spouse or relatives, without providing evidence that such services were actually rendered;
- losses from illegal operations;
- remuneration paid to persons or organizations for assistance rendered from abroad;
- profits used to increase capital or reserves;
- undocumented expenses.

F. Exempt income

New exemptions include the following:
- the annual net income of resident individuals up to RD$ 60,000, adjusted annually for inflation;
- profits derived from the sale of a residence up to RD$ 500,000, provided the taxpayer lived in and owned the property during the three years prior to the sale;
- child support and alimony;
- income derived by state and municipal governments (except income derived from entrepreneurial activities);
- amounts received for work-related accidents, relocation and travel allowances, severance pay and the Christmas bonus;[20]
- amounts received by virtue of health, disability or life insurance;
- interest paid to resident individuals by financial institutions;
- cash contributions to a company;[21]
- although the acquisition of assets via donations is generally exempt, the capital gains on the assets donated are taxable;
- salaries and other payments to foreign officials and employees of foreign governments (so long as the foreign government grants reciprocity);
- stock and cash dividends paid by a corporation to its shareholders (see below).

Additionally, the Tax Code exempts the following organizations from income tax:[22]
- Chambers of Commerce;
- religious institutions;
- civil organizations devoted to charitable, social, political, literary, artistic and scientific purposes and unions; and
- sports associations.

These exemptions are generally granted provided the income obtained by the exempt institution is destined for the non-profit activity for which the institution was created; otherwise such income will be taxable.

A number of exemptions granted under the old law are abolished under the new Tax Code:
- income derived from the copyright and publication of books;
- capital gains (see "C" above);
- reinvestment in productive activities;
- sums invested in government banks and savings and loans institutions up to 5 percent of taxable income.

G. Losses

Business losses may be set off against other income of the same year and any excess may be carried forward for three years. For capital losses, see "C" above.

H. Relief from tax

Under Article 316(a) income tax effectively paid abroad on foreign-source income taxable under the Tax Code by tax-

15. Art. 293.
16. Art. 287, Item m.
17. Art. 290.
18. The Code does not significantly amend the non-deductible expenses.
19. Art. 288.
20. The Christmas bonus is not exempt from income tax under the Tax Code but under the Labour Code, which amended the Tax Code in this respect.
21. However, capital gains tax is levied on in-kind contributions.
22. Art. 299.

© 1994 International Bureau of Fiscal Documentation

payers residing or domiciled in the DR may be credited against their final tax liability. Under the old law no credit was necessary because only Dominican-source income was taxable.

Taxpayers residing or domiciled in the DR may now credit in each fiscal year:
- taxes paid abroad on income from foreign sources so long as the income is subject to tax in the DR;
- tax withheld on earned income;
- advance payments;
- credits from excessive tax payments or payments which are not yet due; and
- amounts withheld and paid to the State because of the distribution of cash dividends.

Taxpayers who are unable to utilize the full credit in a particular year may carry it forward.[23]

I. Dividends and distributions

Under the new Tax Code cash dividends paid by a resident corporation to its shareholders are tax-exempt provided the distributing company has withheld the appropriate tax.[24] Under Law 5911 cash dividends paid to resident individuals or resident companies were taxable at the rate applicable to Second Category Income.

The new regime operates as follows:[25]
- dividends paid by a resident company are subject to a 27 percent withholding tax (gradually reduced to 25 percent according to the corporate tax timetable), which is a final tax for the recipient (see also "J" below);
- the payor company may credit the tax withheld on the distribution against its corporate tax liability for the year of distribution;[26]
- any excess withholding may be credited against the following year's corporate tax liability;
- a corporation which is a shareholder of another corporation must open a dividend account into which it must add dividends received, and this amount will be excluded from its gross income. When the recipient corporation pays dividends to its own shareholders, the dividends must be first computed from the dividend account and will not be subject to withholding tax;[27]
- dividends received by a resident individual or corporation which have been subject to withholding tax at the corporate level or which derive from the dividend account are not included in the gross income of the individual or corporation.

The new regime ensures that all dividends distributed in cash will have been previously taxed at source at the corporate rate, but taxed only once.

J. Withholding at source

The Tax Code establishes withholding obligations for both corporations and individuals. One of the general objectives of the Tax Code is to facilitate the management and fulfilment of fiscal obligations. Thus the role of companies as withholding agents has been considerably expanded. Income tax must be withheld on behalf of the payee by the payor (whether a company, certain individuals or public entities) in the case of dividends paid in cash, salaries paid to employees, when remitting taxable income abroad, interest on loans executed abroad, or professional services paid to independent contractors. In the case of resident individuals the amount withheld may be credited against their final income tax liability.

1. Corporations

Corporations must withhold tax as follows:
- 27 percent, gradually reduced to 25 percent according to the rates and timetable applicable to the corporate income tax, on all Dominican-source taxable income paid abroad[28] other than interest paid or credited on account to financial institutions abroad (whose obligation is reduced to 15 percent of such interest),[29] dividends and taxable income derived by permanent establishments of non-residents;[30]
- 27 percent, gradually reduced to 25 percent on all Dominican-source dividends paid to all individuals or legal entities (regardless of where resident);[31]
- at the applicable rates for individuals[32] upon the payment of wages, salaries or other emoluments;[33]
- on payments to resident individuals. The rate of withholding depends on the type of income, as follows:[34]
  - 20 percent on rent or lease payments;
  - 10 percent on payments for independent personal services;
  - 15 percent on major prizes in the National Lottery;
  - 2 percent on the value of the transfer of personal property or real estate;
  - 10 percent on any other type of income (with the exception of bank dividends and interest).

23. Art. 317. The Code does not provide any time limit for the carry-forward of such credits, although the Regulations may address this issue.
24. Art. 299, Item n and Art. 308.
25. Art. 308.
26. The General Directorate of Taxes recently issued a special ruling dealing with the treatment of dividends distributed out of profits earned in financial years ending before 1 June 1992 when the new Tax Code came into effect. Under Art. 397 such dividends are subject to the 30% withholding tax imposed by Sec. 308 but the amount withheld cannot be credited against the corporate tax liability of the distributing entity. The ruling provides that entities claiming the credit of the withholding tax on dividends against corporate tax liability must first distribute profits and/or dividends earned in financial years ending before 1 June 1992.
27. For example, if Corporation A is a shareholder of Corporation B, the dividends received by A from B will be placed in the dividend account and not regularly added to A's gross income. As a result, when A makes a profit distribution, the dividends deriving from this account will not be subject to withholding tax.
28. Art. 305.
29. Art. 306.
30. Art. 298.
31. Art. 308.
32. Art. 296.
33. Art. 307.
34. Art. 309.

© 1994 International Bureau of Fiscal Documentation

2. Individuals

Individuals are only required to act as withholding agents in respect of payments made on account of their commercial or professional activities.[35]

K. Accounting

1. Closing of the fiscal year

Corporations are required to choose one of the following dates for the closing of their fiscal year: 31 December, 31 March, 30 June or 30 September. Once the date is chosen, it may only be changed with the approval of the tax administration. Such a request must be made at least one month prior to closing of the fiscal year.[36]

2. Accounting method

The Code also requires that corporations follow the accrual method of accounting,[37] although under special circumstances, a different method may be used. A request to use another method must be made at least three months prior to the date when the change is to be made, in order to obtain the requisite approval of the tax administration.[38]

3. Separate accounting by source

The new provisions require separate accounting records by source to ensure that branches and subsidiaries of foreign entities keep their accounting records separate from parent companies, branches or subsidiaries abroad.[39]

4. Inventory

With respect to inventory the last-in, first-out (LIFO) method must be used although other methods may be authorized in certain cases.[40]

L. Assessment and collection

Income tax is assessed on a current year basis, i.e. the taxpayer is assessed to tax in December 1993 in respect of income received from January to December 1993. The assessment is made based on the information provided in the tax return submitted by the taxpayer.[41] All taxpayers (except non-residents who are subject to a final withholding at source) must submit a tax return.

All resident taxpayers (with the exception of taxpayers whose total income is derived from dependent personal services), including permanent establishments of non-residents, are required to make advance payments of tax on account of the tax due in the relevant period as follows: 50 percent in June; 30 percent in September and 20 percent in December.[42] Taxpayers who can show that their income in the current year is lower than their income in the previous fiscal year by at least 30 percent may request a total or partial exemption from advance payment.[43]

M. Tax rates

1. Corporations

Corporate income tax is levied at the rate of 27 percent (for 1993). The rate will be gradually reduced to 26 percent and 25 percent for 1994 and subsequent years.

Employers are also required to make monthly payments to the Treasury at the same rate on the market value of any fringe benefits granted to employees.

2. Individuals

Individual income tax is levied at progressive rates as follows:[44]

Taxable income in DR pesos	Tax due on lower limit (in DR pesos)	Marginal rate on the excess over the lower limit (in %)
0 – 60,000	0	0
60,000 – 100,000	0	15
100,000 – 150,000	6,000	20
150,000 and over	16,000	27

The top rate will be 26 and 25 percent for the 1994 and subsequent tax years.

N. Inflation adjustments

Title II, Chapter XVI provides an inflation adjustment for each calendar year based on the Central Bank's Consumer Price Index. The adjustment is applied to:

- the tax rate scale for individuals;
- any other amounts expressed in Dominican Pesos in the Code;
- net equity in the capital of a business or capital assets unrelated to a business;
- transfer of net operational losses and dividend accounts to subsequent years;
- credit for taxes paid abroad;
- non-taxable minimum amount for individuals.

The inflation adjustment mechanism will annually adjust the tax-free amount and remaining tax brackets in the scale for individuals. As a result individuals who receive higher nominal salaries under inflationary conditions will not necessarily have to pay higher tax rates. This will remedy the problems created by the lack of such a mechanism where individuals are pushed by inflation into higher tax brackets as a result of the progressive nature of the tax, even though their real

35. Art. 309, para. II.
36. Art. 300.
37. Art. 301.
38. Art. 302.
39. Art. 279.
40. Art. 303.
41. The precise terms and requirements for filing tax returns under the new Tax Code will be set forth in regulations which have not yet been issued.
42. Art. 314.
43. Art. 315.
44. Art. 296.

© 1994 International Bureau of Fiscal Documentation

income does not increase. The automatic adjustment of tax credits will also prevent a decrease in real terms of the amounts that the taxpayer receives net of taxes due to inflation.

III. TAX INCENTIVES

One of the most debated innovations of the Tax Code was the virtual elimination of incentives to investment in sectors considered to be in the economic interest of the country.[45] Generally these incentives consisted of full or partial exemption from direct and indirect taxes for specified periods of time. Underlying abolition of the exemptions is the idea that the use of lower and flat income tax rates on individuals and corporations will create a more sound investment climate than a tax system comprised of high and progressive income tax rates mitigated by numerous incentives.

Noteworthy among the incentives totally phased out are incentives granted to the industrial sector, the tourism sector, the agricultural sector and forestry. Other incentives have only been partially repealed.[46] Among the sectors still protected are:

- Export Free Zone enterprises: the only incentives repealed are those relating to exemption of reinvestment and investments in construction, stock certificates and securities;
- the Export Promotion Law remains in force, except for provisions on the utilization of certain "tax credit certificates";
- the agriculture and livestock industry will continue to enjoy certain benefits, with the exception of income tax exemptions which have been expressly repealed by the Tax Code.

The incentives will be phased out gradually as follows:[47]

- Exemptions granted to the tourism, agricultural, forestry and energy development sectors will remain in effect for the period provided in the authorization resolution obtained to operate the projects, provided the exempt income is exclusively derived from the exploitation of the business benefited by the exemption. Although the Code generally prohibits the granting of any kind of exemption to investment or reinvestment of profits, undertakings investing in the above sectors may exceptionally obtain a tax exemption on income derived from their own exploitation under special contracts with the Executive Branch, subject to Congressional approval.
- Any other exemption granted by law, special contract executed with the State, or to individuals or corporations will be eliminated in the shortest period of the following: the deadline specified in the document granting the exemption, a three-year period to run from 1 January 1992 or the period specified by the Executive Power, if any.
- The phase-out is to be made progressively over three years in order to eliminate one-third of the tax benefits by 31 December 1992, two-thirds of the tax benefits by 31 December 1993 and all benefits by 31 December 1994.

IV. TAXES ON TRANSACTIONS

A. Value added tax (VAT)

Section III of the Tax Code governs the value added tax, and repeals the former ITBIS (the Tax on the Transfer of Industrialized Products and Services) law. The tax is charged on the supply of industrial products and services in the DR and the on importation of industrial products.

1. Taxable items

The following items are taxable:[48]

- the supply of industrial products;
- the importation of industrial products;
- communication services in general, including telephone, cable television, telefax, etc.;
- services provided by hotels, motels, bars, restaurants, cafeterias, etc.;
- the leasing of personal property such as vehicles, equipment and machinery;
- flower services.

2. Taxable persons

Generally, individuals and legal entities (whether national or foreign) that carry out the taxable activities listed above are liable to the VAT. An exception is granted to taxpayers who conduct purely commercial activities and whose average monthly income is below or equal to RD$ 50,000. For taxpayers who do not conduct purely commercial activities, the monthly average income or tax-exempt cap resulting from their taxable and non-taxable activities has been increased from RD$ 5,000 to RD$ 30,000.

3. Tax base

In the case of the supply of goods, the tax base is the net price involved in the supply, plus additional costs incurred by the seller (such as transportation, packaging, freight, interest from financing), less bonuses and discounts granted.

The tax base for imported goods has been modified,[49] i.e. the CIF value as increased by custom duties. By adding the cost of transportation insurance, the tax base increases, thus limiting the discretion of the authorities and simplifying administration of the tax.

The tax base for services is the total value of the services rendered. In the case of a lease of personal property, the tax base is the amount involved in the lease.

4. Exemptions

The supply and importation of certain basic products are exempt from VAT, e.g. farm produce and foodstuffs which have been subject to little or no processing; books and news-

45. There is also a prohibition on the granting of new tax incentives.
46. Art. 402.
47. Art. 394.
48. Art. 335.
49. Under Law No. 74 the tax base was "the C&F value in addition to all import taxes".

© 1994 International Bureau of Fiscal Documentation

papers; petroleum and its by-products; fertilizers and seeds; pesticides; and machinery and equipment used in the public sector, and in the agricultural and free zone sectors.

5. Rate

The value added tax rate has been increased from 6 to 8 percent.[50]

6. Credit for input tax

The taxpayer may deduct from his output tax the total amount of taxes paid in advance to customs or to local suppliers, i.e. the input tax. If the input tax exceeds the output tax, the taxpayer may apply the difference to subsequent monthly periods. However, exporters and producers of tax-exempt domestic consumption products, reflecting credits for advance tax on their purchased inputs may apply for a reimbursement within a six-month period.[51] The Code eliminates the possibility of deducting the VAT credits from the net taxable income for income tax purposes.

B. Immovable property transfer tax

All transfers of real property are subject to the following taxes:

- a transfer tax of 4 percent of the sale price;
- 12 percent of the 4 percent;
- RD$ 8 stamp duty for the first RD$ 2,000 of the sale price, and RD$ 2 for each additional RD$ 1,000;
- the tax on capital gains (described above) also applies to any transfer of real property, subject to certain conditions;[52]
- 2 percent of the transfer value of real and personal property must be withheld by the payer when the purchaser is an individual. Transfers in favour of profitable entities legally incorporated are exempt from this requirement.[53]

V. OTHER TAXES

A. Real property tax

Law No. 18/88 of 5 February 1988 imposes an annual tax on dwelling houses which are valued at more than RD$ 500,000, and unimproved plots.[54] The tax rate is 0.5 percent for urban lots and dwelling houses leased to third parties. If a dwelling house is occupied by the owner or his blood relatives, the tax rate is 0.25 percent. Property owned by the State, charitable or religious organizations and diplomatic missions are exempt from the real property tax, as is real property which is deemed to have acquired commercial goodwill by the Office of the Secretary of Industry and Commerce.

An owner of a dwelling house or unimproved urban plot must present an annual sworn declaration to the Office of the Director of the Income Tax at the Secretariat of State for Finance during the first 60 days of the year, and pay half of the annual tax due. The remaining tax is due six months from the date of the first instalment.

B. Inheritance and gift tax

A tax on inheritances and gifts is levied in the DR. The tax, which is payable by the recipient, is levied on personal and real property which forms part of the gross estate of a deceased or the gift, including Dominican-situs property of a deceased or donor, and foreign-situs movable property of a deceased who was Dominican or who had his last domicile in the DR.

The inheritance and gift tax is charged at progressive rates ranging from 1 to 32 percent, depending on the recipient's relationship to the deceased/donor and his taxable base.

Non-residents must pay a 50 percent surcharge on inheritances and gifts.

Exemptions to the inheritance and gift taxes are granted as follows:[55]

- if the transfer of property is in favour of a blood relative, an exemption is granted for property with a value not exceeding RD$ 1,000; in other cases, the exemption is granted for property valued at less than RD$ 500;
- homestead;
- life insurance of the deceased; and
- bequests or gifts to public or charitable institutions.

C. Other taxes and charges

A number of other taxes are also levied in the DR, including the business licence fee, the travel tax, incorporation fees, tax on public entertainment, the tax on the sale of gasoline and diesel fuel, on casino gambling and on the export of certain traditional products. Stamp duty must be paid on most written contracts, on the registration, renewal and transfer of trademarks, on documents supporting loans, debts, shares and guarantees as well as on documents prepared by or registered with notaries and registrars. None of these taxes and fees were amended by the tax reform.

VI. APPLICATION OF THE TAX CODE

The Tax Code has no retroactive application. Prior law will continue to be important for income received in calendar years preceding 1991.[56] Nevertheless, where accumulated profits of previous fiscal years were distributed after the Code became effective, such dividends will be subject to the 30 percent withholding tax under Article 308.[57] Accumulated losses for previous fiscal years will be acknowledged and the

50. Art. 342.
51. Arts. 342 and 350.
52. Art. 29, Item m grants an exemption for up to RD$ 500,000 of the profit obtained by an individual in the sale of his residence.
53. Art. 309.
54. Unimproved lots include property on which there are no legal structures or a plot of land where construction covers less than 30% of the total surface area of the property.
55. Law No. 25/69.
56. Art. 396.
57. However, see *supra* note 26.

© 1994 International Bureau of Fiscal Documentation

provisions established for losses in the new Code will apply.[58]

Finally, the Tax Code provides that until new regulations for the application of the Code are approved, the existing laws and regulations on administrative controls will remain in force as provisional regulations, in those sections which do not contradict the wording or spirit of the Code.[59] As indicated above, to date the regulations for application of the Code have not been given by Presidential Decree.

58. Art. 398.
59. Art. 399.

TAXATION AND INVESTMENT IN THE CARIBBEAN

Key information for a successful investment or operational strategy in the Caribbean — the first independent (and only comprehensive) survey of the many and varied Caribbean tax systems. Individual country chapters include:

- investment climate and regulatory conditions; tax systems and tax incentives to investment;
- succinct country surveys, summarizing each country's economic situation and principal business activities;
- relevant company law, exchange control regulations, business licence fees and other essential information;
- in-depth explanations of the main forms of doing business, organization and taxing powers;
- details of income, indirect, transaction and property taxes, and the latest statistics from official sources; and
- coverage of all aspects of offshore business regimes.

Initial subscription: NLG 1,500 (includes basic volumes, 1994 updates, postage and handling) ■ Updated twice per year ■ Annual renewal NLG 350

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

IFA NEWS

RESOLUTIONS - 47TH IFA CONGRESS, FLORENCE, 1993

SUBJECT I:

INTERPRETATION OF DOUBLE TAXATION CONVENTIONS

Resolution *(original version)*

CONSIDERING 26 National Reports submitted to the General Reporters on the subject of Interpretation of double taxation conventions;

AND CONSIDERING the General Report of Professor Dr Klaus Vogel and Dr Rainer Prokisch submitted to the 47th Congress of the International Fiscal Association (published with the National Reports in Volume 78a of the "Cahiers de Droit Fiscal International");

AND CONSIDERING the statements, views and other interventions made by panelists and other members of IFA during the course of the 47th Congress;

IT WAS RESOLVED by the 47th Congress of the International Fiscal Association that the following principles and recommendations shall be followed and made in respect of the interpretation of double taxation conventions between contracting states:

(1) Tax conventions, whether or not brought into force by domestic legislation of the contracting states remain international treaties and to achieve their purpose of avoiding double taxation should be interpreted in the same way in each contracting state. Therefore it is desirable that:

(a) The rules to be applied in each contracting state for the interpretation of tax conventions should recognize that tax conventions are international agreements governed by international law.

(b) These rules which are derived from public international law are generally described in Articles 31, 32 and 33 of the *Vienna Convention on the Law of Treaties* and are further explained in the *travaux préparatoires* to the *Vienna Convention* should be applied whether they are more flexible in some states, or more rigid in other states, than the rules of interpretation applied to domestic fiscal legislation.

(c) To advance the consistent interpretation and application of tax conventions, the Commentaries to the *OECD* and the *UN Models*, although not legally binding, should be accorded considerable weight in dealing with conventions that conform to these Models.

(d) Mutual agreements by the competent authorities resolving difficulties or doubts arising in the interpretation or application of a tax convention made pursuant to provisions paralleling the first sentence of Article 25(3) of the Models constitute an authentic element to be taken into account in the interpretation of the convention (in accordance with Article 31(3)(a) of the *Vienna Convention*) although whether they are binding in particular contracting states may depend upon the provisions of their respective constitutional laws.

(e) Contracting states should be encouraged to include a provision in the mutual agreement article of the tax conventions to the effect that if difficulties or doubts arising as to the interpretation or application of the convention cannot be resolved by the competent authorities, they should be submitted to arbitration.

(2) To advance the consistent interpretation and application of tax conventions, revenue authorities and courts of a contracting state should consider judicial and arbitral decisions and official revenue authority explanations, regulations and rulings, not only of the other contracting state, but also of third states when such material involves the interpretation or application of identical or substantially similar provision[s] of a tax convention, especially when they are derived from the same Model. To facilitate such consideration, revenue authorities should make all this material easily available without copyright restrictions, so that commercial publishers, the International Bureau of Fiscal Documentation, the OECD and other international bodies could assemble and publish it, without editorial deletions or changes, both in the original language(s) and translated into one or more languages that have widespread use.

(3) States should be encouraged to expand the use of express definitions of terms used in the tax conventions, either in the conventions themselves, in concurrent or subsequent protocols or through the mutual agreement procedures. This should become more practical if, as and when there develops an international consensus on the meaning of terms used in conventions that are not now defined.

(4) It is recognized that Article 3(2) of the Models will continue to play a role in providing the meaning of terms that have not been defined in a convention. The OECD should improve and clarify the wording of and commentary to Article 3(2) in order to remove any doubts as to its meaning and intended application. In doing so, the OECD should, in particular:

(a) Improve the wording of Article 3(2) to clarify that the meaning of undefined terms is intended to be the meaning that such terms have in internal law as at the time the convention is applied;

© 1994 International Bureau of Fiscal Documentation

(b) Clarify whether the "leeway" allowed to the competent authorities of a contracting state in applying Article 3(2) of the Model is intended to permit them to refer to revised internal law definitions of undefined terms only if such definitions have been amended for *bona fide* purposes other than to alter the scope and application of the tax convention, or other tax conventions made by that contracting state;

(c) Clarify whether the state of residence of a taxpayer should in principle recognize that the revenue authority of the state where the income arises should apply its own internal law definitions when it applies the convention;

(d) Clarify what is, and what is not, part of, or included in, the "context" for the purposes of establishing whether the context requires that internal law definitions not be applied; and

(e) Clarify whether or not Article 3(2) is intended to be applied only if the revenue authorities or the courts find that there is no general international consensus on the meaning of the undefined term.

Remarks on the resolution for subject 1 by David A. Ward, discussion leader for the panel.

(1) Prior to the Congress, the General Reporters and the members of the Panel prepared a draft Resolution which was presented to the Congress for discussion. The discussion was divided into four sections each dealing with a paragraph of the Resolution. After the discussion of each paragraph of the Resolution, proposed amendments if any were voted and then the paragraph including any amendments was then put to a vote. At the end of the discussion, the entire Resolution as amended was again put to a vote and confirmed.

(2) In respect of paragraph 1 of the Resolution, an amendment to paragraph 1(c) was proposed and accepted. This amendment had the effect of stating that the Commentaries to the Models be accorded considerable weight in dealing with conventions that *conform to* the Models. The previous wording referred to Commentaries being accorded considerable weight in dealing with conventions *derived* from the Models and implied that Commentaries should be given considerable weight only if the Commentaries predated the particular convention that is being interpreted. The amendment which was supported by the Congress supports the view that Commentaries that are made or amended subsequent to the particular convention can also be given considerable weight in interpreting provisions of conventions that conform to the Models.

(3) Paragraph 2 of the Resolution was amended to recommend that revenue authorities and courts should also consider arbitral decisions of the other contracting state and also of third states.

(4) There was also a proposed amendment to paragraph 2 to include within the matters that revenue authorities and courts should consider in order to advance the consistent interpretation and application of the tax conventions, articles and other writings of tax advisors and tax professionals. This amendment was not accepted by the Congress. Such materials are published and therefore there is no need to call for their publication. Further, although such materials are often helpful and are cited by courts, they are beyond the scope of what is intended to be dealt with in paragraph 2 of the Resolution, which calls for the publication of materials that can be relevant to the application of the principles of interpretation set out in Article 31(3) of the *Vienna Convention on the Law of Treaties*.

(5) Finally, a proposal was made to replace paragraph 4 of the draft Resolution with a completely different provision. It was proposed that Article 3(2) of the Models should be deleted and the counterpart of Article 3(2) in conventions should be repealed. This proposed amendment was not approved by the Congress and paragraph 4 was accepted unamended.

SUBJECT II:
NON-DISCRIMINATION RULES IN INTERNATIONAL TAXATION

Resolution *(original version)*

CONSIDERING 26 National Reports submitted to the General Reporter on the subject of Non-discrimination rules in international taxation;

AND CONSIDERING the General Report of Professor Avv. Pietro Adonnino submitted to the 47th Congress of the International Fiscal Association (published with the National Reports in Volume 78b of the "Cahiers de Droit Fiscal International");

AND CONSIDERING the statements, views and other interventions made by panelists and other members of IFA during the course of the 47th Congress;

IT WAS RESOLVED by the 47th Congress of the International Fiscal Association as follows:

(1) The Congress has considered a number of alternative approaches to a non-discrimination article and expresses a preference for a complete re-design of it, and in addition including a binding arbitration procedure for settling disputes relating to discrimination between states.

(2) The Congress has identified a number of points of difficulty in Article 24 of the OECD Model and puts forward the following solutions:

(a) The Commentary should state how the article is to be applied to transparent partnerships and tax-exempt bodies such as pension funds;

(b) The Commentary should make clear that states which do give credit to residents under internal law must give the same credit to permanent establishments of treaty partner resident enterprises; states which cannot give credit under internal law should include in their treaties the additional wording in paragraph 52 of the Commentary to Article 24;

© 1994 International Bureau of Fiscal Documentation

(c) Dividends received by a permanent establishment should be given the same relief as is available to dividends received by a resident company;

(d) Branch profits taxes should continue to be prohibited by the article so that states can negotiate a maximum rate;

(e) The Commentary should make clear that in a split-rate system the rate of tax on a permanent establishment should not be higher than the rate charged on distributed profits, where it applies, plus a dividend withholding tax at the rate that applies to a wholly-owned subsidiary of a parent company resident in the other contracting state;

(f) The second sentence of the permanent establishment provision should be drafted in the light of the tax systems concerned so as to achieve the result that allowances etc. should be given to non-residents to the extent that they are taxed in the permanent establishment state; in principle a pro rata allowance for non-business deductions and exemptions made in calculating the tax should be allowed in the permanent establishment state;

(g) All references in Article 24 to permanent establishment should be extended to a fixed base;

(h) Reliefs available under internal law between two resident companies should be permitted where there is ownership through a treaty partner resident company;

(3) The OECD should look at the inconsistencies and difficulties in the drafting of Article 24 and the Commentary identified during the discussion at the Congress, particularly in relation to the explanation of "the same circumstances".

Note by the chairman of the panel, Dr J.F. Avery Jones

Paragraph (1) of the Resolution

Under the new procedure, participants at the congress were asked to choose between four alternatives, which were as follows:

(a) a complete re-design of Article 24 of the OECD Model; or

(b) making clear in the article or the Commentary that states are free to include provisions for protecting the coherence of their tax system; or

(c) retaining the article in its present form with an addition stating its object and purpose and expanding on the Commentary; or

(d) retaining the article in its present form but clarifying the points of difficulty listed in paragraph (2) of the resolution.

As the resolution indicates the vote was in favour of (a) but in the panel discussion there was support for (b) and (c) (paragraph (d), which is essentially the status quo, was not specifically discussed). Had the participants been able to vote for or against each paragraph, as opposed to choosing one of them, it is likely that there would have been a majority in favour of all of them since the one involving the greatest change was chosen. The form of the resolution should not necessarily be taken as a rejection of the other solutions.

In addition a proposal for arbitration was put forward and is included in the resolution.

The re-design of the article which was before the meeting was as follows, although the detail was deliberately not included in the resolution.

1. *Non-residents*

1.1. [*General rule*] A resident of a Contracting State who is subject to tax in the other Contracting State, shall be taxed by that other State not less favourably than a resident of that other State.

1.2. [*Tax rate*] The rate at which the income of the resident of the first-mentioned State is taxed by that other State, may be higher than the rate at which a resident of that other State who derives the same income from the other State is taxed but, provided that the resident reports his worldwide income to the other State, it may not exceed the average rate at which his worldwide income would be subject to tax in the other State.

1.3. [*Personal allowances, etc.*] The other State shall grant to an individual resident of the first-mentioned State a pro rata share of personal deductions, exemptions [etc.], provided that the individual reports his worldwide income to the other State.

1.4. [*Gross basis taxation*] If a resident of a Contracting State is subject to tax in the other Contracting State on a gross basis whereas residents of the other State are subject to tax on a net basis, he shall be entitled to the same tax treatment by that other State as a resident of that State, provided he reports his worldwide income to that State. Such tax treatment shall take into account, but is not limited to, imputation credits, dividend tax exemptions and a pro rate share of personal allowances, deductions, exemptions, [etc.].

2. *Residents owned or controlled by non-residents*

Residents of a Contracting State, who are wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which residents of the first-mentioned State are or may be subjected.

3. *Nationals*

Nationals of a Contracting State shall be taxed in the other Contracting State not less favourably than nationals of that other State, except to the extent the other State subjects its nationals to comprehensive taxation (full liability to tax) because of their nationality. This provision shall, notwith-

© 1994 International Bureau of Fiscal Documentation

standing the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

4. *Payments to non-residents*
Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, payments made by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable income of the resident, be deductible under the same conditions as if they had been made to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

[5. *Source*
A resident of a Contracting State who derives income from the other Contracting State shall be entitled to the same tax treatment on such income as is given to income derived from the first-mentioned State, except as otherwise provided in Article 23 (Elimination of double taxation).]

Paragraph (2) of the Resolution

In some cases panel members would have favoured more extreme solutions but these were put forward as having a consensus among the panel, and were all approved by the congress.

There were two further items put forward by the panel that were not discussed because time did not permit, as follows:

(i) The article should be extended to cover non-business payments made to a resident of the other state should be allowed as a deduction under the same conditions as if they had been paid to a resident of the same state.

(j) The all taxes provision should be restricted to taxes of the same type as those covered by the treaty, for example local income taxes;

The following item put forward by the panel was rejected by the congress:

The Commentary should state that if the comparison indicated by Article 24(1) is impossible to make (for example because a non-resident national company cannot exist) there is no discrimination.

Paragraph (3) of the Resolution

Although no detailed discussion of them took place, the following were the inconsistencies and difficulties included in the papers which were before the congress:

A. Whether a difference in meaning is intended by the use of different expressions

Difficulty is caused by the use of different expressions where it is unclear whether different interpretations are intended, such as

1. *more burdensome* and *less favourably levied* taxation,
2. *same circumstance*, *same activities* and *similar enterprises*; is the US right to equate the first two (see the US national report at p. 724 of the Cahiers)? Do same activities include activities carried on by the enterprise outside the permanent establishment state?
3. *legal persons* in Article 24 and *body corporate* in Article 3, while the French text uses *personne morale* in both places
4. definition of national: legal person etc. *deriving its status as such* in English; *constituée* in French

B. Expressions which are not defined

1. "Other" taxation in Article 24(1) and (5) (see para. 6.7.7 of the General Report)
2. Similar enterprises

   Do *similar enterprises* in Article 24(5) mean third-country owned enterprises (as decided by the Amsterdam Tax Court, see p. 594 of the Cahiers) or home-country owned enterprises (as decided by the Swedish Supreme Administrative Court, see p. 662 of the Cahiers)?
3. Scope of connected requirements

   Whether, for example, absence of interest on tax repayments (UK national report p. 697), requirement of timely filing of returns (US national report p. 722) or extended statute of limitations (US national report p. 728) are included. Can the Commentary para. 59 (reversal of the burden of proof in transfer pricing enquiries) fit with the wording of the article and be used to interpret existing treaties (see Norway national report p. 615)? Should there be a let-out for necessary differences?

C. Uncertainties arising from the Commentary

1. What is the meaning of *subject to reciprocity* in Article 24 Comm. para. 1?
2. *In the same circumstances* is explained in the Commentary as meaning "placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact," which has given rise to many uncertainties, such as why factual circumstances are mentioned at all, since a hypothetical taxpayer can be given the exact factual circumstances as the actual taxpayer. Would it not be better to delete this explanation and rely on the ordinary meaning of *in the same circumstances*? Is the American Law Institute's proposal of *reasonably comparable given the circumstances* preferable? Is the generic approach correct (see US national report p. 721)?

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

South Africa

INTERNATIONAL TAX AND BUSINESS Guide: South Africa.
New York, Deloitte Touche Tohmatsu. 1992, pp. 137.
Information for potential foreign investors on the South African business environment, including the factors a foreign investor should consider in deciding whether to acquire an existing South African company or to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 13.473)

Hong Kong

INVESTMENT IN HONG KONG.
Hong Kong, KPMG Peat Marwick. 1993, pp. 58.
The booklet presents an overview of matters to be considered by those contemplating investment in Hong Kong. Information is given on profits tax, business tax, taxation of individuals, estate duty, property tax, labour and more related matters.
(B. 57.915)

ASIA & THE PACIFIC

New Zealand

DOING BUSINESS IN NEW ZEALAND.
New York, Price Waterhouse. 1993, pp. 214.
Information guide on doing business in New Zealand. Topics covered include: business environment, foreign investment and trade opportunities, investment incentives, banking and finance, labour relations and social security, tax administration, taxation of corporations and individuals, taxation of shareholders and foreign corporations, indirect taxes, trusts and estates, and tax treaties.
(B. 57.883)

Singapore

DOING BUSINESS IN SINGAPORE.
New York, Price Waterhouse. 1993, pp. 219.
Revised and updated information guide on doing business, foreign investment, banking and finance, audit and accounting, labour relations and social security, taxation of corporations and individuals, shareholders, estate and trusts, indirect taxes and tax treaties in Singapore.
(B. 57.881)

EUROPE

Belgium

POPPE, G.
Vennootschapsbelasting.
Diegem, CED Samsom. 1993, pp. 258.
860.- Bfrs.
Booklet describing Belgian corporate tax law.
(B. 113.023)

EEC

BUYING A EUROPEAN BUSINESS.
A guide to negotiated acquisitions in Europe.
London, Clifford Chance. 1991, pp. 50.
Guide dealing with negotiated acquisitions in seven Member States of the EC: Belgium, France, Germany, Italy, the Netherlands, Spain and the United Kingdom. This guide concentrates on agreed cash acquisitions by a foreign buyer of 100% of the shares of a limited liability company serves as a helpful introductory guide to the acquisition process in these countries.
(B. 113.006)

VAT IN THE SINGLE MARKET.
The Price Waterhouse guide through the maze.
London, Graham & Trotman. 1993, pp. 223.
£ 33.-.
Reference guide on the new European VAT accounting and trade statistic regimes, as implemented by the UK relating to the intra-Community movement of goods. It also covers the VAT treatment of services. A number of appendices, sample copies of UK VAT forms and an index are also included.
(B. 113.139)

Germany

DAUMKE, Michael.
Grundriss des deutschen Steuerrechts. Die wesentlichen Steuerarten, Verfahrensrecht, Internationales Steuerrecht. 2. Auflage.
Bielefeld, Erich Schmidt Verlag. 1993, pp. 270. 39.80 DM.
Basic principles of German tax law. Textbook contains a discussion of significant German taxes, procedural law and international tax law.
(B. 113.138)

SCHOMBURG, Walter.
Lexikon der deutschen Steuer- und Zollgeschichte. Abgaben, Dienst, Gebühren, Steuern und Zölle von den Anfängen bis 1806.
Munich, Verlag C.H. Beck. 1992, pp. 444.
58.- DM.
Glossary on German tax and customs history up to 1806. An impressive and comprehensive collection of terms of German tax history.Every term refers to further sources.
(B. 112.329)

KÖRPERSCHAFTSTEUER
Handausgabe 1992.
Körperschaftsteuergesetz mit Durchführungsverordnung, Richtlinien, Nebenbestimmungen und Rechtsprechung in Leitsätzen. Bearbeitet von Ewald Dötsch und Hans Singbartl.
Bonn, Stollfuss Verlag. 1993, pp. 624.
62.80 DM.
Corporate income tax handbook 1992.
(B. 113.118)

GRÜNEWALD, Andreas.
Finanzterminkontrakte im handelsrechtlichen Jahresabschluss.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 353. 78.- DM.
Financial futures contracts in commercial annual financial statements. Includes a description of estimation, valuation and proof of interest rate futures and share index futures contracts.
(B 112.629)

TESS, Wolfgang.
Vermögensteuer-Richtlinien 1989 mit Bewertungsgesetz, Bewertungs-Durchführungsverordnung, Vermögensteuergesetz. Aktualisierter Nachdruck, Stand Dezember 1991.
Bonn, Stollfuss Verlag. 1992, pp. 261.
29.80 DM.
Net wealth tax guidelines 1989.
(B. 111.869)

GEWERBESTEUER HANSAUSGABE 1992.
Gewerbesteuergesetz, Gewerbesteuer-Durchführungsverordnung, Gewerbesteuer-Richtlinien, Ergänzende Hinweise, Rechtsprechung. Bearbeitet von Dietmar Pauka.
Bonn, Stollfuss Verlag. 1993, pp. 239.
43.80 DM.
Business tax handbook 1992.
(B. 113.117)

© 1994 International Bureau of Fiscal Documentation

SCHMIDER, Karl-Heinz.
Die neuen Verfahrenserlasse zu steuerorientierten Kapitalanlagen.
Cologne, Peter Deubner Verlag GmbH. 1992.
Steuer-Telex Sonderinformation. pp. 72.
36.80 DM.
New decrees with regard to tax-related investments. Includes a description and explanation of the decrees of 13 July 1992 and 24 April 1992, as well as the procedures necessary to obtain a consideration of losses in income tax and VAT.
(B. 112.299)

SONNEMANN, Erik.
Immobilien in den neuen Bundesländern. Gesetze, Adressen, Antragsformulare.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 287. 68.- DM.
Immovable property in the new Länder. Includes material such as wordings of the laws, addresses and forms with regard to investments in immovable property situated in the new German Länder.
(B. 112.300)

KLAAS, Helmut.
Steuerliche Gestaltungsmöglichkeiten bei der Abfassung von Sozietätsverträgen.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 114. 48.- DM.
Drafting options with respect to partnership agreements. Includes tax planning tips on the formulation of partnership contracts.
(B. 112.921)

BIALEK, Karl H.
Captive-Versicherung und deutsches Körperschaftsteuerrecht.
Berlin, Duncker & Humblot. 1993.
Schriften zum Steuerrecht, Band 44. pp. 209.
98.- DM.
Captive-assurances and German Corporate Income Tax Law. Includes a description of the term captive and gives a comprehensive description of the circumstances and the taxation of captive assurances in general. A second part covers their treatment under German corporate income taxation, including deductibility of premiums to captive assurances and hidden distributions of capital by captives. A third part describes taxation in an international context.
(B. 113.099)

RUPPERT, Bernd.
Währungsumrechnung im Konzernabschluss.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 252. 78.- DM.
Valuation of foreign currency in annual group accounting of international groups under different types of laws, such as the German Corporate Tax Act of 1965, the 7th EEC Directive and the revised German Commercial Code of 1985. Also includes a discussion of the different methods of exchange.
(B. 112.741)

AUSFÜHRUNGSGESETZE ZUR
Europäischen wirtschaftlichen Interessenvereinigung.
Cologne, Bundesstelle für Aussenhandelsinformation. 1992.
Ausl. Wirtschafts- und Steuerrecht, Reihe A: Gesetzestexte und Erläuterungen, Heft 20/92.
pp. 366. 45.- DM.
Executing acts with regard to the European Economic Interest Grouping.
(B. 112.668)

STUHRMANN, Gerd.
Die neuen Erlasse zur Erbauseinandersetzung und zur vorweggenommenen Erbfolge.
Cologne, Peter Deubner Verlag GmbH. 1993.
Steuer-Telex Sonderinformation. pp. 80.
38.80 DM.
New decrees with regard to inheritance and anticipated succession.
(B. 112.709)

PICH, Hildegard.
Das neue Umsatzsteuer-Binnenmarktgesetz.
2. Auflage.
Cologne, Peter Deubner Verlag GmbH. 1993.
Steuer-Telex Sonderinformation. pp. 95.
38.80 DM.
The new VAT Single Market Act. An explanation of the new provisions on intercommunity acquisitions. Also includes examples of intercommunity supply, mail order regulations, intercommunity transport as to the identity number. The Simplification Directive 92/III/EEC of 14 December 1992 is considered.
(B. 112.782)

UMSATZSTEUER HANDAUSGABE
1992/93. Bearbeitet von Christian Forst, Horst Treptow und Michael Langer.
Bonn, Stollfuss Verlag. 1993, pp. 815.
69.80 DM.
VAT handbook 1992/93.
(B. 113.119)

ROSE, Gerd.
Grundzüge des Internationalen Steuerrechts.
2. Auflage.
Wiesbaden, Verlag Th. Gabler GmbH. 1992.
Betrieb und Steuer, 5. Buch. pp. 269.
Basic principles of international tax law. Textbook on German international tax law.
(B. 111.887)

MÖHLER, Thomas.
Absicherung des Wechselkurs-, Warenpreis- und Erfüllungsrisikos im Jahresabschluss. Zulässigkeit und Grenzen der Berücksichtigung von Kompensationsgeschäften bei der Bewertung.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 250. 72.90 DM.
Safeguarding of foreign currency-, price- and performance risks in the annual account.
(B. 112.027)

RECHNUNGSLEGUNG UND PRÜFUNG
in den neuen Bundesländern. Sammlung von Verlautbarungen der Treuhandanstalt und des Instituts der Wirtschaftsprüfer.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 467. 48.- DM.
Accounting and auditing in the new Länder. Collection of announcements by the Treuhandanstalt and the Institute of Accountants.
(B. 112.677)

BREDECK, Hans Martin.
Rechnergestützte Stichprobenverfahren im Prüfungswesen.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 300. 148.- DM.
Computer aided sample auditing. Explanation of sample auditing. The use of statistics and PC software for auditing purposes.
(B. 112.742)

BAETGE, Jörg.
Rechnungslegung und Prüfung. Perspektiven für die neunziger Jahre.
Jubiläumsveranstaltung 25 Jahre Institut für Revisionswesen.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 238. 58.- DM.
Accounting and auditing. Perspectives for the 90s. A summary of the speeches given on the 25th anniversary of the Auditing Institute. Topics covered include publicity, the profession of auditing and European accounting law.
(B. 112.625)

BEGER, Wolf Dietrich.
Methodenlehre und Klausurtechnik.
Stuttgart. Schäffer Verlag. 1991.
Finanz und Steuern, Band 15. pp. 196.
48.- DM.
Methodology and technique of writing exam papers with regard to tax law.
(B. 111.336)

KRAUSE, Clemens.
Kreditwürdigkeitsprüfung mit Neuronalen Netzen.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 278. 78.- DM.
Test of credit worthiness by using neuronal nets. The author describes a new computer aided method to determine credit worthiness based on mass quantities of data by using neuronal net structures.
(B. 112.628)

Hungary

UNGARISCHE WIRTSCHAFTSGESETZE.
Deutsch-ungarische Textausgabe mit Erläuterungen. Herausgegeben von Coopers & Lybrand.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 362. 58.- DM.
Hungarian commercial and business law.
(B. 112.304)

Ireland

INTERNATIONAL TAX AND BUSINESS Guide: Ireland.
New York, Deloitte Touche Tohmatsu International. 1992. pp. 127.
Guide for potential investors containing information about investing in Ireland. These include information on taxes, employment and

© 1994 International Bureau of Fiscal Documentation

labour considerations, financing, imports and exports, financing and accounting matters.
(B. 112.970)

Italy

INTERNATIONAL TAX AND BUSINESS
Guide: Italy.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 115.
Guide for foreign investors contemplating direct investments or passive investments in Italy. Basic information about the Italian business environment, including taxation.
(B. 112.971)

GARBARINO, Carlo.
Imprese multinazionali del diritto tributario.
Torino, UTET – Unione Tipografico Editrice Torinese, Corso Raffaello 28, 10125 Torino. 1992, pp. 30.
Tax treatment of multinationals.
(B. 113.015)

Netherlands

GIELE, J.F.M.; VERMEEND, W.A.
De vennootschap onder firma. De heffing van inkomstenbelasting bij oprichting en ontbinding van de firma en bij toe- en uittreden van firmanten. 6th Edition.
Deventer, Kluwer. 1993.
Fiscale Monografieën, No. 10. pp. 344.
75.50 Dfl.
Sixth revised and updated edition of monograph dealing with the income taxation aspects of the partnership from its establishment, liquidation and entering of new partners. Legal aspects are dealt with.
(B. 113.062)

ROUWENHORST, J.A.; MEULENBELD, J.
Gids voor belastingstudie 1993. 19th Edition.
Groningen, Wolters-Noordhoff BV. 1993, pp. 404. 79.- Dfl.
Nineteenth edition of textbook explaining the major principles of the 1993 tax regime in the Netherlands. The major taxes are explained with illustrations covering corporate income tax, individual income tax, net wealth tax and value added tax. International tax law is also dealt with.
(B. 113.129)

OOSENBRUG, Alfred.
Levensverzekeraar en vennootschapsbelasting. De voorziening verzekeringsverplichtingen binnen de fiscale resultaatbepaling.
Arnhem, Gouda Quint BV. 1993, pp. 346.
82.50 Dfl.
Dissertation discussing the life assurer and corporate income tax with emphasis on technical provisions and fiscal profit determinations.
(B. 113.076)

HANDLEIDING OP DE HANDLEIDING
voor loonbelasting en premieheffing 1993.
Deventer, Fed. 1993, pp. 55. 50.- Dfl.
Instructive guide on the wage tax and social security premiums.
(B. 112.897)

WILLEMSE-RAIJMANN, T.W.A.M.
Loonbelasting 1993. 3rd Edition.
The Hague, SDU Juridische & Fiscale Uitgeverij. 1993.
SDU Belastingwetten. pp. 171. 64.- Dfl.
Third revised annual edition of monograph on wage tax containing text of statutes and regulations on wage tax in the Netherlands.
(B. 113.073)

STEVENS, L.G.M.
Pensioen in de loonsfeer.
Deventer, Fed. 1993.
Fed Fiscale Brochures. pp. 142. 49.50 Dfl.
Monograph discussing the reform of taxation of life insurance and annuities in the individual income tax, wage tax (effective as of 1 January 1992) and taking into account the second reform phase on the same as if it were enacted and effective.
(B. 113.096)

VERVLOED, J.L.M.J.; DIELWART, V.C.E.
Kernboekje BTW 1993.
Deventer, Fed/KMPG Meijburg & Co. 1993, pp. 172. 36.- Dfl.
Revised and updated edition on the value added tax system in the Netherlands, EC regulations and the abolition of EC tax borders.
(B. 112.900)

THE 1992 UNITED STATES–
Netherlands Tax Convention. Edited by Mary C. Bennett, Fred C. de Hosson and Philip D. Morrison.
Deventer, Kluwer Law and Taxation Publishers.
1993, pp. 167. 85.- Dfl.
Text of the treaty and an extensive commentary.
(B. 113.075)

STAATSALMANAK VOOR HET
Koninkrijk der Nederlanden 1993.
The Hague, Government Printer. 1993, pp. 750. 134.69 Dfl.
1993 Annual Government Almanac containing names and addresses of the Ministries, Cabinets, representatives abroad, etc.
(B. 112.976)

BOVENBERG, A. Lans.
Fiscus en vergrijzing. Naar een ander fiscaal systeem?
Rotterdam, Erasmus University. 1992.
OEFEB Reprint No. 9204. pp. 14.
Reprint of article discussing another possible tax system to the financed national old-age pension fund.
(B. 112.796)

VOLLEBERGH, H.R.J.
Fiscale milieu-instrumenten en bedrijfsmatige vergroening.
Rotterdam, Erasmus University. 1993.
OCFEB Reprint No. 9302. pp. 14.
Article discussing tax instruments for environmental purposes.
(B. 112.861)

PUNT, H.G.
Zakboekje Beslagrecht 1993.
Arnhem, Gouda Quint BV. 1993, pp. 267.
45.- Dfl.
Discussion of law governing the seizure of assets. Includes a summary of the present law on seizure of assets in the Netherlands.
(B. 113.081)

Norway

INTERNATIONAL TAX AND BUSINESS
Guide: Norway.
New York, Deloitte Touche Tohmatse International. 1992, pp. 110.
Guide for potential foreign investors containing fundamental information about the Norwegian business environment, including the factors a foreign investor should consider in deciding whether to acquire an existing Norwegian company or to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 112.967)

EXNER, Martin.
Handelsvertreterrecht. Angleichung an EG-Recht.
Cologne, Bundesstelle für Aussenhandels-information. 1993.
Ausl. Wirtschafts- und Steuerrecht, Reihe A: Gesetzestexte und Erläuterungen, Heft 8/93. pp. 84.
Commentary on the new Norwegian commercial agency law.
(B. 113.063)

Russia

HACKER, Franz.
Die Doppelbesteuerungsabkommen Russlands und der anderen GUS-Staaten.
Munich, Verlag C.H. Beck. 1992.
Münchener Schriften zum Internationalen Steuerrecht, No. 15. pp. 227. 68.- DM.
The tax treaties of Russia and the other CIS states. Includes an analysis of the problems arising with the application of the tax treaties of the former USSR.
(B. 112.587)

United Kingdom

CORPORATION TAX SURPLUS
A.C.T. Proposals for reform.
London, Inland Revenue. 1993, pp. 39.
£ 2.-.
(B. 112.787)

BUTTERWORTHS YELLOW
Tax Handbook 1993-94.
Income tax, corporation tax, capital gains

© 1994 International Bureau of Fiscal Documentation

tax. 32nd Edition. Edited by Moiz Sadikali.
London, Butterworths. 1993, pp. 5000.
(B. 113.116)

BUTTERWORTHS UK TAX GUIDE
1993-94. Income tax, capital gains tax, corporation tax, inheritance tax, national insurance contributions, stamp duties, value added tax.
12th Edition. Edited by John Tiley.
London, Butterworths. 1993, pp. 1754.
£ 17.95.
This edition incorporates all the changes resulting from the 1993 Finance Act, the pay and file system and changes to VAT legislation following the introduction of the Single Market. New statutory instruments, statements of practice, extra-statutory concessions and cases have also been included.
(B. 113.124)

STANLEY, OLIVER.
Taxation of farmers and landowners. 5th Edition.
London, Butterworths. 1993, pp. 378.
A comprehensive survey of UK taxes to which farmers and landowners may be liable. Includes a discussion of the law and practice of income tax, corporation tax, capital gains tax, inheritance tax, value added tax, stamp duty, community charge and council tax. Also includes an introductory summary of national insurance contributions.
(B. 113.114)

INTERNATIONAL TAX AND BUSINESS
Guide: United Kingdom.
New York, Deloitte Touche Tohmatsu. 1992, pp. 155.
Fundamental information for potential foreign investors about the UK business environment, including the factors a foreign investor should consider in deciding whether to acquire an existing UK company or to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 112.963)

BUTTERWORTHS ORANGE TAX
Handbook 1993-94.
Inheritance tax, national insurance contributions, stamp duties, VAT. 18th Edition. Edited by Moiz Sadikali.
London, Butterworths. 1993, pp. 4042.
(B. 113.115)

INTERNATIONAL

BROER, D.P.; WESTERHOUT, E.W.M.T.
Taxation in an intertemporal general equilibrium model of a small open economy.
The Hague, Ministry of Economic Affairs. 1993.
Reprint No. 9307. pp. 16.
A computable general equilibrium model of a small open economy, similar to the Auerbach-Kotlikoff model. An investigation of the effects of partial switches in the choice of tax base from capital or wage income taxation to consumption taxation.
(B. 57.917)

NON-DISCRIMINATION RULES IN
international taxation. 47th Congress of the International Fiscal Association, Florence 1993.
Deventer, Kluwer Law and Taxation Publishers. 1993.
IFA Cahiers de Droit Fiscal International, Volume LXXVIIIb. pp. 760.
A summary in French, English, German and Spanish of each country report is appended. The report by the general reporter Prof. Avv. Pietro Adonnino, is printed in full in the four languages.
(B. 112.888)

INTERPRETATION OF DOUBLE
taxation conventions.
47th Congress of the International Fiscal Association, Florence 1993.
Deventer, Kluwer Law and Taxation Publishers. 1993.
IFA Cahiers de Droit Fiscal International, Volume LXXVIIIA. pp. 678.
A summary of each report in German, English, French and Spanish is appended. The report by the general reporters Klaus Vogel and Rainer G. Prokisch is published in full in the four languages.
(B. 112.887)

TRENDS IN TAX POLICY AND TAX
administration.
Editors: Angel Q Yoingco and Milwida M. Guevara. Bulacan, Ms. Milwida M. Guevara, 76 Pag-Asa, Obando, Bulacan, Philippines. 1992, pp. 71.
Selected papers presented in the Sixth Round Table Conference of the Council of Executive Secretaries of Tax Organizations (CESTO), sponsored jointly with Sherbrooke University, held in Sherbrooke, Canada, on 8-11 April 1991. Contributors: S.I. Chelvathurai, Edison Gnazzo, C.L. Thompson, Angel Q. Yoingco, Milwida M. Guevara, Cho Joong Hyung and Sheng-Ford Chang.
(B. 113.064)

ACQUISITION OF SHARES IN A
foreign country.
Substantive law and legal opinions. Report of the Subcommittee on Legal Opinions of the Committee on Banking Law of the Section on Business Law of the International Bar Association and the Committee on Business Organisations of the Section on Business Law of the International Bar Association. Editors Michael Gruson and Stephan Hutter.
London, Graham & Trotman Limited; International Bar Association. 1993, pp. 502.
£ 83.-.
Compilation of papers by various authors on the legal requirements in connection with the issuance and transfer of shares in a foreign country. Each country report follows the same outline in order to maintain comparative uniformity and permit ease of use.
(B. 113.140)

Developing Countries

TRANSITION TO MARKET.
Studies in fiscal reform. Edited by Vito Tanzi.
Washington, IMF International Monetary Fund. 1993, pp. 387.
Compilation of papers of various staff members of the IMF. The authors have distilled their first-hand experience with fiscal reform in transition economies in many African, Asian and European countries from centrally planned to market economies. Case studies Bulgaria, Czech and Slovak Federal Republic, Hungary, Poland, Romania, Soviet Union and Russian Federation, East Germany, Yugoslavia, China, Vietnam, Mongolia, Kazakhstan, Algeria, Angola and Ghana are included.
(B. 57.922)

PUROHIT, Mahesh C.
Principles and practices of value added tax. Lessons for developing countries.
Delhi, Gayatri Publications, P.O. Box 8495, Ashok Vihar, Delhi-110052, India. 1993. pp. 235.
This book is the outcome of a study of the VAT systems of various countries, particularly France. Its emphasis is on understanding the organization and operations of a VAT and aims at drawing lessons for countries which do not have a VAT. Topics covered include: economic effects and structure of VAT; harmonization of VAT in EC countries; general features of VAT management; VAT management in France and management information systems for VAT administration. The book concludes with lessons for developing countries: an agenda for reform.
(B. 57.827)

OECD

TAXATION IN OECD COUNTRIES.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 112.
Report providing a detailed inventory of the tax measures in force in 1990 in OECD countries. It considers and analyses in turn personal income taxes, corporate income taxes, value added taxes and taxpayers' rights and obligations.
(B. 112.595)

REVENUE STATISTICS OF THE
OECD Member countries/Statistiques des recettes publiques des pays membres de l'OCDE 1965-1992.
Paris, OECD Organisation for Economic Cooperation and Development. 1993, pp. 267.
This annual publication first provides a conceptual framework with the purpose of defining which government receipts should be regarded as taxes and how the different types of taxes may be classified. It then presents a unique set of detailed and internationally comparable tax data in a common format for all 24 OECD Member countries covering the period from 1965 onwards. With 165 tables and 13 charts.
(B. 113.067)

© 1994 International Bureau of Fiscal Documentation

LATIN AMERICA

Argentina

VILLEGAS, Hector B.
Curso de finanzas, derecho financiero y tributario. 5th Edition.
Buenos Aires, Ediciones Depalma Srl., Talcahuano 494, 1013 Buenos Aires, Argentina. 1993, pp. 857.
Course on finances and on financial and tax law. Manual on public financial and on finance and tax legislation.
(B. 18.788)

Guatemala

CODIGO TRIBUTARIO 1991.
Guatemala, Ediciones Legales Comercio e Industria. 1991, pp. 62.
Booklet containing the text of the Tax Code of 1991.
(B. 18.789)

NORTH AMERICA

Canada

AMENDMENTS TO THE INCOME
Tax Act and related statutes. Draft Legislation and Explanatory Notes. Issued by the honourable Gilles Loiselle, Minister of Finance. August 1993.
Scarborough, Carswell Thomson Professional Publishing. 1993, pp. 199.
(B. 113.086)

WILSON, Thomas A.; DUNGAN, D. Peter.
Fiscal policy in Canada. An appraisal.
Toronto, Canadian Tax Foundation. 1993.
Canadian Tax Paper No. 94. pp. 224.
(B. 113.061)

USA

THE OMNIBUS BUDGET
Reconciliation Act of 1993.
The impact of the new tax law on individuals, businesses and international transactions.
New York, Watson, Farley & Williams. 1993, pp. 23.
(B. 113.036)

AMICO, Joseph C.
Introduction to the US income tax system.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 245. 155.- Dfl.
An explanation in plain language of the complexity of the US tax system, often by comparison and contrast with European and other national tax systems. Topics covered include individual and corporate income taxes, partnership taxation, special types of taxpayers (pensions, Subchapter S-corporations) and the underlying "unwritten law" of US taxation. Special emphasis is placed on international rules, particularly inbound business, sales and investment. Broad coverage is given to anti-avoidance rules which contribute to the US tax system's complexity (e.g. Subpart F, FIRPTA and transfer pricing).
(B. 113.043)

THE 1992 UNITED STATES–
Netherlands Tax Convention. Edited by Mary C. Bennett, Fred C. de Hosson and Philip D. Morrison.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 167. 85.- Dfl.
Text of the treaty and an extensive commentary.
(B. 113.075)

Looseleaf Services

Received between 1 and 31 October 1993

AFRICA

FIDAFRICA
release 9
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 16, 17
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
- Rulings and guidelines
  release 139

Butterworths, North Ryde.

BELGIUM

FISCALE DOCUMENTATIE
VANDEWINCKELE
Tome II, releases 58 and 59
Tome III, releases 81, 82, 82bis
Tome IV, release 97
Tome IX, releases 265, 266
Tome XIV, releases 238, 239
CED-Samsom, Diegem.

GUIDE PRATIQUE DE FISCALITE
Tome II, release 91
Tome III, release 92
CED-Samsom, Diegem.

VENNOOTSCHAP EN BELASTINGEN
release 19
Kluwer Rechtswetenschappen, Deurne.

CANADA

INCOME TAX
REFERENCES/REFERENCES
A LA LOI DE L'IMPOT SUR LE REVENUE
release 51
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 855, 857-859
Prentice-Hall of Canada Ltd., Scarborough.

TAXATION OF REAL ESTATE IN CANADA
Atlas
release 1
Carswell Thomson Professional Publishers, Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Skattenyt – Kronologisk
  releases 21 and 22
- Skattebestemmelser – Systematisk
  release 10

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  releases 334 and 335

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – FISCAL
release 4
Editions Francis Lefebvre, Levallois-Perret.

FISCALITE PRATIQUE – IMPOTS INDIRECTS
release 2
Editions Francis Lefebvre, Levallois-Perret.

JURIS CLASSEUR – CHIFFRE D'AFFAIRES – COMMENTAIRES
release 6158
Editions Techniques, Paris.

JURIS CLASSEUR – CODE FISCAL
release 248
Editions Techniques, Paris.

GERMANY (Fed. Rep.)

DEUTSCHE GESETZE
Schönfelder
release 81
Verlag C.H. Beck, Munich.

© 1994 International Bureau of Fiscal Documentation

DAS EINKOMMENSTEUERRECHT. KOMMENTAR ZUM EINKOMMENSTEUERGESETZE
Littmann – Bitz – Meincke
release 17
Verlag Schäffer & Co., Stuttgart.

HANDBUCH DER EINFUHRNEBENABGABEN
release 4
Von der Linnepe Verlagsgesellschaft KG., Hagen.

STEUERRECHTSPRECHUNG IN KARTEIFORM
release 501
Verlag Dr. Otto Schmidt, Cologne.

INTERNATIONAL

THE INTERNATIONAL TAX TREATIES
release 16
In-Depth Publishing Ltd., Dublin.

INTERNATIONAL TAX SYSTEM AND PLANNING TECHNIQUES
Saunders
release 25
Oyez Longman Publishing Ltd., London.

NETHERLANDS

BELASTINGWETGEVING
- inkomstenbelasting 1964
  release 243 and 244
- Loonbelasting
  release 148
- Omzetbelasting 1968 (BTW/1978)
  release 87
- Successiewet
  release 59
- Vennootschapsbelasting 1964
  release 71

Noorduijn BV, Arnhem.

CURSUS BELASTINGRECHT
Mobach
releases 207 and 208
Gouda Quint/D. Brouwer, Arnhem.

DUTCH BUSINESS TAX
Schuit – Beek – Zevenboom – Schifman
release 7
Kluwer, Deventer.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Gemeentelijke belastingen e.a.
  release 139

Kluwer, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Belastingheffing bij invoer
  releases 443-445
- Tarief van invoerrechten
  releases 101-103
- Algemene wetgeving inzake douane
  release 250

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
release 363
Kluwer, Deventer.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
releases 166 and 167
Kluwer, Deventer.

DE SOCIALE VERZEKERINGSWETTEN
- AKBW, releases 44 and 45
- AWBZ, releases 102 and 103
- Heffing over uitkeringen en loon
  release 44

Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Inkomstenbelasting 1964
  releases 875-877
- Invorderingswet
  releases 49 and 50
- Omzetbelasting
  releases 235-237
- Vennootschapsbelasting
  release 310
- Vermogensbelasting 1964
  release 156
- Lokale belastingen en milieuheffing
  release 10

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, release 9
B, release 17
Norsk Skattebetalerforening, Oslo.

SWEDEN

GRS SKATTE-HANDBOK
release 15
Norstedts Förlaget, Stockholm.

UNITED KINGDOM

BRITISH TAX ENCYCLOPEDIA
Wheatcroft
release 140
Sweet & Maxwell Ltd., London.

SIMON'S TAX CASES
releases 30 and 31
Butterworth, London.

SIMON'S TAXES
release 192
Butterworth, London.

SIMON'S TAX INTELLIGENCE
releases 37-41
Butterworth, London.

TAX HAVENS ENCYCLOPEDIA
Spitz
release 36
Butterworth, Sevenoaks.

VALUE ADDED TAX – DE VOIL
release 218
Butterworth, London.

USA

UNITED STATES TAX REPORTER
releases 39-42
RIA – Research Institute of America Inc., New York.

© 1994 International Bureau of Fiscal Documentation

List of addresses

of the major publishing houses appearing in the Bibliography

AUSTRALIA

Australian Government Publishing Service, P.O.Box 84, Canberra ACT 2600, Australia

Australian Taxpayers' Association, Suite 5 A, 343 Little Collins Street, Melbourne 3000, Australia

Australian Tax Research Foundation, 7th Level, 64 Castlereagh Street, Sydney, NSW 2001, Australia

Butterworth Pty., Ltd., 271 – 273 Lane Cove Road, North Ryde, NSW 2113, Australia

CCH Australian Ltd., P.O.Box 230, North Ryde, NSW 2113, Australia

Commissioner of Taxation, Canberra ACT 2600, Australia

John Wiley & Sons, 65 Park Road, Milton, QOLD 4064, Australia

Monash University, Centre of Policy Studies, Clayton, Vic. 3168, Australia

AUSTRIA

Grenz – Verlag, Flossgasse 6, 1025 Vienna, Austria

Linde Verlag Wien GmbH., Scheydgasse 24, 1210 Vienna, Austria

Manz'sche Verlag, 1 Kohlmarkt 16, P.O.Box 163, 1014 Vienna, Austria

Selbstverlag Dr. Karl-Werner Fellner, Resselstrasse 8, 4470 Enns, Austria

Wirtschaftsverlag Dr. Anton Orac, Graben 17, P.O.Box 56, 1014 Vienna, Austria,

BELGIUM

Administration Contrôle des Contributions, C.A.E. boulevard du Jardin Botanique, P.O.Box 32, 1010 Brussels, Belgium

Belgische Dienst voor de Buitenlandse Handel, World Trade Center, Toren 1, Emile Jacqmainlaan 142, 1210 Brussels, Belgium

BDO Binder, 60 boulevard de la Woluwe, 1200 Brussels, Belgium

Uitgeverij Biblo, Brasschaatsteenweg 200, 2180 Kalmthout, Belgium

Emile Bruylant, S.A. Establishments, 67 rue de la Régence, 1000 Brussels, Belgium

Ced-Samsom / Wolters-Samsom, Kouterveld 14, 1831 Diegem, Belgium

Commission of the European Communities, 200 rue de la Loi, 1049 Brussels, Belgium

Editions Service, 230 – 232 boulevard Emile Bockstael, 1020 Brussels, Belgium

International Customs Tariffs Bureau, 38 rue de l'Association, 1000 Brussels, Belgium

Kluwer Rechtswetenschappen, Santvoorbeeklaan 21-23 , 2100 Deurne, Belgium

Ministère des Finances, P.O.Box 32, 50 boulevard du Jardin Botanique, 1010 Brussels, Belgium

Uitgeversbedrijf TIJD N.V., Brouwersvliet 5, P.O.Box 3, 2000 Antwerp, Belgium

University of Brussels, 26 avenue Paul Héger, 1050 Brussels, Belgium

CANADA

Butterworth Pty., 2265 Midland Avenue, Scarborough, M1P 4S1, Canada,

Canadian Tax Foundation, 1 Queen East Street, Toronto, Ont. M5C 2Y2, Canada,

CCH Canadian Ltd., 6 Garamond Court, Don Mills, Ontario M3C 1Z5, Canada

Coopers & Lybrand, 145 King Street West, Toronto, Ont. M5H 1V8, Canada

Prentice Hall of Canada Ltd., 1870 Birchmount Road, Scarborough, Ont M1P 2J7, Canada

Thomson Professional Publishing Canada, Carswell / Richard de Boo Publishers, One Corporate Plaza, 2075 Kennedy Road, Scarborough, Ontario M1T 3V4, Canada

CHINA

Arthur Andersen, Room 3054 Beijing Hotel, Beijing, China (People's Rep.)

Shandong Foreign Economic Relations & Trade Commission, 1 Shengfuquain Street, Jinan, Shandong, China (People's Rep.)

DENMARK

A/S Skattekartoteket Informationskontor, Palægade 4, P.O.Box 9026, 1022 Copenhagen – K, Denmark

Juristförbundets Förlag, Gothesgade 133, 1123 Copenhagen – K, Denmark

FINLAND

Painatuskeskus Oy, Postimyynti, P.O.Box 516, 00101 Helsinki, Finland

FRANCE

The American Tax Institute in Europe, SA., 9 avenue Matignon, 75008 Paris , France

Les Cahiers Fiscaux Européens, 51 avenue Reine Victoria, 06000 Nice, France

Direction des Journaux Officiels, 26 rue Desaix, 75727 Paris CEDEX 15, France

Editions J. Delmas & Cie. SA., 13 rue de l'Odéon, 75006 Paris, France

Editions Fiduciaire France Afrique, 51 rue Louis Blanc, 92037 Paris – La Défense, France

Editions Jupiter SARL , 21 – 23 rue du Mont Thabor, 75001 Paris, France

Editions Francis Lefebvre, Chantal Bordas, 42 rue de Villiers, 92300 Levallois – Perret, France

Editions Législatives, 80 avenue de la Marne, 92546 Montrouge CEDEX, France

Editions Montchrestien, 26 rue Vercingétorix, 75014 Paris, France

Editions et Services Techniques Professionnels, 31 avenue Pierre 1er de Serbie, 75116 Paris, France

Fidafrica, 18 Place Henri Bergson, 75008 Paris, France

Jurisprudence Générale Dalloz, 11 rue Soufflot, 75240 Paris CEDEX 05, France

Lamy SA, 187/189 Quai de Valmy, 75490 Paris CEDEX 10, France

Librairie Générale de Droit et de Jurisprudence, 26 rue Vercingétorix, 75014 Paris, France

Librairies Techniques s.a. LITEC, 158 rue Saint-Jacques, 75005 Paris, France

Nouvelles Editions Fiduciaires, 2bis rue de Villiers, 92300 Levallois Perret, France

Organisation for Economic Co-operation and Development, 2 rue André Pascal, 75775 Paris CEDEX 16, France

Technique et Documentation Lavoisier, 11 rue Lavoisier, 75384 Paris CEDEX 08, France

© 1994 International Bureau of Fiscal Documentation

GERMANY (FEDERAL REPUBLIC)

Bowker-Saur Verlag, Ortlerstrasse 8, P.O.Box 701620, 81316 Munich, Germany

Bundesstelle für Aussenhandelsinformation, Agrippastr. 87-93, 50676 Cologne, Germany

C.H. Beck Verlagsbuchhandlung, Wilhelmstrasse 9, 80801 Munich, Germany

Dr. Peter Deubner Verlag GmbH., Wolfgang-Müller Strasse 14, P.O. Box 510627, 50942 Cologne, Germany

Deloitte, Haskins and Sells GmbH., Stresemannstr. 15, 4000 Düsseldorf 1, Germany

Duncker & Humblot GmbH., Dietrich-Schäfer- Weg 9, P.O.Box 410329, 12113 Berlin, Germany

Forkel Verlag GmbH., P.O.Box 2120, 65011 Wiesbaden, Germany

Rudolf Haufe Verlag, P.O.Box 740, 79007 Freiburg, Germany

Carl Heymanns Verlag KG., Luxemburger Strasse 449, 50939 Cologne, Germany

IDW Verlag, P.O.Box 320580, 40420 Düsseldorf, Germany

Institut "Finanzen und Steuern", P.O.Box 1808, 5300 Bonn 1, Germany

Institut für Ausländisches und Internationales Finanz – und Steuerwesen der Universität, Hamburg, Grindelhof 38-40, 2000 Hamburg 13, Germany

Institut für Weltwirtschaft, Dusterbrooker Weg 120, 2300 Kiel, Germany

Friedrich Kiehl Verlag GmbH., P.O.Box 210747, 67007 Ludwigshafen, Germany

Von der Linnepe Verlagsgesellschaft, Bahnhofstrasse 28, P.O.Box 2260, 58095 Hagen, Germany

Hermann Luchterhand Verlag, P.O.Box 2352, 56513 Neuwied, Germany

J.C.B. Mohr (Paul Siebeck) P.O.Box 2040, 72010 Tübingen, Germany

C.F. Müller Juristischer Verlag GmbH., Im Weiher 10, P.O.Box 102640, 69016 Heidelberg, Germany

Verlag Neue Wirtschafts-Briefe GmbH., P.O.Box 101849, 44621 Herne, Germany

Nomos Verlagsgesellschaft, P.O.Box 610, 76484 Baden-Baden, Germany

Verlagsgesellschaft Recht und Wirtschaft mbH., P.O.Box 105960, 69049 Heidelberg, Germany

Schäffer-Poeschel Verlag, Kernerstrasse 43, 70182 Stuttgart, Germany

Schäffer & Co., Alexanderstrasse 169-171, 70180 Stuttgart, Germany

Dr. Otto Schmidt Verlag, Unter den Ulmen 96-98, 50968 Cologne, Germany

Erich Schmidt Verlag GmbH & Co., P.O.Box 102451, Viktoriastr. 44A, 33524 Bielefeld, Germany

Springer Verlag GmbH & Co. KG., P.O.Box 105160, 69041 Heidelberg, Germany

Steuer- und Wirtschaftverlag GmbH., Agnesstrasse 60, 2000 Hamburg 60, Germany

Stollfuss Verlag KG., P.O.Box 2428, 53014 Bonn, Germany

Verlag Deutscher Wirtschaftsdienst, Marienburger Strasse 22, 50968 Cologne, Germany

Verlag Peter Lang GmbH., Eschbornerlandstr. 42-50, 60489 Frankfurt am Main, Germany

Verlag Dr. Peter Mannhold, Üchendorfer Strasse 88, 45886 Gelsenkirchen, Germany

Verlag Franz Vahlen GmbH., Wilhelmstrasse 9, 80801 Munich, Germany

Verlag Weltarchiv GmbH., Jungfernsteig 21, D-2000 Hamburg 36, Germany

GREECE

Coopers & Lybrand, Abacus House, 9 Semitelou Street, 155 28 Athens, Greece

GUERNSEY

Pannel Kerr Forster, P.O.Box 296, Suites 13-15, Sarnia House, Le Truchot, St. Peter Port, Guernsey, CI.

HONG KONG

The Economist Intelligence Unit, 10th Fl., Luk Kwok Centre, 72 Gloucester Road, Hong Kong

The Hong Kong & Shanghai Banking Corporation, Level 8, 1 Queen's Road Central, Hong Kong

Ta Kung Pao, 7/8., 342 Hennesy Road, Hong Kong

INDIA

Company Law Institute of India, 88 Thyagaraya Road, Madras 60017, India

Eastern Book Co. Publishing PVT Ltd, Manav Law House, 2A Strachey Road, Civel Lines, Allahabad, India

Eastern Law House, 54 Ganesh Chunder Avenue, Calcutta 700013, India

Current Tax Bulletin, P-16, C.I.T. Road, Calcutta 700014, India

Intax Publications Private Ltd., Regd. Office: 368 Lajpat Nagar, Jalandhar 144001, India

Law Publishers, Sardar Patel Marg, P.O.Box 1077, Allahabad 211011, India

Nabhabrota Publishers, 29 C Kalimuddin Sarkar Lane, P.O.Box 167, Calcutta 700010, India

Orient Law House, P.O.Box 1-094, OPP High Court, Allahabad 211011, India

Taxmann Publication Private Ltd., 1871 Kucha Chelan, Khari Baoli, Dehli 110006, India

N.M. Tripathi Private Ltd., 164 Samaldas, Gandhi Marg., Bombay 400002, India

INDONESIA

Berita Pajak, J.L. Jend. Gatot Subroto No.4, Jakarta Selatan, Indonesia

INTERNATIONAL

Coopers & Lybrand, 1251 Avenue of the Americas, New York, N.Y. 10020, U.S.A.

Deloitte & Touche, 1114 Avenue of the Americas, New York, N.Y. 10036, U.S.A.

Ernst & Young International, 787 Seventh Avenue, New York, N.Y. 10019, U.S.A.

KPMG International Headquarters, P.O. Box 74111, 1070 BC Amsterdam, The Netherlands

Official Publications of the European Communities, 5 rue du Commerce, 2985 Luxembourg, Luxembourg

Organistation for Economic Co-operation and Development, 2 rue André Pascal, 75775 Paris, France

Price Waterhouse & Co., 1251 Avenue of the Americas, New York, N.Y. 10020, U.S.A.

Touche Ross International, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom

United Nations Economic and Social Commission, for Asia and the Pacific (ESCAP), U.N. Building, Raiadamnern Avenue, Bangkok 10200, Thailand

United Nations, New York, N.Y.10017, U.S.A.

The World Bank, 1818 H. Street N.W., Washington DC 20433, U.S.A.

IRELAND

Butterworth Ireland Ltd., 26 Upper Ormond Quay, Dublin 7, Ireland

Government Publications Sale Office, Sun Alliance House, Molesworth Street, Dublin 2, Ireland

In-Depth Publishing Ltd., Alton House, Herbert Steet, Dublin 2, Ireland

The Institute of Taxation in Ireland, 15 Fitzwilliam Square, Dublin 2, Ireland

© 1994 International Bureau of Fiscal Documentation

KPMG Stokes Kennedy Crowley, 1 Stokes Place, Dublin 2, Ireland

ISRAEL

A.G. Publications Ltd., P.O.Box 8100, 91080 Jerusalem, Israel

Kesselman & Kesselman, Certified Public Accountants, 37 Montefiore St. , 65201 Tel-Aviv, Israel

ITALY

Arthur Young International, Via del Pozzetto 105, 00187 Rome, Italy

CEDAM S.A., Via Jappelli 5, 35121 Padova, Italy

Dott. Antonio Giuffrè Editore S.p.A., Via Statuto 2 , 20121 Milano, Italy

IPSOA, S.p.A., Largo Augusto 8, 20122 Milano, Italy

JAPAN

Ministry of Finance, 3-1-1- Kasumigaseki, Chiyoda-Ku, Tokyo 100, Japan

Zaikeo Shoho Sha, 1-2-14 Higashi Shimbashi, Minato-Ku, Tokyo , Japan

LUXEMBOURG

Official Publications of the European Communities, 5 rue du Commerce, 2985 Luxembourg, Luxembourg

Imprimerie Saint-Paul, P.O.Box 1908, 2 rue Chr. Plantin, Luxembourg, Luxembourg

NMB Trust Company Ltd., 64-66 Avenue Victor Hugo, P.O.Box 2383 , 1023 Luxembourg, Luxembourg

NETHERLANDS

Annoventura/Elsevisier Science Publishers B.V., P.O. Box 211, Hoogoorddreef 60, 1000 AE Amsterdam, the Netherlands

FED B.V., P.O.Box 23, 7400 GA Deventer, the Netherlands

ITA-International Tax Academy, c/o International Bureau of Fiscal Documentation, Sarphatistraat 600-618, P.O.Box 20237, 1000 HE Amsterdam, the Netherlands

Gouda Quint B.V./D. Brouwer & Zn., Postbus 1148, 6801 MK Arnhem, the Netherlands

KPMG Meijburg & Co., KPMG Peat Marwick, Burgermeester Rijnderslaan 10-20, 1185 MC Amstelveen, the Netherlands

Kluwer B.V., P.O.Box 23, 7400 GA Deventer, the Netherlands

Marinus Nijhoff Publishers, P.O.Box 566, 2501 CN The Hague, the Netherlands

Ministry of Finance, P.O.Box 20201, 2500 EE The Hague, the Netherlands

Moret, Ernst & Young, Jan Willem Frisolaan 13, 2517 JS 's Gravenhage, the Netherlands

Noorduijn B.V., P.O.Box 1148, 6801 MK Arnhem, the Netherlands

Price Waterhouse & Co., Strawinskylaan 3127, 1077 ZX Amsterdam, the Netherlands

SDU Uitgeverij, Postbus 20014, 2500 EA The Hague , the Netherlands

Samsom Uitgeverij B.V., P.O.Box 4 , 2400 MA Alphen a/d Rijn, the Netherlands

VUGA B.V. Uitgeverij, P.O.Box 16063, 2500 AC The Hague, the Netherlands

W.E.J. Tjeenk Willink, P.O.Box 25, 8000 AA Zwolle, the Netherlands

Wolters-Noordhoff, P.O.Box 58, 9700 MB Groningen, the Netherlands

NEDERLANDS ANTILLES,

Corporate Trust N.V., P.O.Box 816, Curaçao

NEW ZEALAND

Butterworths of New Zealand Ltd., P.O.Box 472, Wellington 1, New Zealand

Commerce Clearing House New Zealand Ltd., 17 Kahika Road, Beach Haven, Auckland 10, New Zealand

Institute of Policy Studies, Victoria University of Wellington, Private Bag , Wellington, New Zealand

NORWAY

Jacob Jaroy, Torgeir Vraasgt. 18, 3700 Skien, Norway

Norsk Skattebetalerforening, P.O.Box 313, Oslo 1, Norway

PAKISTAN

Tax Publications (Ptv) Ltd., Salam Chambers, 22 Link McLeod Road, P.O.Box 354, Lahore, Pakistan

PANAMA

Centro Interamericano de Administradores Tributarios/Inter-American Center of Tax Administrators, Apartado 2129, Panamá 9A, Panamá

PAPUA NEW GUINEA

Institute of National Affairs Inc., P.O.Box 1530, Port Moresby, Papua New Guinea,

PERU

Editorial Economías y Finanzas, Las Orquideas 435, Lima, Peru

SINGAPORE

APTIRC – Asian Pacific Tax and Invesment Research Centre, 257 Selegie Road, 09-275, Selegie Complex, Singapore 0718, Singapore

Federal Publications Ltd., 2 Jurong Port Road, Singapore 2261, Singapore

Longman Singapore Publishers Ltd., 25 First Yand Road, Singapore 2262, Singapore

Oxford University Press, Unit 221, 4 Ubi Avenue, Singapore 1440, Singapore

Singapore International Chamber of Commerce, 6 Raffles Quay, Denmark House, Singapore 0104, Singapore

SOUTH AFRICA

Butterworths Professional Publishers (Pty) Ltd., 8 Walter Place, Waterval Park, Mayville, Durban 4091, South Africa

Juta & Co Ltd., P.O.Box 14373, Kenwyn 7790, South Africa

Old Mutal, P.O.Box 66, Cape Town, South Africa

SPAIN

Deutsche Handelskammer für Spanien, Córcega 301-303, 08008 Barcelona, Spain

Editorial Praxis, Via Layetana 30, 08003 Barcelona, Spain

Instituto de Estudios Fiscales, Casado del Alisal 6, Madrid 14, Spain

T.A.L.E., Maudes 51, Madrid 3, Spain

SWEDEN

P.A. Norstedt Förlag, P.O.Box 2052, 103 12 Stockholm, Sweden

SWITZERLAND

Business International, 12 – 14 chemin Rieu, 1208 Geneva, Switzerland

Cosmos Verlag AG, Oberer Wehrliweg 5, 3074 Muri-Bern, Switzerland

Paul Haupt Verlag, Falkenplatz 14, 3001 Bern, Switzerland

© 1994 International Bureau of Fiscal Documentation

Organisator Verlag AG, Löwenstrasse 16, 8021 Zürich, Switzerland

Schulthess Polygraphisher Verlag, Zwingliplatz 2 , Zürich 1, Switzerland

Seminar Services SA, boulevard de Pérolles 7A, 1700 Fribourg, Switzerland

Verlag Peter Lang, Jupiterstrasse 15, 3015 Bern, Switzerland

Verlag für Recht und Gesellschaft AG, Wallstr. 14, P.O.Box 646, 4010 Basel, Switzerland

TAIWAN

China External Trade Development Council, 9th & 10th Fl., 201 Tun Hwa North Road, Taipei 105, Taiwan

Industrial Development and Investment Centre, 10th Fl., 7 Roosevelt Road, Sec.1, Taipei, Taiwan

Ministry of Economic Affairs, 15 Foo Chow Street, Taipei, Taiwan

UNITED KINGDOM

Arthur Andersen & Co., 1 Surrey Street, London WC2R 2PS, United Kingdom

Binder Hamlyn, 8 St. Bride Street, London ECA 4DA, United Kingdom

Bowker-Saur Ltd., Borough Green, Sevenoaks, Kent TN15 8PH, United Kingdom

Butterworth & Co.(Publishers) Ltd., Borough Green, Sevenoaks, Kent TN15 8PH, United Kingdom

CATA – The Commonwealth Association of Tax Adminstrators, c/o Commonwealth Secr., Marlborough House , Pall Mall, London SW1Y 5HX, United Kingdom

The Chartered Association of Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE , United Kingdom

CCH Editions Limited, Tax, Business and Law Publishers, Telford Road, Bicester, Oxfordshire OX6 OXD, United Kingdom

J.F. Chown & Company Ltd., 51 Lafone Street, London SE1 2LX, United Kingdom

Croom Helm Ltd. Publishers, Provident House Burrell Row, Beckenham, Kent BR3 1AT, United Kingdom

The Economist, Intelligence Unit, 40 Duke Street, London W1A 1DW, United Kingdom

Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, United Kingdom

Europa Publications Ltd, 18 Bedford Square, London WC1B 3JN, United Kingdom

Eurostudy Publishing Co. Ltd., 36-38 Willesden Lane, London NW6 7SW, United Kingdom

Financial Times Business Information, Tower House, Southampton Street, London WC2E 7HA, United Kingdom

Gee (A division of Professional Publishing Ltd.), South Quay Plaza, 183 Marsh Wall, London E14 9FS, United Kingdom

Gower Publishing Co. Ltd., Gower House, Croft Road, Aldershot, Hampshire GU11 3HR, United Kingdom

Graham Bannock & Partners Ltd., 53 Clarewood Court, Crawford Street, London W1H 5DF, United Kingdom

Graham & Trotman, Sterling House, 66 Wilton Road, London SW1V 1DE, United Kingdom

Grant Thornton, Melton Street, Euston Square, London NW1 2EP, United Kingdom

H.F.L. (Publishers) Ltd., 9 Bow Street, London WC2E 7AL, United Kingdom

Her Majesty's Stationery Office, 49 High Holborn, London WC1V 6HB, United Kingdom

Inland Revenue, West Wing, Somerset House, London WC2R 1LB, United Kingdom

The Institute for Fiscal Studies, 3rd Floor, 7 Ridgmount Street , London WC1E 7AE, United Kingdom

Institute of Taxation, 12 Upper Belgrave Street, London SW1X 8BB, United Kingdom

John Wiley & Sons Ltd., Baffins Lane, Chichester, West Sussex PO19 1UD, United Kingdom

KMG Thomson McLintock, 70 Finsbury Pavement, London EX2A 1SX, United Kingdom

The Law Society's Hall, 113 Chancery Lane, London WC2A 1PL, United Kingdom

Lloyd's of London Press Ltd., Legal Publishing and Conferences Division, One Singer Street, London EC2A 4LQ, United Kingdom

Longman Group UK Limited, 21-27 Lamb's Conduit Street, London WC1N 3NJ, United Kingdom

Oxford University Press, Walton Street, Oxford OX2 6DP, United Kingdom

Francis Pinter Publishers, 25 Floral Street, Covent Garden, London WC2E 9DS, United Kingdom

Pitman Publishing (A division of Longman Group UK Ltd.), 128 Long Acre, London WC2E 9AN, United Kingdom

Price Waterhouse, Southwark Towers , 32 London Bridge Street, London SE1 9SY, United Kingdom

Professional Publishing Ltd., 7 Swallow Place, London W1R 8AB, United Kingdom

Routledge, 11 New Fetter Lane, London EC4P 4EE, United Kingdom

Sweet & Maxwell Limited, South Quay Plaza, 183 Marsh Wall, London E14 9FT, United Kingdom

Taxation Publishing Co., Ltd., 17 Scarbrook Road, Croydon CR0 1SQ, United Kingdom

Tolley Publishing Co Ltd., Tolley House, 2 Addiscombe Road, Croydon, Surrey CR9 5AF, United Kingdom

Touche Ross International, Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom

World of Information, 21 Gold Street , Saffron Walden, Essex CB1O 1EJ, United Kingdom

USA

American Bar Association, 1155 East 60th Street, Chicago, Illinois 60637, USA

Matthew Bender & Co. Inc., P.O.Box 220030, Albany, N.Y. 12201-2030, USA

R.R. Bowker Company, a division of Reed Publishing (USA) Inc., 245 West 17th Street, New York 10011, USA

The Brookings Institution, 1775 Massachusetts Avenue, N.W. Washington D.C. 20036, USA

The Bureau of National Affairs Inc., 1250 23rd Street, N.W. Washington D.C. 20077-6742, USA

Coopers & Lybrand, 1251 Avenue of the Americas, New York, N.Y. 10020, USA

Commerce Clearing House Inc., 2700 Lake Cook Road, Riverwoods, Ill. 60015, USA

D.C. Heath and Company, Lexington Books, 125 Spring Street, Lexington, Mass. 02173, USA

DRT (Deloitte Ross Tohmatsu) International, 1633 Broadway, New York, NY 10019-6754, USA

The Economist Intelligence Unit, 215 Park Avenue South, New York, N.Y. 10003, USA

Ernst & Young, 787 Seventh Avenue, New York, N.Y. 10019, USA

Federation of Tax Administrators, 444 North Capitol Street, Washington D.C. 20001, USA

Government Printer, North Capitol and HSts. N.W., Washington, D.C. 20401, USA, Hoover Institution, Stanford University, Stanford CA 94305, USA

International Monetary Fund, Washington, D.C. 20431, USA

© 1994 International Bureau of Fiscal Documentation

Klynveld Main Goerdeler, Park Avenue Plaza, 55 East 52nd Street, New York, N.Y. 10055, USA,

RIA – Research Institute of America Inc., 90 Fifth Avenue, New York, N.Y. 10011, USA

Metropolitan Studies Program, Maxwell Graduate School, Syracuse University, 400 Maxwell Hall, Syracuse, New York 13244-1090, USA

National Bureau of Economic Research, 1050 Massachusetts Avenue, Cambridge, MA 02138, USA

Oceana Publications, Dobbs Ferry, New York, N.Y. 10522, USA

Practising Law Institute, 810 Seventh Avenue, New York N.Y. 10019, USA

Ross & Hardies, 150 North Michigan Avenue, Chicago, I11. 60601, USA

Tax Analysts, 6830 North Fairfax Drive, Arlington, Virginia 22213, USA

Tax Management Inc., 1231 NW 25 Street, Washington, D.C. 20037, USA

Touche Ross International, One World Trade Center, Suite 9300, New York N.Y. 10048, USA

University Microfilms International, 300 N Zeeb Road, Ann Arbor, M1 48106, USA,

Warren, Gorham, Lamont, 31 St. James Avenue, Boston, Mass.02116-4112, USA

West Publishing Co. , 50 West Kellogg Boulevard, P.O.Box 64526, St. Paul, Minnesota 55164-1003, USA

VENEZUELA

Legislación Económica Ltda., Torre Phelps, Piso 15, Plaza Venezuela, Caracas, Venezuela

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

JANUARY 1994

Current Transfer Pricing Issues affecting Europe and the U.S.A., Brussels, 27-28 January 1994 (English):

VLEKHO, Koningsstraat 336, B – 1210 Brussels, Belgium, Tel.: 322-221 1211, Fax: 322-219.7879.

Principles of International Taxation, Amsterdam, 31 January-4 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

FEBRUARY 1994

22nd International Company Lawyers' Conference, Barcelona, 9-11 February 1994 (English, Spanish and French):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Essential Tax Planning for Groups of Companies, London, 15-16 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

2nd Caribbean Tax Conference, Cancún, 17-18 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Death and Taxes in Europe, Amsterdam, 21-22 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

International Transfer Prices between Companies, Düsseldorf, 23 February 1994 (German).

Verlag Dr. Otto Schmidt, Postbox 51 10 26, 50946 Koln, Germany. Tel.: 0221/93738-419, Fax: 0221-93738-941.

© 1994 International Bureau of Fiscal Documentation

New

The Taxation of

PERMANENT ESTABLISHMENTS

This looseleaf publication is the most in-depth and comprehensive treatment of the practical and theoretical aspects of permanent establishments available.

A detailed commentary section written by leading international tax experts offers explanation and analysis of international tax law provisions from the OECD and EC. This is followed by a series of individual country chapters giving full information on the establishment and operation of permanent establishments in a wide range of countries. Virtually all OECD member countries will be included. Each country chapter is written by a local specialist and covers:

- Description of resident and non-resident tax liability
- Definition of 'permanent establishment' in national law and tax treaties
- Practical aspects of setting up a permanent establishment
- Details of the tax treatment of permanent establishments: taxation of income, avoidance of double taxation and setting off of losses
- Items of special interest from a practical and/or theoretical viewpoint
- Principle differences between inward and outward investment via a permanent establishment and operation via a subsidiary
- Taxation of personnel employed in a permanent establishment

Chapters on EC Member States also include the effect of EC tax measures.

The looseleaf comes in a single convenient volume, which will be updated twice a year. 1994 subscriptions are inclusive of 1994 updates and supplements, which will include additional country chapters as the book expands.

NLG 1,200

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 2 FEBRUARY 1994

NEW ZEALAND:

TAXATION OF NON-RESIDENT EQUITY INVESTMENT IN NEW ZEALAND: UNILATERAL EXTENSION OF DOMESTIC IMPUTATION REGIME TO NON-RESIDENT PORTFOLIO INVESTORS 59

Andrew M.C. Smith

As part of its ongoing international tax reform programme the New Zealand government recently enacted a new tax regime which applies to non-resident equity portfolio investors. The new regime is designed to extend to such investors some of the tax relief currently provided to domestic shareholders under New Zealand's dividend imputation regime.

PEOPLE'S REPUBLIC OF CHINA:

NEW INDIVIDUAL INCOME TAX – UNIFIED TAXATION OF CITIZENS AND FOREIGNERS 64

Jinyan Li

On 31 October 1993 the Individual Income Tax Law of the PRC was promulgated to become effective as of 1 January 1994. This article explores the rationale for the promulgation of the new tax and examines its major provisions, focusing on the variations from previous laws and the implications for taxpayers.

INTERNATIONAL:

MODERNIZATION OF TAX ADMINISTRATIONS: REVENUE BOARDS AS AN INSTRUMENT FOR CHANGE 75

Glenn P. Jenkins

Countries throughout the world are embarking on major changes in their fiscal and trade policies. These new policies present administrative challenges for the public sector that can only be met if a fundamental reform of the administrations of taxation systems takes place. This paper explores the potential of using autonomous revenue authorities to carry out the main functions of tax administration, and outlines the regulatory guidelines needed for such an authority to operate with efficiency and integrity. It also explores the possibilities that efficiency might be enhanced if many of the routine functions vested upon the tax administration were privatized. The experiences of a number of developed and developing countries with autonomous revenue authorities are reviewed.

BOTSWANA:

DOUBLE CORPORATE TAX: UNTANGLING THE UNDERGROWTH OF COMPANY AND SHAREHOLDER TAX RULES 82

Peter Nanyenya Takirambudde

This article examines the background and content of the amendments to corporate tax, suggesting that the recent changes reflect a major shift in economic policy and strategy on the part of the Government.

FRANCE:

THREE PERCENT TAX ON REAL ESTATE IN FRANCE 89

Pierre-Jean Douvier

The 1993 Finance Act introduced a number of amendments to the 3 percent real estate tax, and in October 1993 the tax authorities issued a Guideline which clarifies how the tax will be applied. This article analyses the new provisions in light of the Guideline.

MALAYSIA:

THE 1994 BUDGET AND RECENT DEVELOPMENTS – THE PATH TO SUSTAINABLE GROWTH 94

Veerinderjeet Singh

This article examines various measures introduced in the 1994 budget and finance bill with regard to direct and indirect taxation.

© 1994 International Bureau of Fiscal Documentation

BIBLIOGRAPHY
– Books 103
– Looseleaf services 107

CONFERENCE DIARY 81

CUMULATIVE INDEX 109

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

NEW ZEALAND:

TAXATION OF NON-RESIDENT EQUITY INVESTMENT IN NEW ZEALAND: UNILATERAL EXTENSION OF DOMESTIC IMPUTATION REGIME TO NON-RESIDENT PORTFOLIO INVESTORS

Andrew M. C. Smith
Senior Lecturer in Accountancy,
Faculty of Commerce and Administration, Victoria University of Wellington.

I. INTRODUCTION

As part of its ongoing international tax reform programme the New Zealand government recently enacted a new taxing regime applying to non-resident equity portfolio investors. The new regime is designed to extend to non-resident equity investors some of the tax relief currently provided to domestic shareholders under New Zealand's dividend imputation regime introduced in 1988.[1] These new provisions follow from the removal of withholding taxes on interest paid to non-residents in 1991 and are consistent with principles laid out in an international tax policy document released in 1991.[2]

The new regime for non-residents has been designed to ensure that the tax relief provided in New Zealand will not be clawed back by foreign governments in the investor's home country under foreign tax credit provisions. In this regard it appears the new regime will be successful in ensuring that non-resident investors enjoy increased after-tax returns from their New Zealand investments.

II. THE OLD REGIME

Until 1988 New Zealand taxed companies using the classical approach which gave rise to double taxation of distributed corporate earnings. Dividends paid to non-residents were subject to a final non-resident withholding tax (NRWT) of 30 percent. Dividends paid to investors resident in countries with which New Zealand had concluded a double tax agreement (DTA) were subject to a reduced rate of withholding tax normally at a rate of 15 percent.[3]

In April 1988 a comprehensive dividend imputation regime was introduced which relieved double taxation for domestic investors in respect of taxes paid in New Zealand. However, the benefits of imputation (insofar as a source country can unilaterally determine the total tax burden of a non-resident) were expressly denied to non-residents.[4] No changes were made to the tax treatment of non-residents and the NRWT provisions continued to apply. As a result, non-resident investors suffered a much higher overall tax burden than did resident investors as is shown in the following table:

	NZ Resident Shareholders	*DTA Country Shareholders*	*Non-DTA Country Shareholders*
Pre-tax income	$1,000	$1,000	$1,000
less company tax @ 33%	330	330	330
Net profit after tax	$ 670	$ 670	$ 670
Dividend paid to shareholder	$ 670	$ 670	$ 670
plus imputation credit	330	nil	nil
Gross dividend	$1,000	$ 670	$ 670
less tax @ 33%	330	nil	nil
less NRWT 15%/30%	330	101	201
Net return after NZ tax	$ 670	$ 569	$ 469
Effective NZ tax rate:	33.0%	43.1%	53.1%

Since 1988 there had been widespread criticism about the continued imposition of NRWT on dividends paid with imputation credits attached especially in light of the government's objectives to encourage foreign investment. When a similar dividend imputation regime was introduced in Australia, NRWT on dividends paid with full imputation credits attached was unilaterally removed. As a result, many dividends paid by Australian companies to both portfolio and direct non-resident investors are paid free of withholding tax.

The New Zealand imputation regime (along with the Australian regime) provides for imputation at a variable rate[5] unlike the fixed rate basis used in the United Kingdom under the advance corporation tax. Therefore the variable rate system prima facie would allow streaming arrangements where imputation credits would only be attached to dividends paid

1. For detailed explanation of New Zealand's imputation regime, see A.M. Smith, "Comprehensive Dividend Imputation, Neutrality and Double Taxation Of Corporate Profits", *Bulletin For International Fiscal Documentation* (October 1993), at 568.
2. *Taxing Income Across International Borders: A Political Framework*, New Zealand Government (1991).
3. The main exceptions are India (20%) and the Philippines (15% for companies and 25% for all others).
4. Per Sec. 390(2)(b)(i) of the Income Tax Act 1976.
5. The minimum rate of imputation is 0%, the maximum is 49.25%, which is the corporate tax rate of 33% grossed up by the following formula:

$$\frac{0.33}{1-0.33} = 49.25\% \text{ (Sec. 394 G(1))}$$

In Australia the dividend is split into two components, one being fully imputed ("franked"), the other not.

© 1994 International Bureau of Fiscal Documentation

to resident shareholders while dividends paid to non-residents would be without imputation credits. With the potential for such arrangements, the imputation regime has complex anti-avoidance provisions to prevent dividend streaming techniques. These include requirements to attach imputation credits at the same rate[6] to all dividends paid during an imputation year[7] unless certain restrictive conditions are met. "Stapled-stock" arrangements are also subject to sanctions.[8]

However, under the imputation regime introduced in 1988 a more favourable treatment was accorded to foreign dividends received by New Zealand companies and distributed onto non-resident shareholders. This treatment is maintained for non-resident portfolio shareholders under the new regime discussed in this article.

Foreign dividends passed through New Zealand companies to non-resident shareholders have in effect only New Zealand NRWT imposed upon them, avoiding an additional layer of New Zealand corporate income tax. When foreign dividends are received by a New Zealand company they are subject to an inwards withholding tax known as foreign dividend withholding payments.[9] When these foreign dividends are subsequently distributed by the New Zealand company to shareholders, the "withholding payments" can be passed on to all shareholders in the form of a "withholding payment credit" attached to the dividend in a similar way as imputation credits are. In the case of non-resident shareholders, any withholding payment credit attached to a dividend and any excess is refundable to non-resident shareholders.[10]

III. THE NEW PROVISIONS

In early August the Government announced it would reduce taxes imposed on dividends paid by New Zealand companies to non-resident portfolio investors (being investors with less than a 10 percent stake in a New Zealand company, i.e. passive investors). Unusually, instead of reducing the rates of NRWT, the relief is to be provided at the corporate tax level and NRWT upon dividends will continue at the existing rates.

The tax relief is provided to the company conditional upon the payment of an additional dividend to the non-resident investor (known as "supplementary dividend").[11] This increases the total dividend paid to the non-resident shareholder and also the amount of NRWT payable. The amount of the tax credit (and hence the supplementary dividend) is determined by the amount of imputation credits attached to the dividend.

The following example shows how the new regime is intended to apply (assuming that in columns 2 and 3 all shareholders are non-resident portfolio ones):

	NZ Resident Shareholders	*DTA Country Shareholders*	*Non-DTA Country Shareholders*
(1) *Company Level*			
Pre-tax income	$1,000	$1,000	$1,000
less company tax @ 33%	330	330	330
plus tax credit	nil	118	118
Net profit after tax	$ 670	$ 788	$ 788
(2) *Dividend Declared*			
Gross dividend	$ 670	$ 670	$ 670
Imputation credits	330	212	212
Supplementary dividend	nil	118	118
(3) *Shareholder Taxation*			
Dividend paid to shareholder	$ 670	$ 670	$ 670
Supplementary dividend	nil	118	118
plus imputation credits	330	nil	nil
Total gross dividend	$1,000	$ 788	$ 788
less income tax upon resident shareholders	330	n/a	n/a
less NRWT @ 15%/30%	n/a	118	236
Net return after NZ tax	$ 670	$ 670	$ 552
Effective NZtax rate :	33.0%	33.0%	44.8%

The reason that tax relief is provided to non-resident shareholders by way of a supplementary dividend and the continued imposition of NRWT is to maximize any foreign tax credits or NRWT the shareholders will receive in their home country. If tax relief had been provided by merely reducing or eliminating NRWT (as was done in Australia when dividend imputation was introduced there) the New Zealand tax forgone would have resulted in more tax paid offshore, leaving the non-resident investors with very little overall advantage.[12] The following table shows this effect:

Facts: Non-resident investor receives a dividend from a New Zealand company. The taxpayer's marginal tax rate in his home country is 40 percent.

	NRWT and no tax relief (New Zealand approach to September '93)	*Removal of NRWT (Australian approach)*	*Supplementary Dividend and NRWT (New Zealand approach from October '93)*
Gross dividend	$ 670	$ 670	$ 670
less tax @ 40%	$ 167 §	$ 268	$ 197 *
less foreign tax credit	101	nil	118
Net dividend	$ 402	$ 402	$ 473

§ Calculated as ($ 670 x 40%) less foreign tax credit of $ 101.
* Calculated as ($ 788 x 40%) less foreign tax credit of $ 118.
Increase in after-tax income 17.7%

6. Sec. 394G.
7. Being 1 April to 31 March regardless of the company's fiscal year.
8. Sec. 394 ZG.
9. A number of existing DTA's requires New Zealand to exempt from tax dividends paid by a company in the other contracting state to New Zealand companies. This withholding tax in effect taxes incoming foreign dividends without overriding these DTA obligations.
10. Sec. 394ZQ. This is to be contrasted with imputation credits which cannot be refunded to any shareholder and are not taken into account when calculating NRWT on dividends paid to non-residents.
11. Sec. 308A(1) and (2).
12. The advantage would only arise where the non-resident shareholder was in an excess credit position, exempt from tax or facing some regime where it was preferable to substitute domestic tax for foreign tax (as under most dividend imputation regimes).

© 1994 International Bureau of Fiscal Documentation

Aggregate Tax Breakdown:

New Zealand tax	$ 431	$ 330	$ 330
Foreign tax (home country)	167	268	197
Total tax paid:	$ 598	$ 598	$ 527

Thus the relief provided by New Zealand is maintained in the hands of the non-resident shareholder. The foreign government also collects more tax (from $ 167 to $ 197). There seems little reason why foreign countries should react negatively to the New Zealand supplementary dividend method as they will collect more tax in their countries which is borne by the New Zealand Government.

This regime applies to dividends paid from the end of September 1993.

IV. LEGISLATION AND ANTI-AVOIDANCE PROVISIONS

While the principle behind the new regime is simple, the legislation enacting the regime is deceptively complex.

Firstly, the regime is available only to "non-resident portfolio investors" and there are a number of provisions to ensure that the relief is not extended to direct investors. A "non-resident portfolio investor" is defined as a non-resident[13] with a voting interest of less than 10 percent in the company or if the company is listed, if the "market value interest" of the shareholder is also less than 10 percent.[14] Interests of "associated persons"[15] are aggregated together for the purposes of the 10 percent rule. In this respect the regime is much tighter than the "approved issuer levy" regime which applies to interest income derived by non-residents.

Companies paying dividends are required to seek written confirmation from non-resident shareholders that they are eligible to be deemed "non-resident portfolio investors".[16] Such persons must not be "associated with the company" and the company must not have reasonable grounds for believing that the person is not a "non-resident portfolio investor".[17]

If a dividend is paid to a non-resident shareholder and the company receives a refund of income tax on the basis that the shareholder was a "non-resident portfolio investor" when he was not eligible, the shareholder becomes liable for the tax credit given to the company and associated tax penalties under Section 398.[18] The company's liability in respect of the tax avoided it would otherwise have as a deemed agent of the non-resident shareholder under Section 283 is also removed, provided the company did "not have reasonable grounds" for believing that the shareholder is not a non-resident portfolio investor.[19]

The exact mechanism for calculating the company's tax credit is complex as the provisions have to interface with anti-streaming rules under the existing dividend imputation regime. Under Section 308A(7) two important modifications to these rules are made. Firstly, for the purposes of streaming rules the "supplementary dividend" is ignored. Thus implicitly the company paying the dividend is not required to (and would not want to) attach imputation credits to any supplementary dividend paid to portfolio non-resident shareholders. Secondly, the maximum imputation ratio and the benchmark dividend ratio are to be calculated as if the imputation credit attached to the dividend is increased by the amount of the tax credit granted to the company. Thus the maximum imputation ratio must take into account the tax credit as well as the imputation credits therefore requiring that dividends paid to portfolio non-resident investors have imputation credits attached at a different rate than those paid to other investors. This is permissible as the tax credits are treated as imputation credits for the purposes of the streaming rules.

Under Section 308A(2) the special credit is calculated at a rate of 0.5583 of the imputation credits attached to the dividend if *no* dividend withholding payment credits are attached to the dividend. If dividend withholding payment credits are attached to the dividend the credit is 0.5583 of the following formula:

Imputation Credit - [((a-b) x c) - b]

Where:

a = the "dividend withholding payment portion" of the dividend, which is the amount of the dividend withholding payment credits divided by the rate of NRWT applicable to the dividend;

b = the dividend withholding payment credit;

c = the imputation ratio of dividends paid to other shareholders of the maximum imputation ratio.

The maximum imputation credit ratio for a dividend paid to a non-resident portfolio investor is as follows:

$$\frac{\text{Maximum rate of } 49.25}{1 + 0.5583} = 31.607\%$$

Thus in the case of a dividend of $ 67 which is paid to resident shareholders with full imputation credits attached (being $ 33 - the maximum imputation rate of 49.25%) the maximum imputation credit which can be attached to dividends paid to the non-resident portfolio shareholders will be $ 21.18 ($ 67 x 31.60%). The company will be entitled to a credit of $ 11.82 ($ 21.18 x 0.5583). When the tax credit and the imputation credits are combined ($ 21.18 + $ 11.82) they equal $ 33 which is the same as the imputation credits attached to dividends paid to other shareholders. Therefore compliance with the benchmark and maximum imputation ratio rules required under Sections 394 G and 394 ZG is maintained.

The credit is offset against the income tax payable by the company for that income year. If there is insufficient income tax to offset such credits, refunds can be made from income tax paid in the previous four income years. The refund will give rise to a debit in the imputation account which is com-

13. Determined under Sec. 241.
14. Sec. 308A(1). Voting interests and market value interests are calculated under Secs. 8C and D, respectively.
15. Defined in Sec. 245B. The Act contains different definitions of "associated persons" applying to different parts of the Act and this particular definition is the most demanding of those contained in the Act.
16. Sec. 308A(5)(a)(ii).
17. Sec. 308A(5)(b) and (d).
18. Sec. 308A(6).
19. *Id.*

© 1994 International Bureau of Fiscal Documentation

pensated by the dividends paid to non-resident portfolio shareholders having less maximum imputation credits attached to them in the first place.

The following example shows how the credit is applied where the dividend has both imputation and dividend withholding payment credits attached at a combined imputation rate below the maximum of 49.25 percent.

Facts: A dividend of $ 80 is paid.
For resident shareholders dividend withholding payment credits of $ 8 and imputation credits of $ 12 are attached.
For non-resident portfolio shareholders dividend withholding payment credits of $ 8 and imputation credits of $ 7.27[20] are attached.

The supplementary dividend is calculated as follows:

(i) Firstly, the dividend withholding payment portion of the dividend is:

$$\frac{\$\,8}{15\%} = \$\,53.33$$

(ii) The amount of the credit is as follows:

$$0.5583 \times [\$\,7.27 - [((\$\,53.33 - \$\,8) \times \left(\frac{\$12}{\$80}\right)) - \$8]] = \$\,4.73$$

When the supplementary dividend of $ 4.73 is added to the imputation credits of $ 7.27 an overall imputation ratio of

$$15\% \left(\frac{\$12}{\$80}\right)$$

is obtained.

This is the same as imputation ratio applying to domestic shareholders of also

$$15\% \left(\frac{\$12}{\$80}\right)$$

As the regime requires that companies pay different levels of dividends to shareholders depending on whether they qualify for the new regime or not it appears to conflict with company law requirements that all shareholders of the same share class be paid dividends at the same rate. While it would theoretically be possible for different classes of shares to be issued for the purposes of the regime, in the case of widely-held companies listed on a stock exchange it would be highly impractical. Therefore Section 308A(8) provides that if a company pays a supplementary dividend to certain shareholders of a particular class of shares, that differential payment will not be regarded as contravening any provisions of the Companies Act 1955 or Section 45 of the Companies Act 1993, nor any provision of a company's articles of association or constitution nor any other rules of law which otherwise would prevent dividends being paid to shareholders of the same class of shares at different rates.

V. OTHER EQUITY INVESTORS

The above relief for non-resident investors only applies to portfolio investors. Direct investors (those investors with interests above 10 percent) still face the imposition of NRWT. At the time the above proposals were announced the Minister of Finance stated that the position of direct investors was further being considered. This was dependent on the Government examining "the effectiveness and appropriateness of existing rules governing the taxation of direct investment by non-residents, including transfer pricing and thin capitalization rules, before proceeding further."[21]

The Minister of Revenue first announced in October 1991 that the Government wished to review transfer pricing and thin capitalization, and the above statement by the Minister of Finance restates the Government's position. It is hoped that the review of the taxation of direct investment (along with any consideration of transfer pricing and thin capitalization rules) is being given a high priority as such statements serve to raise uncertainty in the minds of both potential and current foreign direct investors as to what taxing regime they may face in future. Given the Government's stated policy to encourage foreign investment it would seem highly desirable that this matter be clarified as soon as practical.

VI. CAPITAL GAINS

The new regimé for dividends paid to non-resident portfolio investors covered in this article does not change the taxing regime applying to capital gains derived by them from shares in New Zealand companies.

While New Zealand has no comprehensive capital gains tax, certain gains of a capital nature may be taxed as ordinary income. Non-residents face the same taxing provisions as do residents in this regard where the property in question was situated in New Zealand.

Gains from the sale or disposition of shares are taxable under any one of three limbs of Section 65(2)(e):

- where the taxpayer was carrying on a business of dealing in that type of property (i.e. share dealing business); or
- if the shares were acquired for the purpose of resale or disposition (such purpose is determined at the time of acquisition); or
- if the shares were used as part of some profit-making scheme or undertaking.

The second limb is regarded as being the widest and brings within the tax net profits or gains of casual or speculative nature. Investors need to ensure that shares held are for the purpose deriving dividend income. However, a recent Court of Appeal decision (National Distributors)[22] does illustrate the breadth of this second limb of Section 65(2)(e).

On a practical level it may be difficult for the Commissioner to assess the non-resident if the shares have been sold and the non-resident has no further assets in New Zealand. If the shares in the New Zealand company were held on an offshore share registry of the company the sale would be deemed not

20. The method for calculating the amount of imputation credits to be attached to the dividends paid to the non-resident portfolio shareholder where dividend withholding payments are attached to the dividend is explained in Appendix 1.
21. Statement of the Minister of Finance announcing the non-resident portfolio shareholder where dividend withholding payments are attached to the dividend regime dated 5 August 1993.
22. (1989) 11 NZTC 6,346.

© 1994 International Bureau of Fiscal Documentation

to have a New Zealand source and thus would be outside the taxing jurisdiction of New Zealand for non-resident shareholders.

VII. REVIEW OF LEGISLATION AND REGIME

The market reaction to the announcement by the Minister of Finance was swift and positive. One of the biggest beneficiaries of the change was shareholders in Telecom Corporation of New Zealand as the company pays dividends with imputation credits attached at the maximum rate. The company's shares are also traded on the New York Stock Exchange.

The new regime applying to non-resident portfolio shareholders is a welcome one and is long overdue given the introduction of dividend imputation for resident shareholders in 1988. The manner in which the relief is given is complex but ensures that the relief is maintained in shareholder's hands under taxing crediting provisions in the shareholder's home country. Even if the shareholder is exempt from tax in his home country his cash returns from New Zealand portfolio investments are improved.

It is of concern that the full benefit of the reforms was not extended to shareholders in non-DTA countries. The exact reason for this is not clear but may centre around anti-avoidance concerns and the loss of bargaining levers for future DTA negotiations. Investors from non-DTA countries still face a high overall tax rate on dividends from New Zealand which will encourage the more sophisticated investors to structure their investments via vehicles located in countries which have a DTA with New Zealand. Singapore is one jurisdiction which may provide such advantages.

An unexpected side effect of the change is that as a result of paying dividends to non-resident portfolio investors, companies will pay less income tax and thus will be able to report high after-tax profits to their shareholders. While obviously this will be attractive to some companies, it seems undesirable that reported profitability could be enhanced in an artificial way by dividends to non-resident shareholders. It is hoped that the tax credits are accounted for in an appropriate way (possibly netted off against dividend payments in the accounts) or that the New Zealand Society of Accountants issues a standard giving authoritative guidance as to the appropriate way for these credits to be reported in financial statements.

It is disappointing that reforms have not yet been made for direct investors. While the reasons given for not extending tax relief at this stage are understandable, further long delays are not desirable. It appears best that the New Zealand Government quickly concludes the reform programme as it applies to direct investment to provide encouragement and certainty for foreign direct investors.

APPENDIX 1:

Determination of the Maximum Imputation Credits to be Attached to a Dividend Paid to a Non-Resident Portfolio Investor where the Dividend has Both Dividend Withholding Payment Credits and Imputation Credits Attached

$$\text{Maximum Imputation Credit} = \frac{a + 0.5583\,[((b-c) \times d) - c]}{1.5583}$$

Where:

a = Imputation credits attached to dividends paid to resident shareholders;

b = the dividend withholding payment portion of the dividend;

c = the dividend withholding payment credit;

d = (i) the imputation ratio applying to shares of the same class paid to shareholders other than non-resident portfolio ones; or

(ii) in any other case the maximum imputation ratio in Section 394G (being 49.25 percent currently).

© 1994 International Bureau of Fiscal Documentation

PEOPLE'S REPUBLIC OF CHINA:

NEW INDIVIDUAL INCOME TAX – UNIFIED TAXATION OF CITIZENS AND FOREIGNERS

Jinyan Li

Assistant Professor, Faculty of Law,
University of Western Ontario.
The author wishes to thank Professor Tim Edgar and Carol Hargreaves for their comments on the drafts of the article.

I. INTRODUCTION

On 31 October 1993, the Individual Income Tax Law of the People's Republic of China was promulgated (the "New IIT")[1] to become effective as of 1 January 1994.[2] The New IIT was intended to consolidate and replace three existing taxes:

- the Individual Income Tax (the "Old IIT"),[3] which was introduced in 1980 and applied to non-business income earned by resident aliens and non-residents;
- the Individual Income Regulatory Tax (IIRT),[4] which was introduced in 1986 and applied to similar income earned by Chinese citizens domiciled in China; and
- the Household Income Tax,[5] which was introduced in 1986 and applied to business income earned by Chinese citizens.[6]

The promulgation of the New IIT marks the beginning of a process initiated by the Chinese government to unify tax regimes for Chinese and foreign taxpayers and to move the Chinese tax system closer to international tax norm. The process will continue in the year to come in the areas of enterprise income tax, sales taxes and local taxes.[7]

The New IIT Law is a brief statute that, typical of Chinese laws, leaves most key issues of interpretation to implementing regulations. Detailed implementing regulations are expected to be promulgated by the State Council in the near future.

Although many key issues need to be clarified in the implementing regulations, it appears that the New IIT will not adversely alter the tax position of foreigners. In fact, most foreigners may find that their tax burden is reduced under the new regime. The tax position of Chinese citizens will be affected more substantially. Their tax liability may be reduced in some areas and in others significantly increased depending on the taxpayer's position under the IIRT or Household Income Tax and their current circumstances.

The purpose of this article is to explore the rationale for the promulgation of the New IIT and to examine its major provisions, focusing on the variations from the previous laws and the implications for taxpayers.

II. RATIONALE FOR THE PROMULGATION OF THE NEW LAW

There seem to be two rationales for the promulgation of the New IIT: (a) to consolidate the three taxes, and (b) to make the Chinese individual income tax system more equitable and consistent with international tax norms.

No individual income tax was imposed in the People's Republic of China prior to the introduction of the Old IIT in

1. Individual Income Tax Law of the People's Republic of China, adopted by the 4th Session of the Standing Committee of the 8th National People's Congress on 31 October 1993 and promulgated by the President on the same date (hereafter the "New IIT Law"). The author's English translation of this law is appended to this article.
2. Art. 14 of the New IIT Law provides that the law becomes effective on the date of promulgation - 31 October 1993. The Order of the President of the People's Republic of China that promulgated the law states that the law enters into force on 1 January 1994. The lack of transitional rules seems to indicate that the law will come into effect in 1994.
3. Individual Income Tax Law of the People's Republic of China, adopted by the 3rd Session of the 5th National People's Congress and promulgated 10 September 1980 (hereafter the "Old IIT Law"); Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China, approved 10 December 1980 by the State Council and promulgated 14 December 1980 by the Ministry of Finance (hereafter the "Old IIT Regulations"). For a discussion of the Old IIT, see Alex Easson and Jinyan Li, *Taxation of Foreign Investment in the People's Republic of China* (Deventer: Kluwer, 1989), chapter 3.
4. Interim Regulations of the People's Republic of China on Individual Income Regulatory Tax, promulgated on 25 September 1986 by the State Council (hereafter the "IIRT Law"); Detailed Rules and Regulations for the Implementation of the Interim Regulations of the People's Republic of China on Individual Income Regulatory Tax, promulgated by the Ministry of Finance on 10 December 1986 (hereafter "IIRT Regulations"). For a discussion of the IIRT and the English translation of the IIRT Law, see Jinyan Li, "The New Regulatory Tax on Individual Income," 41 *Bulletin for International Fiscal Documentation* (April 1987), at 167.
5. Interim Regulations of the People's Republic of China Concerning Income Tax on Individually-Operated Industrial and Commercial Households, promulgated by the State Council on 7 January 1986. See Jinyan Li, *Taxation in the People's Republic of China* (Praeger, 1991), 83-87.
6. See "New Amendments to the Draft Amendments to the Individual Income Tax Law", *Renmin Ribao (Haiwai Ban)* (People's Daily, Overseas Edition), 1 November 1993, at 3. Strangely, however, the New IIT Law contains no provisions declaring that the new law will replace the previous laws.
7. See Peter Goodspeed, "China's Leaders Adopt Economic Masterplan", *Toronto Star*, 16 November 1993, A14; and International Bureau of Fiscal Documentation, 47 *Tax News Service*, "People's Republic of China" (8 November 1993), issue 45, at 42.

© 1994 International Bureau of Fiscal Documentation

1980. Each of the Old IIT, IIRT and Household Income Tax was introduced on an *ad hoc* basis in order to respond to the immediate demands of economic reforms in China. Although under the Old IIT "all individuals who reside for one year or more in the People's Republic of China" were required to pay tax,[8] most Chinese citizens were effectively exempt from the tax because of the monthly exemption of 800 yuan,[9] which was several times more than the average income in China at that time.

During the early 1980s, more and more Chinese citizens were being allowed by the government to earn non-wage income. As a result, the income gap between those citizens and ordinary wage-earners widened. It was considered necessary to impose taxes on high-income earning citizens in order to minimize these income differences.[10] Since the exemption level under Old IIT was too high for this purpose, IIRT was introduced to apply to non-business income. The Household Income Tax was introduced to tax business income derived by newly-emerged private entrepreneurs. Therefore, individuals have been taxed differentially based on the nature of the income earned and on citizenship.

The system has resulted in complexity in compliance and administration and caused unfair tax liability for different taxpayers. In general, business income has been taxed more heavily than employment income and citizens have been taxed more heavily than foreigners. For example, the Old IIT is different from the IIRT in the following aspects:

(1) there were six categories of income taxable under the Old IIT, and eight under the IIRT;
(2) the basic exemption was 800 yuan under the Old IIT, and about 400 yuan under IIRT;
(3) under the Old IIT, only employment income was subject to progressive rates; other income was taxed at a flat rate of 20 percent. Under the IIRT, employment income, personal service income and rental income were all taxed at progressive rates ranging from 20 to 60 percent;
(4) the Old IIT was less progressive than IIRT. Under the Old IIT, rates ranged from 5 to 45 percent (2.5 to 22.5 percent on wages and salaries earned by foreign individuals)[11] and the marginal rate applied to monthly income in excess of 12,000 yuan; under IIRT, rates ranged from 20 to 60 percent and the marginal rate applied to a monthly income in excess of 800 yuan. A monthly wage of 1,000 yuan was taxed at 5 percent under the Old IIT and at 60 percent under IIRT.

The differential tax treatment is no longer considered necessary in the 1990s. The tax burden on Chinese citizens has been excessive. The 400 yuan deduction under the IIRT, which used to be two or three times more than average income in 1986, represents about the average income of urban residents.

The New IIT is modelled on the Old IIT. By applying the same rules to citizens and aliens, differential taxation will be reduced and tax administration will be simplified. For example, the New IIT increases the monthly deduction to 800 yuan for Chinese citizens.

In addition to the consolidation, the New IIT Law contains provisions that will make the tax system more equitable. For example, under the New IIT, tax base is broader, more categories of income are subject to progressive rates of taxation, deductions are more reflective of costs of living, and a credit is allowed for tax paid to a foreign government.

III. MAJOR PROVISIONS UNDER THE NEW LAW

Compared to the income taxes imposed by most Western countries, the New IIT has some unique features. It is essentially a schedular tax; only certain listed types of income are subject to tax; each category of income is computed separately; and there is not aggregation of the different categories. Some categories of income are taxed at progressive rates, others are taxed at a flat rate.

A. Liability for tax

Article 1 of the New IIT provides that an individual is liable to tax if he or she is domiciled in China, resides in China for a full year or derives income from Chinese sources. The terms "domicile," "residence" or "source of income" are undefined.

(1) Domicile (zhu suo)

Under Article 1 of the New IIT, an individual domiciled in China is liable to tax on his or her worldwide income.[12] The concept of "domicile" was not used under the Old IIT, and has been apparently taken from the IIRT.[13]

Under Chinese law, "domicile" refers to a permanent place of residence, which is generally deemed to be the place where an individual's household registration is kept.[14] Every Chinese citizen residing in China must be registered with the Public Security Bureau.[15] An individual can only have one place of domicile. "Domicile" must, therefore, be distinguished from "residence". "Residence" normally refers to a place where a person stays for a period temporarily.[16] An individual may have more than one place of residence. In practice, as Chinese citizens are required to have their household registration in China, the concept of "domicile" will mostly apply to citizens.

8. Old IIT Law, Art. 1, *supra* note 3.
9. As of 29 November 1993, the official exchange rate was US$ 1 for 5.77 yuan.
10. See Li, *supra* note 4.
11. See *infra* note 53 and accompanying text.
12. Individuals liable to tax on their worldwide income are allowed to deduct the amount of tax paid outside China in computing tax payable. The amount of deduction is limited to the amount of Chinese tax otherwise payable on the amount of foreign source income. New IIT, Art. 7, *supra* note 1.
13. IIRT Law, Art. 2, *supra* note 4.
14. See Jiang, Ping, ed., *Zhongguo Sifa Dacidian (China's Law Dictionary)* (Changchun, China: Jilin People's Press, 1991), at 556.
15. Regulations of the People's Republic of China on Household Registration, promulgated by the Standing Committee of the National People's Congress on 9 January 1958.
16. Jiang, *supra* note 14.

© 1994 International Bureau of Fiscal Documentation

Chinese nationality law is a complex subject.[17] Many Overseas Chinese have dual nationality and are recognized as Chinese citizens by the Chinese government, as are Chinese residents of Hong Kong and Macao. Since many executives and employees of foreign enterprises and joint ventures are of Chinese origin and may be Overseas Chinese, they could be treated as "domiciled" in China, if their stay in China is extended. For practical purposes, however, Overseas Chinese have been treated as aliens.

Foreign individuals may enter China and stay for a short period with a valid visa (multiple- or single-entry). A "residence permit" (*ju liu zheng*) is generally issued to individuals who intend to stay in China for a longer period, such as personnel employed by joint ventures, wholly foreign-owned enterprises, branches and representative offices of foreign companies.[18] A residence permit is generally valid for a year and may be renewed. For the purposes of IIRT, an individual has been considered domiciled in China if the individual lives in China and keeps his or her household registration in China.[19] If "domicile" is defined in the same manner under the implementing regulations for the New IIT, Chinese citizens who live in China will be subject to tax on their worldwide income. Foreigners will not likely be considered to be domiciled in China if they have no household registration with the Public Security Bureau.

(2) Residence (ju zhu)

In addition to the imposition of tax liability on the basis of domicile, the New IIT follows the pattern used throughout the world of providing different tax treatment for non-residents and residents. Individuals who reside in China for one year or more may be taxed on their worldwide income. Non-residents, individuals resident in China for less than one year, are taxed only on Chinese source income (the "one-year rule").

Although "residence" is undefined, the term has been interpreted to mean "physical stay" for the purposes of the Old IIT. The period of residency is calculated by counting the number of days of actual presence in China, regardless of whether the period is consecutive or cumulative.[20] Where a taxpayer's stay in China straddled two taxation years, the stay for each year is calculated separately.

For the purposes of the Old IIT, various exceptions to the one year rule have been provided by regulations. In effect, most foreigners staying in China for one year or more have been treated as non-residents and taxable only on Chinese source income.

Residents in China for one year or more: There have been two exceptions to the rule that individuals resident in China for one year or more are taxable on their worldwide income.[21] The first exception applies to an individual who stay in China for one year or more, but not more than five years. Foreign-source income has been taxable only if the income is remitted to China.[22] The second exception[23] has exempted foreign source income from tax regardless of whether it is remitted to China. This exemption applies whether the residency is for one year or more, or for more than five years, provided that the foreigner's presence is attributable to his or her employment by a foreign enterprise, joint venture, cooperative joint venture or a wholly foreign-owned enterprise in China, and provided that the individual has no general intention of taking up long-term residency in China.

Residents in China for less than one year: Under Old IIT, an individual who does not reside in China or an individual who resides in China for less than one year has been subject to tax only on Chinese-source income. An exception has been provided to this rule for an individual who is resident in China for an aggregate of ninety days or less during the year (the "90-day rule").[24] Such persons are exempt from tax on any compensation paid by employers outside China for services performed within China.[25]

The New IIT does not contain the 90-day rule or the exceptions to the one-year rule in respect of foreign source income. Based on past experience and the Chinese style of legislation, it is reasonable to expect that the implementing regulations for the New IIT will provide similar exceptions so that foreigners working for joint ventures and wholly foreign-owned enterprises will continue to be taxed only on Chinese source

17. See further, T.P. Chen, "The Nationality Law of the People's Republic of China and the Overseas Chinese in Hongkong, Macao and Southeast Asia", 5 *New York Law School Journal of International and Comparative Law* (1984), at 281.
18. Law of the People's Republic of China on Control of the Entry and Exit of Aliens, adopted at the 13th Session of the 6th National People's Congress and promulgated on 22 November 1985, Arts. 6 and 14.
19. IIRT Regulations, Art. 2, *supra* note 4.
20. Old IIT Regulations, Art. 5(1), *supra* note 3. Temporary absences from China during the taxable year were subtracted in calculating the period of stay in China for purposes of the one-year or more residency provision. Prior to 1988, however, foreigners with one-year residence permits or visas who left China and returned during the effective period of their permits or visas (including extensions approved after entry) were considered residents of China for one full year regardless of the amount of time actually spent abroad. See Ministry of Finance Notice (81) *Cai Shui Zi* No. 185 of 2 June 1981.
21. Old IIT Law, Art. 1; Old IIT Regulations, Art. 2, *supra* note 3.
22. Old IIT Regulations, Art. 3, *supra* note 3.
23. This exception was contained in an interpretive notice issued by the Ministry of Finance. See Ministry of Finance Notice Regarding the Exemption from Reporting and Payment of Individual Income Tax for Income Gained Outside China by Personnel of Foreign Nationality Working in China, (83) *Cai Shui Zi* No. 62 of 7 March 1983.
24. The 90-day rule is commonly modified where a tax treaty applies. In such a case, if the employer is a non-resident enterprise and the taxpayer is not present in China more than 183 days in a calendar year, his or her employment income is not taxable in China. This exception applies to Chinese-source wage and salary income earned during the stay in China. See, for example, Agreement between the Government of the People's Republic of China and the Government of the United Kingdom of Great Britain and Northern Ireland for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on 26 July 1984, Art. 16; and Agreement between the Government of the People's Republic of China and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, signed on 30 April 1984, Art. 14.
25. Old IIT Regulations, Art. 5(1), *supra* note 3. The 90-day exemption relates only to the taxability of remuneration paid by non-resident employers for work performed in China, for example, work performed by employees of foreign companies who provide technical services in China on the installation, assembly and use of machinery and equipment sold to China by their employers. The exemption does not apply to individuals who are permanently employed by joint ventures, and other enterprises in China.

© 1994 International Bureau of Fiscal Documentation

income. Otherwise, the shift in tax policy will conflict with the general policy of encouraging foreign investment.[26]

(3) Source rules

Chinese-source income earned by a foreigner is subject to tax under Article 1 of the New IIT. The following items of income have been considered as gained or having their source within China:[27]

- income from work and compensation for services performed within China;
- dividends and bonuses paid by companies in China;
- remuneration for staff members sent to work abroad by the Chinese government or any enterprise;
- fees for the use of proprietary rights within China;
- rent for the lease of property within China; and
- interest paid by the Chinese government and enterprises in China.

Chinese source income is considered to have been "gained" in China, whether actual payment is made in China or abroad. The Chinese tax authorities take a broad view of the notion of the source of wages or salary. All wage and salary income earned by an individual during the period of residence in China is generally considered to be Chinese-source income.[28] However, a foreign individual will not be taxed on a separate salary paid for services outside China while working long-term in China, if the employer can provide proof of the portion of the overall salary attributable to the services outside China.[29]

Similar source rules are expected to be included in the implementing regulations.

B. Categories of taxable income

Article 2 of the New IIT provides the following items of taxable income:

(1) Wages and salaries;
(2) Business income earned by individual industrial and commercial households;
(3) Management fees from the contracted operation or leasing of enterprises and institutions;
(4) Remuneration for independent personal services;
(5) Authors' royalties;
(6) Fees for the right to use proprietary rights (or royalties);
(7) Dividends, bonus dividends and interest;
(8) Rental income;
(9) Gains from the transfer of property;
(10) Incidental income (or windfall gains); and
(11) Other kinds of income specified as taxable by the State Council.

Certain types of income are exempt from tax.[30]

Compared to the Old IIT, tax base is broader under the New IIT. Management or contractual fees, business income, authors' royalties, gains from property transfers and incidental income were not taxable under the Old IIT.

C. Taxable income and tax rates

In computing taxable income, certain deductions are allowed against each category of income.[31] Statutory allowances are automatically provided for employment income, professional income, authors' royalties, rents and royalties, regardless of the amount of actual expenses. Related costs and expenses are deductible in computing income from business, management fees and gains from property transfers. No deductions can be made from other categories of income. Gifts made to educational and other public interest causes are deductible in computing taxable income. It appears that this deduction is not limited to any specific source or category of income.

Each category of income is taxed at different rate schedules. Income from wages and salary, management fees and business income are taxed at progressive rates.[32] All other listed categories of income are taxed at a flat rate of 20 percent.

(1) Employment income

(a) *Income from wages and salaries*

"Wages and salaries" have been interpreted to include "wages, salaries, bonuses and year-end bonuses earned from work in offices, organizations, schools, enterprises, undertakings and other entities".[33] Although "bonuses" are included there is a specific exemption for prizes and awards for scientific, technological and cultural achievements.[34]

Because wages and salaries are taxed on a monthly basis at progressive rates, the inclusion of bonuses in the definition of "wages and salaries" could result in a year-end or other occasional bonus being taxed more heavily than if the same amount had been paid evenly over the year. To avoid this result, the tax authorities have permitted a form of income averaging.[35]

(b) *Fringe benefits and allowances*

There are no statutory rules on the taxation of benefits and allowances, except that wages and salaries do not include allowances and subsidies received by taxpayers from their

26. It is true that China's tax treaties that are based on the OECD Model Convention contain a standard tiebreaker rule to resolve the problem of dual residency. Under the tiebreaker rule, a foreign individual who stay in China for more than one year without taking up a permanent residence in China is probably considered a resident of his or her home country. The tiebreaker rule will not benefit individuals from Hong Kong or a country that has no treaty with China.
27. Old IIT Regulations, Art. 5, *supra* note 3.
28. Old IIT Regulations, Art. 5, *supra* note 3; Ministry of Finance Notice (80) *Cai Shui Zi* No. 189 of 24 November 1980.
29. Ministry of Finance Notice (86) *Cai Shui Wai Zi* No. 034 of 18 February 1986.
30. New IIT Law, Art. 4, *supra* note 1. Exempt income includes welfare benefits, survivors' pensions and relief payments; insurance indemnities; salaries of diplomatic officials of foreign embassies and consulates in China; income exempted from tax as stipulated in international conventions to which China is a party or as stipulated in agreements it has signed; and income exempted from tax with the approval of the Ministry of Finance.
31. New IIT Law, Art. 6, *supra* note 1.
32. New IIT Law, Art. 3, *supra* note 1.
33. Old IIT Regulations, Art. 4(1), *supra* note 3.
34. New IIT Law, Art. 4(1), *supra* note 1.
35. Ministry of Finance (81) *Shui Wai Bian Zi* No. 65 of 17 July 1981.

© 1994 International Bureau of Fiscal Documentation

employers if the allowances and subsidies are paid in accordance with State regulations.[36]

Over the years, the Chinese tax authorities have developed guidelines on the taxability of various fringe benefits and allowances paid to foreigners working in China by their companies for housing, meals, relocation, home leave, family education, hardship allowances and the like. Although not entirely uniform and satisfactory, the administrative guidelines have enabled companies to arrange "remuneration packages" for their employees working in China. For example, certain expenses paid directly by the employer, or paid by the employee and reimbursed by the employer are normally not taxed to the employee. Such expenses include costs of housing or accommodation,[37] travelling costs to return home on leave, relocation or moving costs, local transportation, housekeeping expenses and meals.[38] Similarly, contributions made by an employer to a pension plan, dental plan and insurance plan on behalf of an employee do not seem to constitute a taxable benefit to the employee.[39]

In contrast, where an employee receives a cash "allowance" on a *per diem* or monthly basis, the allowance will normally be treated as part of salary.[40] For example, an overseas allowance or family allowance is clearly taxable. Because no deductions from wages and salaries are permitted under the Old IIT, other than a standard deduction, few employers pay taxable allowances to employees. The employer instead either pays such expenses directly or reimburses the employee for expenses actually incurred as supported by vouchers.

The payment of income tax by an employer on behalf of an employee is also regarded as taxable remuneration. The employee is taxed on the grossed-up amount.[41]

The implementing regulations for the New IIT are expected to provide some clarification of the taxability of employment benefits and allowances. A greater range of benefits and allowances may be considered taxable.[42]

(c) *Deductions*

Tax on employment income is calculated on a monthly basis. In calculating taxable income, a monthly deduction of 800 yuan (US$ 140) is allowed.[43] The 800 yuan deduction is more generous to Chinese citizens than that under the IIRT.

When the Old IIT was introduced in 1980, the 800 yuan deduction appeared generous. Since then, costs of living in China, especially for foreigners, have increased considerably and the value of the Chinese currency, *renminbi*, has fallen. The consumer price index has increased more than 120 percent in the past decade, and *renminbi* has been devaluated for more than 250 percent.[44] The combined effect of increased living costs in China and creeping devaluation of *renminbi* made the 800 yuan less attractive and caused a significant source of foreign business complaints. For example, 800 yuan was worth US$ 548 in 1980, US$ 216 in 1987, US$ 170 in 1989 and US$ 138 at the end of October 1993.[45] It has been indicated that China may soon abolish the official exchange rate.[46] If *renminbi* is further devaluated, foreigners may face a significant increase in their tax burden in *renminbi* on US dollar income.

The New IIT introduces a welcome flexibility to the deduction system. Article 6 provides that individuals not domiciled in China who earn wages and salaries from Chinese sources are allowed a deduction in addition to the 800 yuan.[47] The amount of the additional deduction will depend on the average income levels, average living expenses and the fluctuation of exchange rates. The scope of the deduction will be specified by the State Council.[48] Given the level of sophistication of tax administration in China, indexation of deductions for inflation and changes in the value of *renminbi* may not be a feasible alternative. It has been suggested that the amount of the special deduction for each month be a lump-sum of 2,500 yuan or more.[49]

(d) *Rates of tax*

Income from wages or salary is taxed at progressive rates ranging from 5 to 45 percent.[50] Monthly income is grouped into nine brackets. The New IIT's rates are much lower than those under the IIRT,[51] and higher than those under the Old

36. New IIT Law, Art. 6, *supra* note 1.
37. So far as employer-provided housing allowances are concerned, the employee must take the allowance into income but may deduct the actual amount used for housing if he or she can demonstrate the same with receipts. See Ministry of Finance Notice (88) *Cai Shui Wai Zi* No. 21 of 20 January 1988.
38. Thus, although the Chinese authorities draw a distinction between "personal" expenses and "business" expenses, they appear to take a very generous view of what constitutes a "business" expense. The employer must submit "proof" that was verified by the local tax authorities.
39. Where part of an employee's salary is used to buy stocks of the employer, the employee is not taxed on this amount if the employer does not deduct the same as expenses. See State Tax Bureau Notice *Guo Shui Han Fa* (1990) No. 067 of 19 January 1990.
40. Ministry of Finance Notice (84) *Cai Shui Wai Zi* No. 017 of 18 January 1984.
41. Ministry of Finance Notice (86) *Cai Shui Wai Zi* No. 034 of 18 February 1986.
42. See Chen, Yongqian, "A Discussion of the Treatment of Expenses Incurred by Foreign Companies", 1 *She Wai Shui Wu* (*International Taxation in China*) (1990), at 16; Liu, Zuwu and Lin, Yongan, "Audit Individual Income Tax Payable by Employees of Foreign Enterprises", 5 *She Wai Shui Wu* (*International Taxation In China*) (1991), at 35. Chen argues that taxable income should include all contributions made by an employer to pension plans, stock option plans, living allowances, severance pay and relocation fees.
43. New IIT Law, Art. 6(1), *supra* note 1. At present, the official rate is US$ 1= 5.8 yuan, while the market rate is about US$ 1= 8.8 yuan. The market rate refers to the rate adopted at the currency swap centres. The Chinese government faces further pressures to devaluate its currency in order to be admitted to GAAT.
44. Wang, Xuanhui, "Several Ideas on Reform the Individual Income Tax Law", 9 *She Wai Shui Wu* (*International Taxation in China*) (1993), at 4-7; and Guo Hongde, "Reform of Individual Income Tax Should Be Emphasized", 3 *She Wai Shui Wu* (*International Taxation in China*) (1991), at 3.
45. See Wang, *supra* note 44, at 5.
46. See *China Daily (Business Weekly)*, 10 October 1993, at 1.
47. New IIT Law, Art. 6, *supra* note 1. Similar deductions may be allowed for Chinese citizens deriving employment income from foreign countries.
48. Although the New IIT allows the same statutory deduction to Chinese citizens and foreigners, it is believed that it is realistic to allow higher deductions to foreigners. See Xinhuan, "Consumers Rights, Income Tax Laws Viewed", FBIS-CHI-93-204 (25 October 1993), at 28-29.
49. Wang, *supra* note 44, at 7.
50. New IIT Law, Art. 3(1), *supra* note 1.
51. The rate schedule for Beijing under the IIRT on wages and salaries was as follows:

Monthly Income (yuan)	*Rate (%)*
401 – 500	20
501 – 600	30
601 – 700	40
701 – 800	50
more than 800	60

For further, see Li, *supra* note 4.

© 1994 International Bureau of Fiscal Documentation

IIT. Under the Old IIT, wages and salary have been taxed under a six-bracket progressive schedule that also ranged from 5 to 45 percent,[52] but the rates were reduced by half in 1987 in response to the complaints of foreign taxpayers provoked by the increase in living costs and the devaluation of *renminbi*.[53]

Although the 50 percent rate reduction for foreigners will cease to apply, higher rates under the New IIT do not necessarily mean higher taxes. The widening and increasing of income brackets from six to nine under the New IIT means that most foreigners will not be taxed at rates higher than 25 percent. For example, under the New IIT, 25 percent applies to a monthly salary of 40,800 yuan (US$ 7,034), and the top rate of 45 percent is not reached unless the monthly salary reaches 100,800 yuan (US$ 17,380). Under the Old IIT, the top rate of 22.5 percent applied to a monthly salary of 12,001 yuan (US$ 2,069). Further, the additional deduction will lower the tax burden on foreigners by the amount of deduction multiplied by the marginal tax rate.[54]

Depending on the amount of the additional deduction, many foreigners may in fact find their burden significantly reduced under the New IIT. Monthly tax payable under the Old IIT and the New IIT is compared in the table below.

Table: Monthly tax liability under the Old IIT (with the 50% reduction in rates) and New IIT under the assumption that (a) the 800 yuan standard deduction is allowed; (b) an additional 2,500 yuan is deductible; and (c) an additional 5,000 yuan is deductible

Monthly Salary (yuan)	*Old IIT*	*New IIT*	*New IIT (2,500 yuan deduction)*	*New IIT (5,000 yuan deduction)*
100,000	21,424	29,305	28,305	27,305
50,000	10,010	11,384	10,574	9,884
30,000	5,492	5,925	5,300	4,675
10,000	1,042	1,465	965	465

On the assumption that no additional deductions are allowed, a foreign executive with a monthly salary of 100,000 yuan (US$ 17,241) will pay about 29,305 yuan[55] (US$ 5,052) in monthly tax under the New IIT as opposed to 21,242 yuan (US$ 3,662).[56] If the executive earns a monthly salary of 50,000 yuan (US$ 8,620), monthly tax payable under the New IIT is 11,484 yuan (US$ 1,963) as opposed to 10,010 yuan (US$ 1,726) under the Old IIT. For a less well paid employee with a monthly salary of 30,000 yuan (US$ 5,172), the monthly tax payable is 5,925 yuan (US$ 1,021) under the New IIT as opposed to 5,492 yuan (US$ 947) under the Old IIT.

The ultimate effect of the New IIT on foreigners will depend on the extent of the additional deductions. For example, if the additional monthly deduction is 2,500 yuan (US$ 431), a taxpayer earning a monthly salary of 30,000 yuan (US$ 5,172) will pay 5,300 yuan (US$ 914). This amount is 192 yuan (US$ 33) less than the 5,492 yuan (US$ 947) payable under the Old IIT. If the additional deduction is 5,000 yuan (US$ 862), the amount of tax payable is reduced further to 4,675 yuan (US$ 822).

(2) Business income

Business income is taxed on an annual basis at progressive rates ranging from 5 to 35 percent.[57] Related costs, expenses and losses are deductible in computing taxable income.

52. Under the Old IIT, the standard 800 yuan deduction was built into the rate schedule through a zero bracket for monthly income under 800 yuan. The rate schedule was as follows:

Monthly income (yuan)	*tax rate (%)*
800 yuan or less,	0
801 – 1,500	5
1,501 – 3,000	10
3,001 – 6,000	20
6,001 – 9,000	30
9,001 – 12,000	40
more than 12,000	45

53. Interim Provisions of the State Council of the People's Republic of China Concerning the Reduction of Individual Income Tax on the Income from Wages and Salaries Derived by Foreign Personnel Working in China, issued on 8 August 1987. In 1987, *Renminbi* was devaluated from US$ 1 for 2.8 yuan to 3.7 yuan.

54. In view of the government policy on ensuring that the Chinese tax system compares favourably to that in other countries in Asia and the world, it is reasonable to expect that the extent of the additional deduction will be such that the tax burden for foreigners under the old regime is maintained under the New IIT. See Qin, Panyi, "Suggestions on the Reform of Our Country's Individual Income Tax System", 7 *She Wai Shui Wu* (*International Taxation in China*) (1993), at 15.

55. Under the New IIT, the amount of tax payable is 29,305 yuan, which is calculated as follows:

Level	*Monthly income brackets (after deducting 800 yuan)*	*Rate*	*Tax payable*
1	up to 500 yuan	5%	25
2	501– 2,000 yuan	10%	150
3	2,001– 5,000 yuan	15%	450
4	5,001–20,000 yuan	20%	3,000
5	20,001–40,000 yuan	25%	5,000
6	40,001–60,000 yuan	30%	6,000
7	60,001–80,000 yuan	35%	7,000
8	80,001–99,200 yuan	40%	7,680
total			*29,305*

56. Under the Old IIT, the monthly tax payable is 21,242 yuan:

Level	*Monthly brackets*	*Rate*	*Tax payable*	*FCDA**
1	801– 1,500 yuan	5%	35	40
2	1,501– 3,000 yuan	10%	150	115
3	3,001– 6,000 yuan	20%	600	415
4	6,001– 9,000 yuan	30%	900	1,015
5	9,001– 12,000 yuan	40%	1,200	1,915
6	12,001–100,000 yuan	45%	39,600	2,515
total			*42,485*	

* "FCDA" refers to "fast-calculating" deduction amount. A simpler way of calculating tax payable is that tax payable is the amount of monthly salary multiplied by the marginal rate deduct (FCDA). Tax payable = (100,000 x 45%) - 2,515 = 42,485.

By virtue of the 50% rate reduction in 1987, the amount of tax payable is 21,242 yuan. The effective rate is 21.2%.

57. New IIT Law, Art. 3(2), *supra* note 1. Tax rates under the Household Income Tax were as follows:

Annual Income (yuan)	*Rate (%)*
1,000 or less	7
1,001 – 2,000	15
2,001 – 4,000	25
4,001 – 6,000	30
6,001 – 8,000	35
8,001 – 12,000	40
12,001 – 18,000	45
18,001 – 24,000	50
24,001 – 30,000	55
more than 30,000	60

In addition, a surtax of from 10 to 40% was imposed on taxable income in excess of 50,000 yuan a year, the exact amount of which is determined by local governments. Since most households operate on a fairly small scale, with the number of workers being limited to seven, the surtax was only applicable to a very few enterprises.

© 1994 International Bureau of Fiscal Documentation

Foreigners are unlikely to earn business income for the purposes of the New IIT. "Business income" seems to refer to income derived by "individual industrial and commercial households" that has been taxed under the Household Income Tax. The term "individual industrial and commercial households" normally refers to Chinese individuals or families that are permitted to carry on private businesses in China.[58] Foreign individuals doing business in China are governed by the Equity Joint Venture Law,[59] Cooperative Joint Venture Law[60] or Wholly Foreign-Owned Enterprise Law.[61] Income earned by a joint venture or a wholly foreign-owned enterprise is taxed at a combined national and local rate of 33 percent under the Income Tax Law Concerning Foreign-Investment Enterprises and Foreign Enterprises (the "Foreign Enterprise Income Tax").[62] Various tax holidays are provided under the Foreign Enterprise Income Tax, such as rate reductions in special economic zones and other special areas, tax exemptions and reductions for enterprises engaged in production activities, enterprises with advanced technology, and export-oriented enterprises.[63]

(3) Management or contractual fees

Fees from contractual operation or leasing of enterprises are taxed on an annual basis net of relevant expenses. The progressive rates of 5 to 35 percent applicable to business income also apply to management fees. The top rate applies to annual taxable income in excess of 50,000 yuan.

It is advantageous for an individual to have his or her remuneration treated as management or contractual fees taxable at the top rate of 35 percent rather than as salary taxable at the top rate of 45 percent. Moreover, deductions are more readily available in respect of management fees than salary income.

(4) Professional income

Income from "remuneration for personal services" is taxable at a flat rate of 20 percent.[64] It is crucial to distinguish such income from employment income and from business income or management fees. "Personal services" normally refers to independent personal services, such as designing, installation, law practice, accounting, consulting, artistic performance and sports.[65]

Expenses are not deductible in calculating income, but statutory deductions are allowed. The deduction is 800 yuan "if the amount in a single payment is 4,000 yuan or less"; for single payments of more than 4,000 yuan the deduction is 20 percent of the payment.[66] For the purposes of the Old IIT, income received "in a single payment" has been interpreted to mean income from a lump-sum payment or income earned from performing a single piece of work. Payments of a continuing nature relating to the same item of income that cannot be divided into separate payments may be aggregated as to all such payments received within a month and counted as a single payment.[67] Splitting payments into amounts of less than 800 yuan may be prohibited.[68]

Professional income is taxed at a flat rate of 20 percent.[69] Where a particular payment is "abnormally high", additional tax may be imposed.

It may be more advantageous for an individual to have his or her earnings treated as wages or salary, rather than as remuneration for personal services, if the effective tax rate for wage or salary is lower than 20 percent. The additional deduction for living costs for foreigners is applicable only for income from employment. On the other hand, the 20 percent deduction for professional income may be more generous than deductions for employment income. An individual who receives personal service income from a variety of sources may benefit from self-employed status by being able to claim more than one set of deductions.[70]

(5) Authors' royalties

Income from publications, translation or editing is taxed at the flat rate of 20 percent. Where a treaty applies, the rate is normally reduced to 10 percent.

58. Provisional Regulations Concerning the Administration of Urban and Rural Individual Industrial and Commercial Households, promulgated by the State Council on 5 August 1987.
59. Individuals are allowed to form equity joint ventures with Chinese enterprises under the Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures, adopted by the 2nd Session of the 5th National People's Congress on 1 July 1979, promulgated on 8 July 1979, and amended at the 3rd Session of the Seventh National People's Congress on 4 April 1990; and Regulations for the Implementation of the Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures, promulgated by the State Council on 20 September 1983, and revised by the State Council to conform with the 1990 amendment to the law.
60. Foreign individuals may also invest in China in the form of cooperative joint ventures under the Law of the People's Republic of China on Chinese-foreign Cooperative Enterprises, adopted by the 1st Session of the 7th National People's Congress on 13 April 1988.
61. It is possible for a foreign individual to carry on business in China in the form of partnerships, companies or proprietorships in accordance with the Law of the People's Republic of China on Foreign Owned Enterprises, adopted by the 4th Session of the 6th National People's Congress on 12 April 1986 and promulgated on the same date; and Detailed Regulations for the Implementation of the Law of the People's Republic of China on Foreign Owned Enterprises, promulgated by the Ministry of Foreign Economic Relations and Trade on 12 December 1990.
62. Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, adopted by the 4th Session of the 7th National People's Congress on 9 April 1991, and promulgated on the same date (hereafter "FIT Law"); Detailed Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, promulgated by the State Council on 30 June 1991 (hereafter "FIT Regulations"). For a discussion of this tax, see Stephen Nelson, "New Unified Tax Law Governing Foreign Investment Enterprises and Foreign Companies", *Tax Notes International* (June 1991), at 605; and Jinyan Li, "The Implementing Regulations for the New Consolidated Income Tax on Foreign Investment", 46 *Bulletin for International Fiscal Documentation* (April 1992), at 170.
63. FIT Law, Arts. 6-9, and FIT Regulations, Arts. 68-82, *supra* note 62.
64. Where a tax treaty applies, professional income will generally only be taxed if the recipient is present in China for more than 183 days in aggregate in a calendar year or has a fixed base available in China. Special exemptions are provided in the case of athletes and entertainers.
65. "Personal services" were previously defined to include "designing, installation, drafting, medical practice, law practice, accounting, consulting, lecturing, news reporting, broadcasting, free-lance writing, translating, calligraphy and painting, sculpture, films, drama and opera, music, dancing, acrobatics, ballad singing and comic talk, sports, technical services and other personal services." See Old IIT Regulations, Art. 4(2), *supra* note 3.
66. New IIT Law, Art. 6(4), *supra* note 1.
67. Old IIT Regulations, Art. 12, *supra* note 3.
68. *Id.*
69. New IIT Law, Art. 3(4), *supra* note 1.
70. *Id.*

© 1994 International Bureau of Fiscal Documentation

As in the case of professional income, statutory deductions are allowed in computing taxable income. Where each payment is 4000 yuan or less, 800 yuan is deductible; where each payment is more than 4,000 yuan, 20 percent of the payment is deductible.

(6) Rents and royalties

Income from the lease of property[71] and fees for the right to use proprietary rights (or royalties) are also taxed at the flat rate of 20 percent,[72] and the deduction system is the same as that applicable to professional income.[73] No deduction is allowed for related costs and expenses.[74] Where rents and royalties are paid to non-residents, tax is generally withheld by the payer on the gross amount.[75]

(7) Interest and dividends

Interest and dividend income is taxed at a flat rate of 20 percent,[76] on the full amount received.[77] There is no deduction for carrying charges and other costs of earning such income.

Since the establishment of securities exchange in Shanghai and Shenzhen in 1990,[78] there has been a rapid increase in foreign investment in bonds and shares of Chinese companies denominated in a foreign currency. Some Chinese companies have recently issued shares at stock exchanges in Hong Kong, New York, Toronto and other cities.

Certain types of interest and dividends are specifically exempt from tax. Interest on savings deposits, government bonds and financial bonds issued by the State is not taxed.[79] Interest on bonds issued by the Bank of China in a foreign currency is also exempt from tax.[80] Dividends from joint ventures established under the Joint Venture Law have been exempt from tax.[81] It has been reported that non-resident aliens who purchased shares of Chinese companies through the Hong Kong stock exchange have been exempt from the 20 percent withholding tax under the Old IIT.[82] Similar exemptions on dividends are expected to be included in the implementing regulations to the New IIT.

(8) Gains from property transfers

Gains from the transfer of property were not specified as taxable under the Old IIT. The administrative position of the tax authorities has been to tax certain capital gains as "other income". For example, a gain realized on the disposal by a shareholder of an interest in an equity joint venture is regarded as taxable income.[83]

"Property" is undefined.[84] It will probably include only capital property, such as buildings, land-use rights, shares and bonds. The Chinese Constitution prohibits the transfer of land which is owned by the State or collectives, but land-use right can be transferred.

"Gains" or "income from property transfers" refers to the proceeds from the transfer of property in excess of the original cost of the property and reasonable expenses.[85] Taxable gains are taxed at a flat rate of 20 percent.[86]

(9) Incidental income and "other income"

"Incidental income" may refer to income from isolated transactions, such as gains from speculating in the stock or real estate market, or gains from windfalls.

Also taxable is "other income specified as taxable by the State Council". This provision is typical of Chinese legislative drafting style. The tax authorities are given a leeway to add new categories of income as required in the future.[87]

D. Withholding

Taxes are generally withheld by payers of income and remitted to the government within seven days of the following month.[88] Returns must be filed by withholding agents.[89] A 2 percent service fee is payable to withholding agents.[90] Taxes on business income and management fees are levied on an annual basis and paid in monthly instalments.[91]

Taxes withheld seems to represent the final tax liability of the income-earners. Taxpayers are not required to file returns with respect to income from which tax has been withheld.

IV. CONCLUSIONS

The New IIT has made some positive changes to the Chinese individual income tax system. It is more equitable than the previous one, but problems remain.

---

71. "Income from the lease of property" was previously defined to include "income from leasing buildings, machinery and equipment, motorized vehicles and boats and ships, and other movable and immovable property". See Old IIT Regulations, Art. 4(5), *supra* note 3; IIRT Regulations, Art. 4(4), *supra* note 4.
72. New IIT Law, Art. 3(5), *supra* note 1. This rate is normally reduced under tax treaties.
73. New IIT Law, Art. 6(4), *supra* note 1.
74. In practice, the Chinese tax authorities may allow deductions for property taxes, maintenance and repair costs. See State Tax Bureau Notice *Guo Shui Han Fa* (1990) No. 1236 of 10 October 1990.
75. Old IIT Regulations, Art. 11, *supra* note 3.
76. New IIT Law, Art. 3(5), *supra* note 1. Tax treaties normally reduce the rate to 10 or 15%.
77. New IIT Law, Art. 6(6), *supra* note 1.
78. In October 1993, a third securities exchange was established in the city of Yichang, Hubei Province.
79. New IIT Law, Art. 4(2), *supra* note 1.
80. State Tax Bureau Notice *Guo Shui Han Fa* (1991) No. 814 of 13 June 1991.
81. See Old IIT Regulations, Art. 5(2), *supra* note 3. Dividends paid by a joint venture or wholly foreign-owned enterprise are exempted from tax under the Foreign Enterprise Income Tax. FIT Law, Art. 19(1), *supra* note 62.
82. *South China Sunday Morning Post* (China Business Review), 26 September 1993, at 1. Tsingdao Brewery, Shanghai Petro-Chemical, Guangzhou Shipyard and Beiren Printing have all listed shares in Hong Kong. Maanshan Iron and Steel Company and Kunming Machine Tool Plant are expected to do the same.
83. Ministry of Finance Notice (87) *Cai Shui Wai Zi* No. 033 of 22 February 1987.
84. For the purposes of the Foreign Enterprise Income Tax Law, "property" is defined to include buildings, structures, facilities ancillary to such buildings and structures and land use rights. See FIT Regulations, Art. 61, *supra* note 62.
85. New IIT Law, Art. 6(5), *supra* note 1.
86. New IIT Law, Art. 3(5), *supra* note 1.
87. For example, while capital gains were not a specified category of income under the Old IIT, the tax authorities declared that certain capital gains are taxable as "other income". See note 83 *supra* and accompanying text.
88. New IIT Law, Arts. 8 and 9, *supra* note 1.
89. New IIT Law, Art. 9, *supra* note 1.
90. New IIT Law, Art. 11, *supra* note 1.
91. New IIT Law, Art. 8, *supra* note 1.

© 1994 International Bureau of Fiscal Documentation

A. Equity

With respect to vertical equity, the New IIT is very progressive, despite the lowering of effective tax rates for business income earners and the majority of Chinese citizens.[92] Individuals who earn a taxable monthly salary of more than 100,000 yuan will be taxed at the marginal rate of 45 percent, whereas individuals who earn a taxable monthly salary of 500 yuan or less will be taxed at the rate of 5 percent. By virtue of the monthly exemption of 800 yuan, the majority of Chinese citizens who work for government-owned enterprises or institutions will be exempt from the tax.

Horizonal equity in the tax system will be enhanced as a result of the consolidation of the Old IIT, IIRT and Household Income Tax and the broadening of tax base by including capital gains, authors' royalties, management fees and incidental income. Individuals with similar ability to pay tax will be taxed similarly under the New IIT.

One inequity that remains under the New IIT is the schedular system of taxation. This schedular system is inequitable because it imposes different tax liabilities on taxpayers who may have the same ability to pay tax. Individuals who earn wages and salaries are taxed on a monthly basis at progressive rates ranging from 5 to 45 percent on income in excess of 800 yuan. Individuals earning business income are taxed on an annual basis at progressive rates ranging from 5 to 35 percent on income after a deduction of all expenses, costs and losses. Individuals who earn personal service income are taxed on a per payment basis at a flat rate of 20 percent on income after a statutory deduction of 800 yuan or 20 percent of each payment. Investors who earn interest or dividend income are taxed at 20 percent of the gross amount.

To illustrate, assume that Taxpayer A earns a monthly salary of 5,000 yuan, Taxpayer B earns 5,000 yuan per month from his private law practice, Taxpayer C earns 5,000 yuan gross income every month from his private retail business, and Taxpayer D earns 5,000 yuan interest income every month. The annual tax liability of each individual is as follows:

(a) A's monthly taxable income is 4,200 yuan (5,000 yuan less the statutory deduction of 800 yuan). A's monthly tax payable is 504 yuan, calculated as follows:

Income Brackets (yuan)	*Rate*	*Tax payable (yuan)*
up to 500	5%	25
501 – 2,000	10%	149
2,001 – 4,200	15%	330
total		504

A's annual tax payable is 6,048 yuan (that is, 504 yuan multiplied by 12).

(b) B's monthly taxable income is 4,000 yuan (5,000 yuan less the statutory deduction of 20 percent of 5,000 yuan). B's monthly tax payable is 800 yuan (that is, 4,000 yuan multiplied by 20 percent). B's annual tax payable is 9,600 yuan (800 yuan multiplied by 12).

(c) C's annual taxable income is 36,000 yuan [(5000 yuan less 2,000 yuan) multiplied by 12] if we assume that he deducts 2,000 yuan every month as expenses. C's annual tax payable is 6,550 yuan, calculated as follows:

Income Brackets (yuan)	*Rate*	*Tax Payable (yuan)*
up to 5,000	5%	250
5,001-10,000	10%	500
10,001 - 30,000	20%	4000
30,001 -36,000	30%	1800
total		6550

(d) D's annual tax payable is 7,200 yuan (that is, 20 percent of the 5,000 yuan multiplied by 12).

The tax liability of A, B, C and D on the monthly earning of 5,000.yuan attracts different tax liabilities under the New IIT.

B. Simplicity

Simplicity in tax compliance and collection is crucial to the Chinese individual income tax system. Given the present level of sophistication in tax administration in China, withholding of tax by payers is the only effective way to collect tax. The New IIT almost relies totally on withholding for tax collection. Once tax is withheld, it does not require the filing of tax returns. In order to simplify compliance by withholding agents, the New IIT has adopted a schedular system of taxation. Tax liability is determined for each type of income. Statutory deductions against each specified type of income are allowed so that a payer can easily determine the amount of taxable income. Tax rates are also designed for each category of income.

C. Certainty

The New IIT contains mostly general statements of principle. Like its predecessors, it lacks certainty and clarity, and provides no detailed rules on important issues, such as the determination of "domicile" or "residency". It contains no transitional rules and provides little guidance on its interpretation. It is hoped that the forthcoming implementing regulations will provide some clarification.

INDIVIDUAL INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA

(Adopted by the Fourth Session of the Standing Committee of the Eighth National People's Congress on 31 October 1993 and promulgated on the same date)

Translated by Jinyan Li

Article 1.

Individuals with a domicile in China or those without a domicile in China but who reside in China for one full year shall be liable to individual income tax on their income gained from inside and outside China in accordance with the provisions of this Law.

Individuals who do not have a domicile in China nor reside in China, or individuals without a domicile in China who do not reside in China for more than one full year, shall be liable to

92. Under the IIRT, for example, the tax rate was 60% on monthly income exceeding 800 yuan. Under the new law, 800 yuan is taxed at 5%. See *supra* notes 51 and 52.

© 1994 International Bureau of Fiscal Documentation

individual income tax on income gained within China in accordance with the provisions of this Law.

Article 2.

The following categories of income are subject to individual income tax:

1. Income from wages and salaries;
2. Income from production or business operations of individual industrial and commercial households;
3. Income from fees from contracted operation or leasing of enterprises and institutions;
4. Income from remuneration for personal services;
5. Income from authors' royalties;
6. Income from fees for the use of proprietary rights;
7. Income from interest, dividend and bonus dividend;
8. Income from the lease of property;
9. Income from the transfer of property;
10. Incidental income (or windfall gains);
11. Other income that shall be determined to be taxable by the finance departments of the State Council.

Article 3.

Individual income tax rates:

1. Income from wages and salaries shall be taxed at progressive rates ranging from 5% to 45% (see the appended Table I);
2. Income from business or production operations of individual industrial and commercial households, and fees from contracted operation or leasing of enterprises and institutions shall be taxed at progressive rates ranging from 5% to 35% (see the appended Table II);
3. Authors' royalties shall be taxed at a flat rate of 20% and the amount of tax levied shall be reduced by 30% of the tax payable;
4. Income from remuneration for personal services shall be taxed at a flat rate of 20%. If any one payment of remuneration for personal services is abnormally high, it may be taxed at a higher rate. Specific measures shall be stipulated by the State Council;
5. Income from fees for the use of proprietary rights, interest, dividend and bonus dividend income, income from the lease of property, income from the transfer of property, incidental income, and other income shall be taxed at a flat rate of 20%.

Article 4.

The following categories of income shall be exempt from individual income tax:

1. Awards for achievement granted by a provincial government, ministry or commission of the State Council, Chinese People's Liberation Army, a foreign or international organization in such areas as science, education, technology, culture, health, sports and environmental protection;
2. Interest from deposit accounts, government bonds and financial bonds issued by the State;
3. Subsidies and allowances paid according to the regulations of the State;
4. Welfare benefits, pensions for the disabled and for survivors and relief payments;
5. Insurance proceeds;
6. Decommission or demobilization pay for military personnel;
7. Settling-in allowances, quit-working fees, retirement fees, leaving-office wages, or living allowances received by leaving-office cadres;
8. Income received by diplomatic officials and other personnel of foreign embassies and consulates in China that are exempted from tax according to relevant Chinese laws and regulations;
9. Income that is exempted under international conventions to which China is a party;
10. Income exempted from tax with the approval of the relevant finance department of the State Council.

Article 5.

Individual income tax may be reduced in one of the following situations upon approval:

1. Individuals who are disabled, old-aged and have no family, or members of the revolutionary martyrs' families;
2. Individuals who have suffered losses caused by serious natural disasters; or
3. Other tax reductions approved by the State Council's financial department.

Article 6.

Computation of taxable income:

1. For income from wages and salaries, taxable income shall be the total amount of monthly income after deduction of 800 yuan;
2. For income from production or business operations of individual industrial and commercial households, taxable income shall be the total annual income after deduction of costs, expenses and losses;
3. For fees from contracted operation or leasing of enterprises and institutions, taxable income shall be the total annual income after deduction of necessary expenses;
4. For income from remuneration for personal services, authors' royalties, fees for the right to use proprietary rights, or from the lease of property, taxable income shall be the amount of income after the deduction of 800 yuan where a single payment does not exceed 4,000 yuan, or the deduction of 20 per cent of the amount where the single payment is 4,000 yuan or more.
5. For income from the transfer of property, taxable income shall be the amount of proceeds of disposition after the deduction of the original cost of the property and necessary expenses.
6. For interest, dividends, bonus dividends, incidental income and other income, taxable income shall be the amount of each payment received.

In computing taxable income, an individual may deduct the amount of gift made for the purposes of education or other public benefits in accordance with relevant regulations of the State Council.

© 1994 International Bureau of Fiscal Documentation

For a taxpayer without a domicile in China who earns wages and salaries from China or a taxpayer with a domicile in China who earns wages and salaries from outside China, additional expenses may be deducted based on the average income level, costs of living and foreign exchange rates. The scope of the additional deductions shall be determined by the State Council.

Article 7.

A taxpayer shall be allowed to deduct from the amount of tax payable the amount of individual income tax paid outside China on the income derived from sources outside China. The amount deducted, however, may not exceed the amount of tax payable computed on the income derived from sources outside China in accordance with the provisions of this Law.

Article 8.

For individual income tax, the income earner shall be the taxpayer and paying unit or individual shall be the withholding agent. Taxpayers that earn wages and salaries from two or more sources or have no withholding agent must personally report and pay tax.

Article 9.

Taxes withheld each month by a withholding agent and those to be paid each month by taxpayers who file personal returns shall be remitted to the State treasury and the tax return submitted to the tax authorities within the first seven days of the following month.

Taxes on wages and salaries shall be levied monthly. Taxes withheld by a withholding agent or those to be paid by taxpayers who file personal returns shall be remitted to the State treasury and the tax return submitted to the tax authorities within the first seven days of the following month. Taxes on wages and salaries derived from certain industries may be levied on an annual basis and paid by monthly instalments in accordance with measures to be formulated by the State Council.

Taxes on income from production and business operations of individual industrial and commercial households shall be levied on an annual basis and paid in monthly instalments. Such provisional payments shall be made within seven days of the following month. The final settlement shall be made within three months after the end of each year. Excess payments shall be refunded to the taxpayer or deficiencies made good by the taxpayer.

Taxes on fees from contracted operation or leasing of enterprises and institutions shall be levied on an annual basis and paid to the State treasury within 30 days after the end of each year. A tax return shall be submitted to the tax authorities within the same period. Where fees are received in several payments during the year, provisional payment shall be made by the taxpayer within seven days of the following month. The final settlement shall be made within three months after the end of each year. Excess payments shall be refunded to the taxpayer or deficiencies made good by the taxpayer. Taxpayers who earn income outside China shall pay the tax due to the State treasury and submit a tax return to the tax authorities within 30 days of the end of each year.

Article 10.

Income shall be computed in terms of *Renminbi*. Income in foreign currency shall be assessed according to the exchange rate quoted by the State General Administration of Foreign Exchange Control, and shall be taxed in *Renminbi*.

Article 11.

A service fee of 2% of the tax amount withheld shall be paid to the withholding agents.

Article 12.

The administration and collection of individual income tax shall be governed by the provisions under the Law of the People's Republic of China Concerning Tax Administration and Collection.

Article 13.

Detailed rules and regulations for the implementation of this Law shall be formulated by the State Council.

Article 14.

This Law shall come into force from the date of its promulgation.

Appendices:

Table I: Individual Income Tax Rates Applicable to Wages and Salaries

Level	*Monthly taxable income (yuan)*	*Tax rate (%)*
1	500 or less	5
2	501 – 2,000	10
3	2,001 – 5,000	15
4	5,001 – 20,000	20
5	20,001 – 40,000	25
6	40,001 – 60,000	30
7	60,001 – 80,000	35
8	80,001 – 100,000	40
9	more than 100,000	45

(Note: "Monthly taxable income" is the amount net of the 800 yuan deduction under Article 6 and any additional deductions)

Table II: Individual Income Tax Rates Applicable to Income from Business and Production of Individual Industrial and Commercial Households and Fees from Contracted Operation and Leasing Enterprises and Institutions

Level	*Annual Taxable Income (yuan)*	*Tax rate (%)*
1	5,000 or less	5
2	5,001 – 10,000	10
3	10,001 – 30,000	20
4	30,001 – 50,000	30
5	more than 50,000	35

(Note: "Annual taxable income" is income after the deduction of costs, expenses and losses under Article 6.)

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL:

MODERNIZATION OF TAX ADMINISTRATIONS: REVENUE BOARDS AND PRIVATIZATION AS INSTRUMENTS FOR CHANGE[1]

Glenn P. Jenkins

International Tax Program, Harvard Institute for International Development

I. INTRODUCTION: THE ROLE OF A MODERN TAX ADMINISTRATION

We are now witnessing the implementation of a new concept regarding the role of the public administration in a democratic society. The two principles that best embody this new approach are: (i) the public administration is an entity whose main function is to render services to its citizens. This view abandons the thinking that deemed the public administration as an organization vested with vast powers and privileges which could act irrespective of the needs and interests of the public; (ii) the public administration is a series of differentiated functions which have different organizational needs and working methods. This requires that we abandon the 19th century view that the public administration is a set of more or less homogeneous functions where the generalist can move easily between functions or departments. As an example of the trend towards skill-based professionalism, modern tax administration has become more like a financial services organization than, say, a public entity in charge of promoting culture.[2]

Within a more general framework of government reform, the tax administration is a crucial element in enhancing the legitimacy of the political group in power. It should promote and provide a uniform application of the tax laws. It must, at the very least, provide an impression of a uniform application of the law if the political legitimacy of the government is to be enhanced.

The proposed model for the administration of taxes is based on the idea that the tax administration must collect the revenue as specified in the law with a high degree of integrity, while rendering better service to the citizen. In other words, it must consider not just administrative costs but also compliance costs. To achieve such objectives, we need to apply the principles and methods of modern management to assist us in the delivery of these administrative services.[3]

This perspective of the role of the public sector goes hand in hand with the new found popularity of tax reform, which arises out of a need of securing adequate and stable financial resources to deliver public services. Tax reform in developing countries has mainly centered on two objectives: (1) restructuring tax systems toward more efficient taxes that do not distort market forces and (2) choosing taxes that work, that is, taxes that are administratively feasible and raise revenue. For example, greater reliance is being placed on indirect taxes such as the value added tax, while less use is being made of commodity specific export and import taxes. Undeniably, this new emphasis on taxes that work has shifted the focus of reform toward the tax administration.[4] The experience of countries that have fundamentally changed their tax and trade policies demonstrate that, if these economic reforms are to be successful, there is clearly a need for rapid administrative reform.[5] It is now widely acknowledged that tax law or tax policy is only as good as its administration. In tax reform there is a strict and clear interrelationship between good tax policy and tax administration.[6] Simply, good tax policy cannot exist without good tax administration. Whenever actual practice differs from legislative intent, tax administrators are making tax policy and this may distort the intended economic and trade policies and revenue yields. Tax administrators do this by the allocation of the tax burden on different sectors of the economy, and by altering the required compliance costs incurred by the taxpayer.[7] The tax administrators can easily and directly affect tax policies through the assignment and allocation of resources to some taxes and not to others. It has been said that "without a constant reorganization of fiscal administration, without a daily improvement of management methods, it will be very difficult for tax reform to be constructive and feasible".[8]

1. The assistance of Ronald E. Evans of the International Tax Program, Harvard University, in the preparation of this paper is greatly appreciated. We also wish to thank for the collaboration and comments provided by Carlos Silvani, James Owens, Jaime Vasquez, Louisa Rains, Edison Gnazzo, Seth Terkper and Clive Nicholas. The comments and suggestions of the participants at the Annual Conference of the Center for Inter-American Tax Administration, in Santiago, Chile, April 1993 has served to greatly improve subsequent drafts of this paper.

2. Diaz Yubero, Fernando, "La Agencia Estatal de Administracion Tributaria (The Official Tax Administration Agency)", *Revista de Administracion Tributaria (Tax Administration Review)*, Spain (March 1992), No. 10.

3. *Id.*

4. See Mansfield, Charles, "Tax Reform in Developing Countries: The Administrative Dimension", 44 *Bulletin for International Fiscal Documentation* (March 1990), at 137.

5. Jenkins, Glenn P., "Economic Reform and Institutional Innovation", 46 *Bulletin for International Fiscal Documentation* (December 1992), at 588-596.

6. Gnazzo, Edison, "Functional and Financial Autonomy of the Tax Administration", paper submitted to the Meeting of Executive Secretaries of Tax Organizations (CESTO), Kuala Lumpur, Malaysia (20-24 April 1992).

7. See Mansfield, *supra* note 4.

8. Fuentes Quintana, cited in "The Organization of Tax Administrations in the CIAT Members Countries", CIAT Review in 1985-1986, Technical Publication of the Inter-American Center of Tax Administrators.

© 1994 International Bureau of Fiscal Documentation

II. TRENDS IN TAX ADMINISTRATION REFORM

A. Autonomy of the tax administration

A serious impediment to change in the tax administration of many countries is that revenue institutions have traditionally been part of the general civil service. In many countries this has resulted in salaries that are too low to recruit and retain the quality of skills needed for the efficient operation of a revenue system. Furthermore, hiring practices become part of the political patronage system where the main remuneration of an employee arises from the person's ability to extract compensation for favours given, or is based on the person's ability to use information obtained while working in the public sector to his private profit either immediately or later. There are few places in the public sector where there are greater opportunities for these kinds of remuneration than in the tax administrations. In such a situation the tax administration will be perceived as being inefficient, incompetent and corrupt. When this occurs there is a tendency to let the salaries of the tax officials slide even further behind those of their private sector counterparts. This often occurs with the full knowledge of government officials. Hence, the system of informal payments becomes institutionalized in order for the tax administration to be able to survive. But the revenue loss to the government and the compliance cost to business from such informal payment schemes are huge. The public's perception of a tax administration's integrity, efficiency and effectiveness directly affects the citizens' willingness to voluntarily comply with the tax laws. The central question of this paper is, how does a government reverse this process? How does it turn a corrupt tax administration system, that has built up well defined systems to support this mode of operation, into a professional organization where the staff is willing to work for only a competitive salary?

Even when the tax administration is viewed as being incapable of handling its major functions, we often see other independent public sector institutions, such as central banks, being able to obtain the resources and skills needed to carry out their functions.[9]

When one compares various central banks with the tax administration in their respective countries it is clear that the banks operate with greater efficiency and effectiveness. The banks are most often looked upon by employees as the best place to work in the public sector. There are several reasons for this. First, the pay is usually higher. Second, employees usually receive better training. Third, the office equipment is much better and more modern. Fourth, the working conditions (physical facilities) are usually substantially better.

Revenue authorities or distinct ministries, outside of the Ministry of Finance, with their own schemes of service and compensation scales, have been established in a number of countries in order to provide the type of autonomy for tax administration that central banks enjoy. They have often been set up with the objective of creating an institutional mechanism for separating the professionally competent staff who are willing to work for a competitive salary, from those who want to continue with the old system and perhaps are not capable of making changes. The alternative of setting up revenue authorities has not always been successful. Often they have not been able to establish their intended independence, or to obtain the financial resources to operate effectively. In some countries, frequent transfer of staff to other units of the service disrupts operations and adversely affects specialization.

B. Professionalism in tax administration

The availability and retention of trained human resources is by far the most important factor in determining the efficiency of the tax administration. We need to recognize that the quality and honesty of a tax administration official is largely determined by the environment within which the human element is placed.[10]

Professionalism in tax administration encompasses several things: (a) an adequate remuneration for professional tax administrators taking into account the responsibilities of their jobs. Tax administrators should have incentives for promotion and remuneration based on their performance and capacity; (b) there is a need for a job classification system that clearly defines the responsibilities of each position; (c) employment stability is needed to ensure that people stay in a position long enough to justify adequate training so that they are able to deliver a high quality service. This usually requires that officials should enjoy working conditions free of political interference and pressures, (d) for recruitment, minimum requirements for each position must be established and, in some instances, objective tests should be given for the selection of candidates; and lastly, (e) in respect of training, it should be given in an organized and structured fashion applicable to each level of the tax administration. Further, training should be furnished taking into consideration the human and material resources available.[11]

III. NEW STRUCTURES FOR A NEW TAX ADMINISTRATION

A. Characteristics of a new structure

The above criteria can not be met if old practices and restraints persist in the structure of the tax administration. In effect, the call for a modernization of the tax administration often requires a major overhaul of the present organization and the introduction of new legal and administrative mechanisms.

The proposal being made here is to restructure the tax administration very much in the same manner as central banks have been established around the world. The laws of central banks differ in their focus, scope and degree of detail. Nevertheless,

9. Terkper, Seth E., "Improving the Accountancy Content of Tax Reform in Developing Countries", Development Discussion Paper No. 440 ITS No. 6, International Tax Program Discussion Papers, Harvard University (November 1992), at 10; and 48 *Bulletin for International Fiscal Documentation* (January 1994), at 21.
10. "Professionalism in Tax Administration", *Studies on Tax Administration*, No. 18, Inter-American Center of Tax Administrators, Panama (November 1975), at 4.
11. *Id.*

© 1994 International Bureau of Fiscal Documentation

we may group the legal coding of the central bank independence into four main issues:

(1) the appointment, dismissal and term of office of the chief executive officer of the bank,
(2) the policies over which it is given control,
(3) the objectives of the central bank and, specially important for our purposes,
(4) the financial independence of the agency within the guidelines set out in the law governing it.[12]

Of course, an appropriate degree of oversight at the highest levels is required. Such an autonomous form of organization is one of the means by which a government can try to introduce professionalism and efficiency in the assessment and collection of taxes. Legal autonomy is, of course, an essential component of actual autonomy, but not the only one. It is necessary to provide the tax administration with the ability to pay competitive salaries for the skills required, and to change its administrative procedures so that it can operate efficiently and effectively. This does not change the need for tax policy to be made at the level of the Ministry of Finance or Congress, neither does it preclude close cooperation between the Ministry of Finance and the authority in charge of tax administration.

In sum, the proposed changes for the tax administration should have the following features:

(i) it should have financial independence, meaning that the agency may allocate its budget as it deems appropriate. It might have the possibility (not necessarily) to be legally authorized to use part of the funds it collects for salaries and/or personnel incentives and equipment purchases;
(ii) it should be an agency that is as an autonomous administrative unit, capable of formulating its own administrative policies and objectives,
(iii) derived from the above two features, the agency should be responsible for its own recruitment, training and salary structure, and establishing a code of conduct for its personnel. Along with this responsibility the tax administration should be given the authority to enforce the rules that are established.

Transition difficulties are inevitable. There will be issues relating to: determining which employees should be retained and the standards to be used to make the decision; where to assign those who will not be retained, assuming they cannot be dismissed from the civil service; what are the standards/rules for setting the new pay schedule?

The revenue authority, if organized as a statutory body or as a separate ministry, might be headed by a single individual, perhaps a Minister, or by an appointed group of individuals as a revenue board. Appointing a Minister to head such an authority has had mixed success. In Canada such an arrangement has worked quite well as the Minister of Revenue has always been completely subordinate to the Ministry of Finance on all tax policy matters. In both Bolivia and Ghana, conflicts over division of responsibilities and authority in the area of tax policy between the Minister responsible for the revenue authority and the Minister of Finance has resulted in this Ministerial appointment being dropped from the cabinet. If a revenue board is appointed a further set of organizational and political issues arise, but the fundamental relationships outlined below apply to either situation.

B. Oversight by a revenue board

The mission of a revenue board and the revenue authority it supervises should be to:

> Promote voluntary compliance to the highest degree possible; to continuously improve the administration of the tax laws by ensuring the nation's revenue is collected and; to ensure the tax laws are administered fairly, efficiently, effectively with a high degree of integrity.

The board can and should perform a significant role in accomplishing these objectives. However, the function of the board should not be, or perceived to be, a replacement for the line management of the tax departments. The tax departments should be kept, to the greatest degree possible, professional organizations for the administration of the tax laws. If they become subject to a high degree of political interference, obvious inequities are certain to arise and the legitimacy of the tax system, and perhaps also the government, is likely to suffer. In order to achieve the objectives, the board must have specific responsibility for certain administrative issues and operate as a policy committee by establishing objectives and ensuring they are carried out in a timely and professional manner.

Some of the responsibilities of the board should be to:

- ensure that the tax laws are enforced with the highest degree of integrity;
- ensure the departments (customs, excise and income) coordinate and share information when and where there is a need;
- establish an overall pay and classification structure;
- provide guidance and direction in resource allocation (make sure the resources are allocated properly between and among the various functions of the departments);
- ensure that appropriate personnel and programme management practices are in place and carried out (this would include such things as training, programme management and personnel evaluations and corrective actions taken if appropriate);
- recommend to the Minister of Finance legislative changes needed to improve the administration of the tax laws;
- establish an internal audit function staffed by professional auditors who would be responsible for determining if the policies of the board are being carried out properly (the annual audit plan should be approved by the board);
- provide the Minister of Finance with revenue estimates on existing and proposed tax laws; and
- establish and implement a written code of conduct for all employees in the departments and the board.

No individual member of the board should be permitted to make inquiries into the departments or make decisions without the formal approval of the board. The day-to-day man-

12. See Cukierman, Alex, Webb, Steven and Neyapti, Bilin, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", *The World Bank Economic Review* (September 1992), No. 3, Vol. 6, at 356-366.

© 1994 International Bureau of Fiscal Documentation

agement of the board's operations should be delegated to a chief executive. However, the chief executive should not have general or direct line authority over the department heads (Commissioner of Taxes or Controller of Customs and Excise Tax). The chief executive authority should come from the board and be limited to making sure the department heads carry out the instructions, decisions, policies and mandates of the board.

The creditability, integrity and perception of the board is directly related to its effectiveness and success. Therefore, the criterion for membership on the board is a critical success factor. Permitting someone from the business community or the private sector accounting profession would, at the very least, give the perception that the board cannot fairly enforce the tax laws. At worst, members of the business community or private accounting profession would have inside information and could use the information for their private gain. Within the tax departments their membership would be viewed with suspicion and concern. It would raise serious questions when their own tax returns or clients were being audited or assessed a penalty. The professional staff of the tax department would be reluctant to treat their returns in the same manner they would treat others. The administration of a nation's tax laws is too important to take these risks. Ideally the revenue board would consist of heads of the revenue department and customs, and representatives from the Ministry of Finance, the central bank, the national planning agency (treasury board) and the auditor general's office.

The efficient functioning of the board is somewhat related to the size. There are several reasons to keep the number of people on the revenue board to a minimum. First, a large board makes it difficult to schedule meetings and come to a consensus. Second, the larger the board the more difficult it may be to locate individuals that do not have outside interests who will be perceived to have a conflict of interest. Third, the larger the board membership the less individual accountability. Too few may not provide sufficient support or overall experience to carry out the board's responsibilities. The number of members should be between five and nine.

Members should not be permitted to send a representative to the board meetings. Of course, members should be held to the same rules of confidentiality as employees of the tax departments. The board should operate only as a board. Therefore, board members should not be permitted to have individual staffs.

It is extremely important that the board not have authority to intervene in ongoing tax cases. It should not suggest a review of specific cases, indicate in any way which cases should or should not be examined, assessed or collected, or interfere in an open or ongoing case. This prohibition should be in writing. It is appropriate for the board to inquire into and provide direction regarding areas of non-compliance. Furthermore, the board should have the authority to review, through an internal audit, closed cases to see that they have been properly processed and worked according to the prescribed procedures. *The overall authority to administer the laws as it relates to specific tax cases must rest with the head of each of the departments.*

C. Privatization of administrative functions

We should also consider moving towards what some have referred to as "the application of the subsidiarity principle to the tax administration",[13] that is, assigning to the private sector those functions of the tax administration which can best be performed by it, within the legal limitations of the given country. By way of illustration, Mexico has undertaken a major reform of its tax administration, in which it has privatized many aspects of the computer system used to construct its information for administrative purposes. Thus, a private firm is now providing the Mexican tax system with computer services. The firm is being paid through a fee collected directly from the taxpayers and deposited in a trust fund. The result is that the management of systems, the hiring of all the personnel of the information technology side of tax administration as well as procurement of equipment have been privatized. Banks are also entrusted with being the sole receivers of tax payments and with putting all the information from the returns on tape. Moreover, the private sector was authorized to print and distribute tax returns, registration and notice forms.[14]

By the same tóken, in the customs area, warehousing has been turned over to the private sector and customs personnel withdrawn. The result has been an orderly management of stored merchandise, a virtual disappearance of losses, timely information, to name a few. A private sector customs auditor was also created. These auditors can go over the work performed by customs inspectors and are vested with legal authority to rule on the outcome.[15] In many countries the task of classification and valuation of imports has been turned over to private surveyor companies who are better positioned than customs to make this determination.[16]

As has been stated by Francisco Gil Diaz, "there are myriad governmental activities that can be delegated to third (private) parties with no loss of sovereignty or authority. There are many advantages to such delegation: salaries can be considerable above civil service constraints, while costs can be much lower. Accountability rises, efficiency increases as procurement restrictions are short-circuited. And perhaps, what is more essential, the primary objectives: revenue, compliance, control, are enhanced through these auxiliary activities".[17]

In the United States the majority of states are currently using, planning, or have used some form of privatization in their tax administration. These activities include contracting with the private sector to perform such things as: document storage, deposit of funds, key entry of payments, collection, mail room operations, computer programming, computer hard-

13. Gil Diaz, Francisco, "The Subsidiarity Principle Applied to Tax Administration", paper presented in the Conference on Information Technology and Fiscal Compliance, sponsored by Harvard International Tax Program, Instituto de Estudios Fiscales de Espana and Lincoln Institute of Land Policy, Cambridge, Massachusetts (November 1992), at 4.
14. *Id.*
15. *Id.*
16. Jenkins, Glenn, "Economic Reform and Institutional Innovation," 46 *Bulletin for International Fiscal Documentation* (December 1992), at 590.
17. See Gil Diaz, *supra* note 13.

© 1994 International Bureau of Fiscal Documentation

ware operation, etc.[18] Also, the US Internal Revenue Service is currently considering a plan that would involve a contractual relationship with a private sector organization to collect low dollar yield accounts they are not now pursuing because of a lack of resources.

IV. REVENUE AUTHORITIES: COMPARATIVE EXPERIENCES

Many of the changes in the role of the tax administration have already been undertaken by a number of countries around the world. I will refer, briefly, to some of those experiences.[19]

In the case of Spain, a Tax Administration State Agency ("Agencia Estatal de Administracion Tributaria" or "AEAT") was created in 1991 (although it was put into effect in 1992) for the purpose of providing the Spanish taxpayers with a more modern organization that would enable the pursuit of the objectives of the Spanish tax administration. The AEAT is a public body vested with its own legal entity. Its main objective is the effective application of the tax laws. It encompasses the audit, management and collection of taxes functions.

The AEAT came as a response to the need to improve some of the problems still pending after the administrative reform undertaken in the 1980's, namely: (i) lack of a consistent personnel policy for the tax administration, (ii) an inadequate budgetary and financial system and (iii) lack of coordination of the government's legal position for tax cases before the Courts.

In Jamaica under the Revenue Board Act of 1981 a revenue board was set up to be the central, independent agency with responsibility for exercising a critical overview of the operations of the main revenue departments. As the central tax administration authority, the board is responsible for directing, coordinating, inspecting and monitoring the activities of Inland Revenue, Customs and Excise, Income Tax, Stamp Duty and Transfer Tax and Land Valuation. It has responsibilities very close to those set out as a model in this paper. Although its functions have evolved over time, on the whole it has made a major contribution to effectiveness of the tax administration.

In 1988, Peru created, by Law No. 24829, dated 6 August 1988 (further complemented by legislation enacted in 1992), a National Superintendency of Tax Administration. The Superintendency is a public decentralized agency, vested with its own legal entity, its own financial, administrative, technical and functional autonomy. It is charged, among other things, with the design of fiscal policies, the administration, audit and collection of taxes and the drafting of Regulations to the tax laws. The Superintendency is further responsible with the collection of taxes through the Banco de la Nacion, which is in turn authorized to enter into agreements with other financial entities.

Argentina passed, in 1988, Law No. 23.495, which introduced substantial changes to Law No. 11.683, whereby the General Tax Directorate is given autonomy in its organization, administration, patrimony, personnel, procedures and control. The new statute allows the General Tax Directorate to enter into agreements with state and commercial banks for the purpose of collecting taxes. The General Director has been vested with the power to organize and regulate the internal functioning of the Directorate, including but not limited to, personnel administration and structure, assignment of functions and responsibilities, etc. It also provides for the establishment of a compensation fund to be allocated among the revenue agents in accordance with a merit system which takes into account the responsibility, professional qualifications and the output generated by the agents. The fund is based on 0.60 percent of the amounts of taxes collected.

Colombia has followed a similar path. In effect, Decree No. 1643 of 27 June 1991 provides for the organization of the Directorate of National Taxes ("Direccion de Impuestos Nacionales"). It provides, in substance, that the Directorate will be organized as a special administrative unit, ascribed to the Ministry of Finance and Public Credit, with a special personnel regime with its own nomenclature, classification, budget, salary and hiring procedures.

Furthermore, Decree No. 1647 of 27 June 1991 establishes a personnel system for the Directorate of National Taxes. The Decree provides for the creation of a fund with the purpose of furnishing financial support to the modernization of the tax administration, mainly through the awarding of bonuses to the personnel in accordance with productivity and capacity. The fund will obtain its monetary resources mostly from budgetary allocations, in amounts that are proportional to the interest charges and pecuniary sanctions collected by the Directorate of National Taxes.

Singapore, in September 1992, incorporated the Inland Revenue Authority of Singapore (IRAS) to take over the functions of the Inland Revenue Department. It will be responsible for the administration of income tax, property tax, stamp duty, estate duty, international tax treaty negotiations and some other minor taxes. The motivation for converting the Inland Revenue Department into a statutory authority came from the need to be freed from civil service restrictions on personnel and financial management. It needed to be able to offer competitive wages to attract and retain talent in the organization in order to improve the quality of tax administration. The tight labour market for such skills in Singapore was making the conditions of civil service employment increasingly non-competitive. The move to set up the Inland Revenue Authority of Singapore has been accompanied by a number of changes in administrative practices, and functions to provide better service to the taxpayers while working to reduce their compliance costs.[20] Singapore's experience with its Inland Revenue Authority is a case that should be fol-

18. See "Privatization Survey Release", *Bulletin, Federation of Tax Administrators*, Washington, D.C. (20 July 1992).

19. The information provided in this section has been taken from Laws and Decrees from the countries herein described. We appreciate the assistance kindly furnished to us by Carlos Silvani from the International Monetary Fund (IMF).

20. Ow, Alan S.S., "Developments in Tax Administration in Singapore," 9th Asian-Pacific Tax Conference, November 1992, (Singapore: Asian-Pacific Tax and Investment Research Centre).

© 1994 International Bureau of Fiscal Documentation

lowed closely by other tax administrations. Intent on achieving the highest level of compliance, but with a strong service orientation, its commitment to becoming a highly modern tax administration will likely lead to innovations from which much can be learned.

In Ghana the National Revenue Secretariat was instituted in 1985 and had power to design and execute structural and operations policy. It took over the functions of the Revenue Department of the Ministry of Finance. The Secretariat was empowered with Ministerial responsibilities for all revenue policy and implementation and complete authority for supervising the operations of the revenue institutions in the country. However, it shared the role of policy formulation with the Ministry of Finance. Between 1985 and early 1991, it was headed by a Minister of State and Chief Director (equivalent of principal secretary) who reported directly to the Cabinet and Office of the Head of State (now President).

There was initial resistance to the change in revenue administration by the top hierarchy of the civil service. The persistence of this opposition, coupled with glaring fiscal policy conflicts between the Secretariat and the Ministry of Finance, led in early 1991 to a policy roll-back. The Secretariat remains an autonomous institution but is responsible to the Minister of Finance and the Chief Director (Technical) at the Ministry. Fortunately, the roll-back policy in connection with the National Revenue Secretariat did not affect the autonomy of the revenue institutions.

Most recently Zambia enacted the Revenue Authority Bill, 1993. This law established the Zambia Revenue Authority that will consist of nine board members who will have responsibility for all the income and custom taxes. The law provides for a Commissioner General who will occupy a full time position and carry out the revenue authority's policies and procedures. The law further provides that the effective date of the authority will be set by the Minister of Finance. Currently, they are in the process of developing a set of implementing procedures and guidelines with an expected date of implementation of 1 January 1994. The new authority will not be required to retain any of the employees of the old tax departments. These employees will either retire, be transferred to other agencies or terminated. Of course, those that meet the newly established criteria can be selected to work in the newly formed tax organization.

The above experiences show that the trend for a separation of the tax administration from the public administration is gaining momentum. It also shows that there is still much to be done in this field. The degree of independence vested upon the tax administration varies from country to country. Nevertheless, these experiences are significantly important for countries which are currently undergoing administration reform efforts.

IV. CONCLUSIONS

We have emphasized throughout this paper the need to provide the tax administration with a flexible structure that would allow it to fulfill its administrative and statutory obligations. At the same time, many countries are now trying to break out of their old cycle of tax reform and failure due to costly administration processes that also lack integrity. A possible structure that might assist and should be considered in the achievement of this objective is the creation of a separate administrative unit, namely, a revenue authority, vested with financial and administrative independence. The experience of central banks throughout the world serves as a model for the setting up of such an independent agency.

Some of the countries have taken bold steps toward tax administration reform. It is perhaps too early to reach sweeping conclusions, but the results of these reforms indicate that this may be a promising path to take. Many have been quite successful, at least at the initial stage, ridding the tax administration of many unnecessary, incompetent or untrainable employees while introducing modern information and management systems.

Further, careful consideration should be given to the possibility of privatizing functions of the tax administration that can be more efficiently performed by the private sector. There will be considerable benefit derived from incorporating many of the management techniques used by the private sector in the tax administration. There is a need to continue to instill in the minds of the public administrators the notion that, as members of a tax administration, they should act and be service providers. As such, their actions will be measured in accordance with the quality and efficiency of the service they provide both to the government and the taxpayers. While this may be a significant departure from past practices of the tax administration, it is clearly the future direction of many modern tax administrations.

BIBLIOGRAPHY

Bird, Richard and Casanegra de Jantscher, Milka, *Improving Tax Administration in Developing Countries*, IMF, 1992.

CIAT, "Professionalism in Tax Administration", *Studies on Tax Administration*, Panama, November 1975, No. 18.

CIAT Review in 1985-1986, *The Organization of Tax Administrations in the CIAT Member Countries*, Technical Publication of the Inter-American Center of Tax Administrators.

Cukierman, Alex; Webb, Steven and Neyapti, Bilin, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", *The World Bank Economic Review*, September 1992, No. 3, Vol. 6.

Diaz Yubero, Fernando, "La Agencia Estatal de Administracion Tributaria (The Official Tax Administration Agency)", *Revista de Administracion Tributaria (Tax Administration Review)*, Spain, March 1992, No. 10.

Gil Diaz, Francisco, "The Subsidiarity Principle Applied to Tax Administration", paper presented in the *Conference on Information Technology and Fiscal Compliance*, sponsored by Harvard International Tax Program, Instituto de Estudios Fiscales de Espana and Lincoln Institute of Land Policy, Cambridge, Massachusetts, November, 1992.

© 1994 International Bureau of Fiscal Documentation

Gnazzo, Edison, "Functional and Financial Autonomy of the Tax Administration", paper submitted to the Meeting of Executive Secretaries of Tax Organizations (CESTO), Kuala Lumpur, Malaysia, April 20-24, 1992.

Jenkins, Glenn P., "Economic Reform and Institutional Innovation", in 46 *Bulletin For International Fiscal Documentation*, December 1992.

Mansfield, Charles, "Tax Reform in Developing Countries: The Administrative Dimension", 44 *Bulletin for International Fiscal Documentation*, March 1990.

Mexican Revenue Subsecretary, "Evolucion de la Administracion Tributaria en los Paises Americanos de 1961 a 1980, Analisis Global (Evolution of Tax Administration in the Americas. 1961-1980, Global Analysis)", in *Technical Papers from the XV General Assembly of CIAT Members*, Mexico, 1981.

Privatization Survey Release, *Bulletin, Federation of Tax Administrators*, Washington, D.C., 20 July 1992.

Terkper, Seth E., "Improving the Accountancy Content of Tax Reform in Developing Countries", *Development Discussion Paper # 440 ITS #6*, International Tax Program, Harvard University, November 1992.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

FEBRUARY 1994

Essential Tax Planning for Groups of Companies, London, 15-16 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

2nd Caribbean Tax Conference, Cancún, 17-18 February 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, the Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Death and Taxes in Europe, Amsterdam, 21-22 February 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

International Transfer Prices between Companies, Düsseldorf, 23 February 1994 (German):

Verlag Dr. Otto Schmidt, Postbox 51 10 26, 50946 Koln, Germany. Tel.: 0221/93738-419, Fax: 0221-93738-941.

MARCH 1994

International Estate Tax Planning, Amsterdam, 7-8 March 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Internal Consultant Development Programme, Bruges, 21-25 March and 18-22 April 1994 (English):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel. 32-2-516 1911, Fax: 32-2-513 7108.

International Tax Aspects of Permanent Establishments, Amsterdam, 24-25 March 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

U.K. and International Tax Structuring for Entertainers and Sportsmen, London, 25 March 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

APRIL 1994

Taxation one year after the start of the Single Market, Brussels, 13 April 1994 (English, French, German):

Confédération Fiscale Européenne, Postfach 13 40, D - 53003 Bonn, Germany, Tel.: 49-228-726 3944, Fax: 49-228-726 3952.

Licencing in Europe for 2002, Delft (Netherlands), 17-20 April 1994 (English):

Congress Office ASD, PO Box 40, 2600 AA Delft, The Netherlands, Tel.: 31-15-120 234, Fax: 31-15-120 250.

International Tax Planning Techniques, Amsterdam, 21-22 April 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MAY 1994

International Aspects of VAT, Amsterdam, 9-10 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

7th East West Tax Conference, Sofia, 26-27 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Tax Treatment of Transfer Pricing, Amsterdam, 27-28 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JUNE 1994

International Tax Planning Association Meeting, Monte Carlo, 9-10 June 1994 (English):

Elizabeth Husband, ITPA Convention Bureau, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-762 910, Fax: 44-732-763 762.

Tax Avoidance and Tax Treaties, Amsterdam, 13-14 June 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1994

Leyden–Amsterdam–Columbia Summer Program in American Law, Leyden, 3-29 July 1994 (English):

Mrs B. Zaaijer, University of Leyden, Faculty of Law, Columbia Summer Program, Hugo de Grootstraat 27, 2311 XK Leyden, The Netherlands, Tel.: 31-71-277 632, Fax: 31-71-277 600.

AUGUST 1994

Principles of International Taxation, Amsterdam, 22 August-2 September 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

BOTSWANA:

DOUBLE CORPORATE TAX:

UNTANGLING THE UNDERGROWTH OF COMPANY AND SHAREHOLDER TAX RULES

Peter Nanyenya Takirambudde

Law Department, University of Botswana

I. INTRODUCTION

The corporate tax system in Botswana recently underwent two major overhauls. During 1990 and 1991, the Parliament enacted laws relating to the taxation of companies and shareholders. The 1990 and 1991 Income Tax Acts made sweeping changes to the structure of tax law as it relates to company and shareholder taxation. The policy objective behind the reforms was the creation of a more attractive environment for investment and private sector development. The new law has sought to instal fiscal neutrality, in sharp contrast to past policies and practices. Previously, company taxation which was founded on the so-called classical approach distorted

> three economic and financial decisions. Namely whether to: (1) invest in non-corporate rather than corporate form; (2) finance investments with debt rather than equity; and, (3) retain rather than distribute earnings [Hubbard, 1993, pp 117-8].

The new tax law is the most far-reaching reform in the history of company taxation in southern Africa. The company tax rate has been equated to the top individual rate. Double taxation has been substantially eliminated and the overall tax burden on business income has been significantly reduced.

The dilemma posed by corporate double taxation is not peculiar to Botswana. In English-speaking Africa, it appears to be the norm. For example, an examination of the tax systems of Nigeria, Ghana, Kenya, Uganda, Zambia, Zimbabwe, Malawi, Lesotho and Swaziland reveals that corporate profits are taxed both at the shareholder and at the company level.[1] And in a recent study, Tiley referred to a 1991 OECD study which established that the classical approach to corporate taxation was prevalent "not only in three of the European Community countries (the Netherlands, Belgium and Luxembourg) but also in the United States and Switzerland. According to Tiley:

> Some countries eliminate the economic double taxation of the classical system by having either a zero rate system at the corporation level (Greece and Norway) or full imputation of the corporate tax to the shareholder (Australia, Finland, Germany (in part), Italy, New Zealand and Turkey). Other countries give partial relief but have no fewer than four methods [Tiley, 1992, p 459].

Tiley goes on to outline the prevailing methods of partial corporate integration within the OECD:

> Germany has a split rate system at the corporate level so that the corporate tax on distributed profits is less than that on undistributed profits. Ireland, Spain and Sweden also give relief at the corporate level but by means of a partial deduction of dividends paid. France, Ireland and the United Kingdom give relief at the shareholder level by partial imputation of the corporate tax paid while other countries give partial credit for domestic shareholders; this group comprises Austria, Germany, Denmark, Ireland, Japan, Portugal and Turkey [Tiley, p 459].

In the immediate post-independence era the Government played a leading role in the "growth" of the economy and locating markets for the country's products. During this period, the tax instrument was used as a control and distributive strategy. There was significant intervention by intrusive tax provisions and extensive commercial and industrial licensing. Government thinking has undergone a major transformation. Priority is now placed on the creation and sustenance of an investor-friendly environment. Emphasis is currently on the strategic role of the private sector in the "growth" of the economy, representing a paradigm shift that has affected past policies and instruments, including tax laws. Henceforth, private sector profits are to be the sources of growth, jobs, investment, taxes and redistributive spending. Tax laws must therefore be reformed so that they get out of the way of private initiative in an investor-friendly environment. Tax laws that seek to influence and determine organizational forms, capital structure and dividend policies are being abandoned in favour of a neutral approach.

This article reviews and discusses the background and content of the changes to corporate tax in Botswana. The suggestion is made that the recent changes reflect a major shift in economic policy and strategy on the part of Government. The long-term economic effects of the changes are not assessed, although some preliminary lessons to be drawn by other African countries are pointed out. Part II outlines Botswana's corporate tax system and its associated problems prior to the reform package. Part III outlines the major changes introduced under the 1990 and 1991 legislation, and Part IV provides an assessment and a conclusion.

II. PRE-1990 CORPORATE TAX SYSTEM

The basic approach to company taxation in the period before the changes was the recognition of the legal independence of the company from the shareholder [Clark, 1977, pp 91-134, Lent, 1977, p 724; Williams, 1991, p 62; and, Hubbard, 1993,

1. See *African Tax Systems* (Amsterdam: IBFD, Supplement No. 79 of 1991, 82 of 1992 and 85 of 1992).

© 1994 International Bureau of Fiscal Documentation

pp 111-132]. This approach established three major principles. The first was the so-called separate tax principle, i.e. there will be a separate tax on the income earned by the company [Clark, pp 97-100; Hubbard, p 115]. This principle was established under the 1973 Income Tax Act (1973 Act)[2] which amended and consolidated the law relating to income taxation. The second principle was the distribution principle which mandated a shareholder tax on the company's income upon its distribution from the company to the shareholder [Clark, p 100-4; Hubbard, p 115]. This principle was embodied in Section 32 of the 1973 Act.[3]

Clark explained that the distribution principle has three major aspects. First, the distributions from the company to the shareholders can be income taxable to the shareholders – that was the essence of Section 32(1). Under Section 32(1) the definition of gross income encompassed dividends. Secondly, only corporate "income" is subject to taxation at the shareholder level, the underlying rationale being that a distribution by the company to shareholders that "consists merely of a return of capital originally contributed by those shareholders could not be considered gain, much less taxable income" [Clark, p 100]. The 1973 Act sought to clarify this matter through its definition of dividends under Section 2. It excluded from the scope of "dividend" any amount representing a return of capital. Thirdly, under the "distribution principle" undistributed company earnings are not generally taxable to shareholders on the basis that "gain in value of property, that is, gain that has not yet been realized, should not be taxed as income" [Clark, p 101].

This position was altered by the imposition of capital gains tax on the gross income of any person for any tax year representing any amount in cash or otherwise which is distributed upon the winding-up of a company other than an amount representing a return of capital.[4] Furthermore, the "undistributed income principle" did not preclude the indirect double taxation of undistributed earnings. As Hubbard stated, such earnings increase the value of shares, which appreciation is "taxed at capital gains rates when shares are sold" [Hubbard, p 115]. Thus under Section 32 of the principal Income Tax Act, the gross income of a taxpayer includes any amount in cash or otherwise accruing to him on the disposal of any shares in or debentures of a company.[5] However, such capital gains tax on realized gains is set at preferential rates that are lower than the rates applicable to ordinary income [Clark, p 104-6].

Closely associated with the distribution principle was the imposition of an obligation on the company to withhold an additional tax at the rate of 15 percent on a dividend distribution to the shareholder. The withholding tax was imposed under Section 58(1) of 1973 Act.[6]

The combined effect of the "separate tax" and the "distribution" principles is the creation of a "double tax" on currently distributed corporate income [Clark, p 102]. This provides a strong incentive on the part of both the company and the shareholder to devise methods of escaping the burden of double taxation. One way of nullifying the double tax is to cast corporate distributions to make them appear as something other than dividends [Miller, p 235; Clark, p 104-6]. The other principal modality of nullification is the non-distribution of dividends or delayed extraction of the company's profits by the shareholder. Clark has suggested that the retained earnings strategy rests on the pivotal third aspect of the distribution principle that the undistributed income of the company is not generally taxable to the shareholder [Clark, p 104-6].

III. REACTION AND COUNTERACTION

The overall result of the double tax is a considerable degree of complexity in the system of corporate taxation consisting of litigation, rule-making, major and detailed changes in statutes, internal corporate transactional complexity and heightened administrative costs for compliance and enforcement. This complexity derives from taxpayers attempting to avoid the onerous burden of the double tax, and the retention of earnings even though strictly non-tax business considerations would have recommended a distribution. The counter-response on the part of the government is to devise new rules and other techniques to frustrate the consummation of avoidance techniques [Clark, pp 94-104, 106-7; Miller, p 235].

In the Botswana context, this was represented by the complicated and probably non-enforceable legal enactments in the 1980s that were intended to curtail the disguising of dividends and the delayed extraction of earnings. Simultaneously, Government made an attempt to moderate the adverse impact of the double tax. This represented a recognition of the reality that distributed corporate earnings were taxed twice in the hands of the company and the shareholder.

More specifically, counteraction by Government in Botswana was on seven fronts: (1) enactment of a deemed dividend distribution rule; (2) introduction of the concept of a close company; (3) exemption of bonus shares from income taxation; (4) imposition of a presumptive dividend in respect of remittances to non-resident companies by local branches; (5) granting partial relief in respect of payments to resident companies and shareholders; (6) imposition of capital gains tax on distributed amounts upon the liquidation of a company in excess of the amount originally contributed as capital; and (7) levying capital gains tax on amounts that accrue upon the disposal of shares and other business assets.

A. Deemed dividend distribution

The 1973 Act empowered the Commissioner to define a "standard amount of dividends" to be distributed by every resident company and to impute the undistributed portion of the "standard amount" to the shareholders as income.[7]

2. Laws of Botswana, Income Tax Act, Act No. 10 of 1973, (Gaborone: Government Printer).
3. *Id.*
4. See ITA Sec. 33(2).
5. ITA Sec. 33(1).
6. Sec. 58(1) provides as follows:
"Every person who being a resident company, pays a dividend to a non-resident, shall deduct tax from such payments in accordance with and in the manner specified in the Ninth Schedule..."
7. Sec. 126.

© 1994 International Bureau of Fiscal Documentation

The Botswana approach, though different in form, was motivated by the same considerations as the US "reasonable needs" rule [Miller, p 236]. Some developing countries adopted the US approach but others used the ratio of retained earnings to earnings after tax or the ratio of earnings to business capital. Lent reported that in English-speaking Africa, the favourite device was the technique employed

> "in the British Model Income Tax Ordinance of 1922 which empowered the Commissioner of Revenue to assess additional tax on the incomes of closely held corporations that he determined were retained to avoid personal income tax" [Lent, p 735].

The approach in East Africa was that

> "companies that distributed less than a specified percentage of earnings were assessable unless they showed a need to retain a greater proportion for working capital or expansion needs. These rules were not codified but were agreed with the Association of Accountants in East Africa" [Lent, p 735].

There is, however, no statistical or other evidence to show the degree of earnings to which the deemed provision was enforced in Botswana. Referring to the British Model Income Tax Ordinance anti-retained earnings provision, Lent stated that due to the need to prove "the final requirements of a business for working capital and expansion, and to prove the owner's motives for retaining income", the determination whether the relevant income was retained to avoid personal income tax was subject to taxpayer dispute and litigation.

And writing in 1977 regarding the US accumulated earnings tax, Clark concluded that it was

> extremely doubtful that the accumulated earnings tax provisions have had any significant tendency to curtail the widespread use of the retained earnings strategy. The statute normally requires proof of reasonable business ends – a difficult task [Clark, p 104].

Be that as it may, the undeclared dividend provision was repealed by the 1979 ITA[8] on the ground that it was necessary to boost the capital position of companies, particularly in respect of funds for expansion. However, an unstated reason might have been the non-enforceability of the law. The associated problem of indirect double taxation of retained earnings through the taxation of capital gains in respect of an increase in the value of shares was, however, unaffected by the repeal of the retained earnings rule.[9]

B. Closing in on the "closely held company"

In order to penalize and thus discourage techniques and practices designed to cast corporate distributions in the guise of something other than dividends, the 1984 Act introduced the anti-tax avoidance concept of a close company.[10] The Botswana provisions were modelled on similar British tax provisions [Clarke et al, 1984].

The rationale for the close company concept was stated by Clarke to be that when the shares of a company are held by the general public, market pressures can be relied on to exert adequate pressure to guarantee that the company's affairs are managed according to commercially acceptable practices. However, the position is substantially different if a company is controlled by a small number of individuals, some doubling as directors and shareholders. In the absence of market pressures or special legislation, such a small group would be at liberty to deal with the earnings of the company in a way that will result in the least tax liability. The "close company" rules are therefore intended to neutralize some of the tax benefits that may be secured by such tactics [Clarke, p 145].

When announcing his intention to introduce the concept of a close company, the Minister of Finance stated:

> I am proposing to strengthen the Commissioner's powers relating to tax avoidance through the Income Tax (Amendment) Bill .... much of this legislation will be concerned with transactions between private companies and their shareholders.[11]

The 1984 Act sought to counteract tax avoidance through provisions which addressed three types of transactions: certain payments by the company to participators; dividend remittances or credits in favour of non-resident companies; and interest payments to participants.

The objective was to prevent the shifting of income in general and to penalize specified payments that included loans. First, the Act dealt with payments by the company to participators and mandated the inclusion of gratuities, free passages and loans within the taxable income of the recipients as if they were dividend distributions unless such passages and gratuities were tax exempt and the interest on the loans was equivalent to interest that would have been arrived at in an arm's length transaction. Second, the Act made provision for the inclusion in the taxable income of a resident participator any amount of dividend in any tax year that was remitted or credited in favour of a non-resident company which would have been classified as a close company if it had been resident in Botswana. Third, in circumstances where interest was payable to a participator which was lower than the generally prevailing commercial rate, the Commissioner was authorized to determine the amount of interest at such commercial rate as he deemed reasonable if he was of the opinion that the loan was not an arm's length transaction.

In a related move under the same Act, the Minister of Finance sought to address the problem of under-capitalization of private companies in two ways. First, bonus shares were exempted from income tax in order to encourage private companies to capitalize profits for expansion and diversification. To this end, the 1984 Act amended the principal Act by excluding from the definition of dividend "bonus shares issued by a company on or after 1 July 1984 to a shareholder in satisfaction of bonus award and included in the company's equity share".[12]

Second, the Act sought to encourage proper capitalization of private companies by amending the rules regarding the tax deductibility of interest. The Minister was concerned that the then existing system of

8. Laws of Botswana, Income Tax (Amendment) Act, Act. No. 10 of 1979.
9. See *supra* note 5.
10. Laws of Botswana, Income Tax (Amendment) Act, Act No. 18 of 1984.
11. Government of Botswana, 1984 Budget Speech (Gaborone: Government Printer).
12. See *supra* note 10.

© 1994 International Bureau of Fiscal Documentation

deductibility of interest in arriving at chargeable income not only encourages unduly the use of excessive loans with nominal equity capital, but also deprives the fisc of a fair share of profits of business enterprises, particularly those which are owned by non-residents.[13]

In addressing this issue, the 1984 Act introduced a provision whereby any amount of interest which was deemed to have accrued to any participator in a private company as a result of the application of the close company rules could not be deducted in ascertaining the chargeable income of the company for that tax year. As a result, interest on loans from shareholders would henceforth be treated as part of the taxable income of the close company.

C. Imposition of a presumptive dividend on non-resident companies

In addition to the provisions relating to the "close company", the 1984 Act imposed a 15 percent tax on the after-tax profits of a non-resident company carrying on business in Botswana through a branch in any tax year. This tax was styled the "branch profits tax".[14]

D. Partial credit for distributions by resident companies to resident shareholders and public companies

While retaining the rule regarding the legal independence of the company, the revenue authorities attempted to moderate the double tax result of such a treatment by promulgating rules under the 1973 Act to provide relief in two instances.

First, provision was made for "an allowance for current dividends paid out of chargeable income to resident shareholders liable to tax on those dividends.[15] The relief was available if the paying company and the recipient shareholder were resident in Botswana. In that case, the dividend distributed would be deductible to the company for purposes of determining its taxable income.

The credit was created under the 1979 (Amendment) Act which amended the principal Act by inserting the following new provision:

> Subject to the provisions of this section, in ascertaining the taxable income for any tax year of a resident company there shall be deducted any amount of dividend declared by that company and which in that tax year has accrued to any resident shareholder.

Second, relief by way of exemption from tax was made available when an associated company made a distribution to its holding company provided the receiving company was a resident public company. The dividends so received would not be taxable to the receiving resident public company.[16]

The provision of a partial credit represented the first attempt to move away from the classical system of corporate taxation. As a precursor of the major reforms of 1990 and 1991, it constituted a partial abandonment of the classical approach for a partial integration system.

During the 1970s and 1980s there was a fair amount of litigation involving the definition and applicability of the terms "associated company" and "public company" in connection with claims and counterclaims between the Commissioner and taxpayers involving entitlement or otherwise to the deductibility of dividends declared to resident shareholders in the paying company's assessment.

By the end of the 1980s a considerable amount of complex legislation, rules and judgments regarding the taxation of companies and shareholders had accumulated. The original and basic rules regarding the separate taxation of companies and shareholders had generated attempts by taxpayers to avoid tax liability and counter-responses by the revenue authorities. The result was a mass of amendments. As a result simplicity was gravely compromised and the costs of compliance were increased.

And yet simplicity has been often stated to be a major concern in any tax system and a crucial component of compliance and enforcement. But the rapid and complex changes of the 1980s had an opposite effect. The costs of compliance were increased from the perspective of the taxpayers as they relied more on professional advisers to address their tax liability. As Slemrod observed, albeit in a different context,

> it would not be unreasonable to assume that the demand for professional tax assistance, other things remaining equal, positively correlates to the complexity of the tax system [Slemrod, p 57].

Moreover, complexity of corporate or other tax law has an undesirable incentive effect by enhancing the taxpayers' desire and effort to engage in complex financial transactions to minimize tax liability. The effect: heightened economic costs of tax law in general and compliance costs in particular [Slemrod, p 45-57].

A legal culture of high instability and major transactional costs affects all actors. In the Botswana context, the Department of Taxes was not spared. In its report for the period under review, the Department stated:

> It would be noted that there have been considerable legislative changes over this ten-year period. Almost every year there has been a bulky Amendment Act...indicating in some instances, fundamental alterations to income tax practice....fundamental changes in the tax assessment of companies...brought about a big workload each year for the office to handle. One cannot over-exaggerate in this connection the significance of and relevance of a stable tax law both from the point of view of an efficient tax administration and effective tax compliance from the point of view of the taxpayer.[17]

13. See *supra* note 11.
14. The rationale for a branch profits tax was explained by Lent [p 745]:

When branch earnings are remitted to the home office, it is difficult to enforce a tax on their distribution because of the problem of identifying the nature of the transfer. Such remittances may be disguised repayments of home office advances or other payments. (This problem would not arise in the absence of the double tax situation).

Under a separate entity system, failure to tax distributions of branch earnings on a comparable basis with corporate dividends may unduly encourage the use of branches, rather than resident companies to do business - many countries deal with the problem by imposing a presumptive dividend tax.

15. Government of Botswana, 1979 Budget Speech (Gaborone: Government Printer).
16. See *supra* note 2 at para. XXII of Part II of the Second Schedule.
17. Government of Botswana, Ministry of Finance & Development Planning, Report of the Department of Taxes for the period 1 July 1979 to 30 June 1989.

© 1994 International Bureau of Fiscal Documentation

The legal situation would have been otherwise in the absence of the separate tax principle. As Clark has argued, in the absence of the corporate double tax, counteractive legislative action and complexity would be obviated [Clark, p 98].

It was against this background that Government moved to untangle the fundamental problems of corporate taxation in Botswana which had resulted in wastage of much productive time and resources on tax avoidance strategies and counter-responses by the revenue authorities.

IV. THE NEW STRUCTURE OF CORPORATE TAX

The years 1990 and 1991 witnessed a major shift towards an integrated system of corporate taxation that had been partially introduced in 1979. Government had long recognized the need for reform but was unable to introduce the changes prior to 1990. The primary explanation for this long delay was the complexity of the various issues involved. The Taxation Review Committee decided to focus its attention on the reform and simplification of the personal income tax and sales tax. When this was eventually completed in the late 1980s, the Committee turned its attention to corporate and shareholder taxation. The new system of company taxation seeks to provide equity and neutrality, while abolishing economic double taxation and appropriately balancing individual and company rates of tax.

A. Five fundamentals of the new system of tax on corporate income

The Act established a new system for the taxation of corporate income. Five fundamental changes were made.

First, a two-tiered tax applies to companies.[18] A 30 percent tax on company profits is levied together with an additional company tax of 10 percent. The 15 percent withholding tax on dividends continues to operate but this is creditable against the company's additional tax of 10 percent. In consequence, if any part of the additional company tax cannot be made use of as a credit against additional company tax in any tax year, it can be carried forward as a credit against withholding tax in any future tax year.[19]

Second, dividends were removed from the scope of tax liability at the shareholder level. This represented significant progress toward the resolution of the double tax problem. This did not, however, affect the 15 percent withholding tax since it was still payable by the company on dividends declared. However, the net dividend received by the shareholder did not attract tax. The capital gains taxation of the appreciation in value of shares was also unaffected.

Third, tax burdens as between resident and non-resident shareholders and as between resident and non-resident companies were equated particularly as a result of the abolition of the branch profits tax.

Fourth, neutrality and equity within the tax structure was reinforced. The system would henceforth act as a balancing mechanism providing neutrality and equity between excessive retentions and excessive distributions.[20]

Fifth, the maximum rate of tax applicable to individuals and companies would not exceed 40 percent.

B. Partnership option for small companies

As a consequence of the abolition of income tax on dividends at the shareholder level and equating the company and top personal rates, the need arose to address the implications of this change from the perspective of fiscal neutrality with respect to choice of business organizational form [Clark, p 98; Lent, pp 740-1; King, pp 162-3; Hubbard, pp 118-9]. Before the 1990 Act enjoying a tax advantage as a shareholder rather than as a partner or sole proprietor could be achieved only by top bracket taxpayers who could engage in tax avoidance by disguising dividend receipts as capital gains which were taxed at much lower rates [Clark, pp 104-6; McLure, 1975 pp 574-5]. This would operate in combination with the company tax rate which was lower than the top personal rate to yield a substantially lower tax burden for top bracket earners [Clark, p 141].

However, if dividends are tax free in the hands of shareholders all investors with marginal rates lower than the company tax rate would have a preference for the partnership or proprietorship form unless non-tax considerations were predominant [Clark, pp 146-161]. In the absence of a partnership option for lower-bracketed taxpayers, the tax neutrality between the company form of business organization and the partnership and/or sole proprietorship would therefore be severely undermined. Lent posed the dilemma as follows:

> If tax is not imposed upon the partnership as such – rather partnership income is allocated to the partners and their income is made subject to personal tax – when the company rate is high there is an advantage in using the partnership form especially for small and medium-sized forms.
>
> Greater neutrality in the taxation of big and small companies is achieved by giving small companies the option to be treated as partnerships for tax purposes. A partnership option for small companies makes it possible to enjoy the advantage of the corporate form without paying a penalty" [Lent, pp 740-1].

The 1990 Act made provision for a partnership option:[21]

> "(1) ... a small company means a resident private company whose gross income does not exceed P300,000 in any tax year.
>
> (2) In respect of any such tax year the shareholders of a small company may elect unanimously, and so notify the Commissioner in writing within six months after the end of that tax year, that they be treated for tax purposes as a business carried on in partnership:
>
> Provided that, where all the shares are beneficially owned by a single resident individual, he may elect to be treated for tax purposes as an individual carrying on business.
>
> (4) Where, in any tax year, a company is treated as a partnership under this section, the chargeable income of the company shall be apportioned among the shareholders in the proportions in which they own the equity capital, and such apportioned shares or income shall be included in the chargeable income of such shareholders.

18. Laws of Botswana, Income Tax (Amendment) Act, Act No. 12 of 1990, Government Printer, Sec. 12.
19. *Id.*
20. *Id.* at Sec. 14.
21. *Id.*

© 1994 International Bureau of Fiscal Documentation

However, Lent cautioned that there might be abuses arising from the dual treatment of an enterprise. This is especially true because when a company

> changes its mode of treatment; among other problems, it changes the taxability of dividends and the basis for computing capital gains on the sale of stock. Moreover unless minimum time limitations are imposed on the election, it would be possible for companies to manipulate taxes by shifting from one business form to the other, depending on their changing income and tax considerations [Lent, p 741].

The Botswana legislation anticipated these problems by providing that once an election is made it applies for that year and the two following years unless the company ceases to exist or becomes ineligible for treatment as a small company.

In a related development, the 1991 Act eliminated the multiple taxation of dividends paid by a resident company to another resident company where both companies belong to a group in Botswana. As a result, no withholding tax is deductible where a dividend is distributed by an associated company to a parent company. However, where the dividend is eventually declared in favour of a shareholder outside the group, withholding tax would be deductible.[22]

VI. CONCLUSION

The recent changes in corporate tax have been comparatively bold and remarkable. To a large extent, they represent a paradigm shift. Previously, tax law was driven by short-term objectives of revenue raising and the enhancement of Government's capacity to regulate the private sector which was and still remains largely foreign. The scope of regulation was extended to include such details as the capital structure of private companies.

When revenue raising ceased to be a priority and Government increasingly realized that the continued expansion of the economy in general and job creation in particular depended on expanded private sector growth, there was a major switch from short-term regulation toward long-term macroeconomic management. In particular, the focus was placed on issues and optimal options for reshaping and diversifying the economy with the private sector acting as the key locomotive of growth and job creation. This has been characterized by greater emphasis on the effect of taxes on incentives for individuals and corporate enterprises.

The lesson that can be drawn by other African tax systems from the Botswana experience is that the interaction between the personal and corporate tax systems as well as the structure of the corporate tax itself have major consequences that significantly affect incentives for economic development in general and entrepreneurship, investment and finance in particular [King et al, p 162]. The basic system of company and shareholder taxation has dynamic implications which may not be fully appreciated or intended at the time of their enactment and implementation [Clark, pp 94-6; Kay, p 162].

The basic structure of corporate tax and the various modifications which were introduced to counter avoidance, undercapitalization and excessive reliance on debt as opposed to equity injected tax issues into finance and investment decisions, which experience has indicated are left to the investors themselves [King, p 162]. The lesson for other African countries that will have to make adjustments in their tax systems as part of the structural adjustment of their economies is simple and clear:

> The capital structure of a company and the method by which it finances its investment are matters which the tax system ought not to try to influence, and if it does it will create difficulties for itself [King, p 162].

The rapidity and frequency of changes in corporate and shareholder taxation, as was the case in Botswana, serve to aggravate the difficulties for both the revenue authorities and taxpayers. Therefore, the way forward in corporate taxation is a neutral tax system that avoids the creation of complex instruments that seek to frustrate avoidance, under-capitalization and over-reliance on debt. Such complex instruments merely enhance the taxpayers' motivation for even more ingenious and intricate tax avoidance methods. The result: "diversion of resources of time and skilled manpower to pointless activities" [King, p 163; Clark, pp 94-104].

The objectives and underpinnings of corporate tax neutrality were stated by Williams:

> Our objective now is to be neutral with taxes that do not penalize one person rather than another. They give equality of opportunity, rather than equality of result. The ideal tax is one that takes from us in proportion to what we have, or what we use, in such a way that the tax affects our behaviourial patterns to the minimum. This is a concern for horizontal equality. A "fair" tax is one which presents us with a "level playing field" and does not concern itself with the quality of the teams. It is for them to undertake their own training if they wish to win [Williams, p 23].

A neutral corporate tax structure would therefore avoid the three fundamental biases. First, it would not distort the choice of business organizational form. Tax law would be neutral as regards corporate and non-corporate forms of enterprise. The choice between the two options would be based on non-tax considerations. Second, the tax system would be neutral as regards the three basic sources of funding: new issues of shares, retention of the company's earnings and loan capital. In particular, the inherent bias against equity financing especially on account of the double tax would be eliminated. Third, the distortion of the company's choice between distribution or retention of its earnings would also be removed [Hubbard, pp 118-122].

The recent overhaul of the Botswana tax law has substantially brought its corporate tax system closer to neutrality although outstanding issues still remain, including the continued indirect taxation of retained earnings by reason of the taxation of capital gains upon a disposal of shares.

BIBLIOGRAPHY

African Tax Systems, International Bureau of Fiscal Documentation, (various supplements for 1991 and 1992).

22. Laws of Botswana, Income Tax (Amendment) Act, Act No. 11 of 1991, Sec. 5.

© 1994 International Bureau of Fiscal Documentation

Bebchuk, L.A., *Corporate Law and Economic Analysis*, Cambridge University Press, 1990.

Bird, R.M., "Tax Reform in Latin America; Recent Experiences", 27/1 *Latin American Research Review* 7-36 (1992).

Clark, R.C., "The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform", 87/1 *Yale Law Journal* 90-162 (1977).

Clarke et al, *Sumpton and Clarke's Tax and Tax Planning*, Oyez Longman, London, 1984.

Federal Trust for Education and Research, *The Future of Corporate Tax in the European Community*, Ernst & Young, London 1991.

Gills, M., "Micro and Macroeconomics of Tax Reform", 19/3 *Journal of Development Economics* 221-254 (1985).

Goode, R., "Tax Advice to Developing Countries: A Historical Survey", 27/1 *World Development* 37-53 (1993).

Government of Botswana
- Budget Speeches for 1979, 1984 and 1990, Gaborone, Botswana.
- Reports of the Department of Taxes for the periods 1 July 1979-30 June 1989 and 1 July-30 June 1992.

Gravelle, J.G., "Equity Effects of the Tax Reform Act of 1986", 6/1 *Journal of Economic Perspectives* 27-44 (1992).

Gray, C.W., "Legal Process and Economic Development: A Case Study of Indonesia" 19/7 *World Development* 763-77 (1991).

Hubbard, R.G., "Corporate Tax Integration: A View From the Treasury Department", 71/1 *Journal of Economic Perspectives* 111-132 (1993).

Kay, J.A., et al, *The British Tax System*, Oxford University Press, 1990.

Laws of Botswana – Income Tax Act, Act No. 10 of 1973.
- Income Tax (Amendment) Act No. 10 of 1979, No. 18 of 1984, No. 12 of 1990 and No. 11 of 1991.

Lent, G., "Corporate Income Tax Structure in Developing Countries", 24/3 *IMF Staff Papers* 722-755 (1977).

McLure, C.E., "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals", 88 *Harvard Law Review* 532-582 (1975).

Miller, R.L., *Business Law and Taxes*, John Wiley & Sons, New York, 1984.

Sandford, A. et al, *Tax Policy Making in the United Kingdom*, Heinemann Educational Books, London, 1983.

Sato, M. et al, "International Aspects of the Taxation of Corporations and Shareholders", 22/2 *IMF Staff Papers* 384-455 (1975).

Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?" 6/1 *Journal of Economic Perspectives* 45-57 (1992).

Tiley, J., "The Law of Taxation in a European Environment" 51/3 *Cambridge Law Journal* 451-473 (1992).

Williams, D.W., *Trends in International Taxation*, International Bureau of Fiscal Documentation, Amsterdam 1991.

World Bank, *World Development Report 1988*, Oxford University Press, New York/London/Oxford, 1988.

Trends in International Taxation

David W Williams

This valuable book explores the effect of national changes on international taxation, tracking past reforms and placing current developments in perspective. Authoritative and challenging, this is a classic work for tax professionals and researchers.

David Williams is the Price Waterhouse Professor of International Business Taxation at the University of London, based at Queen Mary and Westfield College's Centre for Commercial Law Studies. He is also actively involved in the commercial application of international taxation law.

NLG 75

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item
Published by IBFD Publications on behalf of the British Branch of the International Fiscal Association

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

FRANCE:

THREE PERCENT TAX ON REAL ESTATE IN FRANCE

Pierre-Jean Douvier

Partner, Bureau Francis Lefebvre

Stringent provisions designed to thwart a common form of tax evasion involving the ownership of real property were introduced in 1983. The targeted practice involved the setting up of a company (generally in a low tax or no tax country) to purchase property which was then rented at below market value to a person who directly or indirectly controlled the company. This allowed individuals to escape wealth tax in respect of the real estate indirectly owned through foreign entities, as the French government was not able to ascertain the identity of the beneficial owners of the entity.[1] To combat this practice the 1983 Finance Act introduced an annual 3 percent tax on the market value of certain real property owned by foreign companies.[2] An exemption was granted to companies:

- which resided in a country which had concluded a tax treaty with France containing an administrative assistance clause for the prevention of tax avoidance and evasion; and
- which filed an annual declaration containing specific information.

Despite the legislative changes, the Supreme Civil Court held in a number of cases that the real estate tax provisions discriminated against companies resident in (or whose seat of management was in) a country which had concluded a double tax treaty with France containing a non-discrimination clause, as opposed to an administrative assistance clause.

In order to limit the impact of the Supreme Court decisions and to avoid any charge that the 3 percent tax was discriminatory, the 1993 Finance Act introduced further amendments to the 3 percent tax. Under the new provisions all legal entities (i.e. both French and foreign) which directly or indirectly own real property in France, or which benefit from real estate rights over such property, are subject to an annual 3 percent tax levied on the market value of the property. On 22 October 1993 the tax authorities issued Guideline 7-Q-3-93 which clarifies how the tax will be applied after the 1993 amendments.[3]

This article analyses the new provisions in the light of the October Guideline.

I. INTRODUCTION

The tax is imposed on immovable property in France and any real estate rights relating to such property owned as of 1 January of the year of taxation, and it is assessed at the rate of 3 percent of the market value of the property or the rights to the property.

Legal entities liable for the 3 percent tax must file a declaration by 15 May of each year, giving the location, a description and the value of the immovable property owned at 1 January of the year of taxation. Failure to file the declaration may give rise to arbitrary (automatic) taxation proceedings.

II. SCOPE

A. Taxable persons

The tax, which is not deductible for purposes of French corporation or income tax, is due by all "persons". According to the Guideline the term "persons" is to be given a very broad interpretation, i.e. it encompasses all legal entities. No distinction is made on the basis of the form (corporation, partnership, non-trading company) or nationality of the entity so long as under the domestic law where the company has its seat it is deemed to have a personality separate and distinct from that of its members.[4] This sweeping definition of "person" will of course include French legal entities within its ambit, even though in practice such companies will be exempt if they undertake to communicate certain information to the tax authorities (see III. below).

1. Indirect ownership

The 3 percent tax is levied on persons owning real property in France either directly or through a third party. A legal entity holding a participation in whatever *form* or proportion, in another legal entity that is

- the owner of real property in France or the owner of real estate rights relating to such real property, or
- the holder of a participation in a third legal entity that is itself the owner of real property or real estate rights relating to the property, or interposed in the chain of participation,

is deemed to own real property or rights in France through an interposed person, and therefore falls within the scope of the 3 percent tax. However, where there is a chain of ownership,

1. Estate and gift tax were also circumvented.
2. See French Tax Code ("CGI"), Art. 990D, E and F. For a discussion of the provisions, see H. Lazarski, "New Measures Affecting Real Property Owned by Foreign Companies and Other Developments", 23 *European Taxation* (February 1983), at 39.
3. The Guideline is binding on the tax inspectors, i.e. they must apply the rules set forth in the official comments.
4. In particular, the French tax authorities have indicated that Liechtenstein "Anstalten" (establishments) and "Stiftungen" (foundations) are to be regarded as entities having legal capacity. See Guideline, para. 3.

© 1994 International Bureau of Fiscal Documentation

the tax is only due by those persons which are nearest to the immovable property and which are not exempt under CGI Section 990E(2) and (3).[5]

For example: A building in France which is to be rented out is owned by non-trading Company (civil company) A, whose seat is in France. Companies B and C, both non-resident companies, each own 50 percent of the share capital of Company A.

If Company A undertakes to provide the tax administration with relevant information and supporting documents (see below), it is exempt from the 3 percent tax.

If Company B has its seat in a country which has either not concluded a tax treaty with France or the treaty does not include an administrative assistance clause or a relevant non-discrimination clause applicable, it is liable for the 3 percent tax on 50 percent of the market value of the building.

If Company C has its seat in a country which has concluded a tax treaty containing an administrative assistance clause or a non-discrimination clause,[6] and 50 percent of C's share capital is owned by Individual X and by Company D, a company not benefiting from a treaty with an administrative assistance clause or a non-discrimination clause, Company C is exempt from the 3 percent tax if it undertakes to satisfy the reporting obligations.

Individual X is also exempt on account of the 25 percent (50% x 50% = 25%) of the building which he indirectly owns.[7] Company D, however, is liable for the 3 percent tax on that portion of the market value of the building which it owns indirectly (i.e. 25 percent).

2. Nationality of the entity

As from 1 January 1993, the location of the seat of an entity is irrelevant in determining whether the entity is subject to the 3 percent tax, i.e. it may be in or outside France.

B. Exemptions

CGI Section 990E provides for an exemption from the 3 percent tax for six categories of persons.

1. Persons that are not deemed to have a majority of their French assets comprised of real property in France

Persons which own immovable property in France, either directly or through an interposed person, the value of which represents less than 50 percent of the value of the entity's French assets, are not liable for the 3 percent tax. To determine whether a majority of assets are comprised of real property in France a comparison must be made. The following ratio is calculated as of 1 January of the year of taxation:[8]

(a) in the numerator, the value of the immovable property in France and any real estate rights relating to immovable property in France, owned directly or indirectly, whether the owner is the person concerned or an interposed person.

Immovable property which the person or any interposed person uses for its commercial activities (other than in the real estate business) is not taken into account in the numerator.

Immovable assets owned by an interposed third party are taken into account regardless of whether or not such party falls within the scope of the 3 percent tax. The buildings or real estate rights on buildings constituting the immovable property inventory of construction-for-sale companies or companies acting as property traders are also taken into account in the numerator. However, the value of securities in quoted property companies and unquoted securities in so-called SICOMIs,[9] which are regarded as financial investments for purposes of wealth tax, are not included in the assets in the numerator.[10]

(b) in the denominator, the value of all French assets.

In addition to the value in the numerator, the value of real property in France which is used for the owner's commercial activities and the value of movable assets in France, mainly French public funds, interest, debt-claims and French securities, should also be included.

In the case of immovable property in France (or rights relating to such immovable property) held through an interposed person, the comparison is effected by determining the ratio which the value of the French immovable property owned by the interposed person bears to the value of the French assets of such person, omitting from the denominator the value of any elements of the interposed person's assets pertaining to another country (buildings abroad, participations in foreign companies, claims on foreign persons).[11] However, where the interposed person is a French company listed on a stock exchange, the total value of the participation held

5. Guideline, para. 5.
6. Where a treaty contains both an administrative assistance clause and a relevant non-discrimination clause, the non-resident company may opt for exemption under either clause.
7. However, Individual X may be subject to French wealth tax.
8. Guideline, paras. 12, 13 and 14.
9. Under French law, a SICOMI is a particular type of vehicle which until recently enjoyed a specific regime whereby it was not subject to corporation tax, even though it is a limited company. Basically, the purpose of such an entity, which must be approved by the French Government, is limited to the purchase and leasing of assets with a purchase option for the benefit of professionals.
10. To illustrate this rule the Guideline provides the following example:
A company owns the following assets in France:
– 60% of the shares in a French corporation that owns a building in which it operates a hotel-restaurant, which has a market value of 5 million FF;
– shares in a SICOMI (3 million FF);
– 60% of a non-trading French company which carries out two activities, i.e. the renting of dwellings and construction/sales. The real estate which is leased is listed as fixed assets, the remaining real estate as inventory. The total fair market value of this real estate is 20 million FF.

Numerator:	20M x 60%	= 12M
Denominator:	5M x 60%	= 3M
	3M	= 3M
	20M x 60%	= 12M
	total	18M

The company is a real estate company as the market value of the real estate in France of the non-trading company represents more than 50% of the value of all French assets, i.e.

$$\frac{12M}{18M} \times 100\% = 66.66\%$$

11. Guideline, para. 15.

© 1994 International Bureau of Fiscal Documentation

in such company must be included in the denominator as a French asset.[12]

2. Legal entities covered by a treaty containing an administrative assistance clause[13]

Legal entities whose seat is in a country or territory which has concluded a double tax treaty with France containing an administrative assistance clause for the prevention of fraud and tax evasion are exempt from the 3 percent tax, even though such entities may be deemed to have a majority of their assets comprised of real property in France. However, to avail itself of this exemption a legal entity must file a declaration with the tax administration by 15 May of each year (discussed in III. below).[14]

3. Legal entities whose effective seat of management is in France or which, by virtue of a treaty, should not be subject to more burdensome taxation, where they either communicate certain information to the French tax authorities each year or make (and uphold) a commitment to communicate information at the request of the tax authorities[15]

Such persons are:

- legal entities with their seat in France;[16]
- legal entities covered by a treaty concluded by France that contains a non-discrimination clause based on nationality which meets the following tests:
  - the clause applies to nationals in general and is not reserved only to individuals;
  - "nationals" are expressly defined to include legal entities; and
  - according to the authorities the non-discrimination clause expressly covers all taxes.[17]

In the Guideline, the French tax administration specified that, unless stated otherwise, these provisions apply to nationals of a state that has concluded a treaty with France containing a non-discrimination clause only if those nationals are residents of that state. Accordingly, companies must furnish evidence that they are resident under the relevant treaty in the country in which they are nationals.[18]

In addition, under French company law, if an entity has its legal seat in one country and its effective place of management in another, the French tax authorities may take into account the place of effective management to deny the exemption. According to the French tax authorities, no entity whose registered office is located in a non-treaty country including a non-discrimination clause based on nationality may claim a difference between its legal seat and place of effective management so as to benefit from the most favourable treaty. However, it is the authorities' position that they may apply the 3 percent tax on the basis of the place of effective management in a country with which France is not bound by a non-discrimination clause.[19]

To avoid payment of the 3 percent tax, a company falling in this category must either file the special declaration or give an undertaking to the tax authorities (see III. below).

Thus it would appear that all entities, regardless of nationality, which own real property in France must ensure that they comply with the declaration obligations, as failure to do so will lead to liability to the 3 percent tax.

4. Quoted companies

Companies quoted either on the official stock exchange or on the secondary market of a French stock exchange, or on a for-

12. Guideline, para. 16. For example:
Company A owns:
- a building in France whose value is 10 million FF;
- 50% of the shares in Company B, which itself owns a building in France with a value of 8 million FF;
- and 10,000 shares in Company C, whose seat is in France and which is listed on the Paris stock exchange, worth 2,000 FF per share as at 1 January.

In order to determine whether Company A has a majority of its assets comprised of immovable property in France, the value of the building directly owned (10 million FF) and 50% of the value of the building owned through Company B (i.e. 4 million FF) should be included in the numerator, and the value of the assets listed above, adding the value of the shares in Company C (20 million FF) should be included in the denominator.
Company A does not have predominant real estate features, as all of the buildings owned directly or indirectly represent 7/7 of its aggregated French assets.

13. Under an administrative assistance treaty, the French administration should be able to procure from the administration of the treaty partner the information necessary to apply the treaty provisions as well as the provisions of French domestic legislation relating to the taxes covered by the treaty.
According to the administration, the countries which have double tax treaties with France containing an administrative assistance clause to combat tax fraud and evasion, are as follows (list up to date at 1 October 1993):

Algeria	Finland	Malaysia	St.-Pierre
Argentina	Gabon	Mali	and Miquelon
Australia	Germany	Malta	Senegal
Austria	Greece	Mauritania	Singapore
Bangladesh	Hungary	Mauritius	Slovakia
Belgium	Iceland	Mayotte(2)	Spain
Benin	Indonesia	Mexico	Sri Lanka
Brazil	Iran	Monaco	Sweden
Bulgaria	Ireland	Morocco	Thailand
Burkina-Faso	Israel	Netherlands(3)	Togo
Cameroon	Italy	New Caledonia	Trinidad and
Canada	Ivory Coast	New Zealand	Tobago
Cent.Afr.Rep.	Japan	Niger	Tunisia
China	Jordan	Nigeria	Turkey
Congo	Korea (Rep.)	Norway	United Kingdom (4)
Cyprus	Kuwait	Pakistan	United States
Czech Rep.	Lebanon	Philippines	Yugoslavia
Denmark	Luxembourg (1)	Poland	Zambia
Egypt	Madagascar	Portugal	
Equador	Malawi	Romania	

(1) Holdings under the Luxembourg Law of 1929 may not enjoy the exemption.
(2) Previous treaty with Comoros.
(3) The income tax treaty of 16 March 1973 does not include the Netherlands Antilles.
(4) The income tax treaty of 22 March 1968 does not include Gibraltar, Hong Kong, the Channel Islands or the Isle of Man.

14. Guideline, para. 20.
15. Guideline, para. 24.
16. It should be noted that for tax purposes France consists of the Metropolitan (i.e. European) territory and the overseas departments of Guadeloupe, Guyane, Martinique and Reunion.
17. The following countries have concluded with France a tax treaty containing such a clause (updated list as of 1 October 1993):

Argentina	Finland	Korea (Rep.)	Portugal
Austria	Germany	Lebanon	Romania
Bangladesh	Greece	Madagascar	Slovakia
Brazil	Hungary	Malawi	Spain
Bulgaria	Iceland	Malta	Sri Lanka
China	Iran	Mauritius	Switzerland
Congo	Ireland	Morocco	Thailand
Cyprus	Israel	Netherlands	Trinidad and
Czech Rep.	Italy	Nigeria	Tobago
Egypt	Japan	Norway	United Kingdom
Equador	Jordania	Poland	Yugoslavia
			Zambia

Thus, for example, according to the authorities Luxembourg and Sweden, whose treaties contain a non-discrimination clause which only applies to taxes covered by the convention, are excluded.
18. Guideline, para. 25.
19. Guideline, para. 26.

© 1994 International Bureau of Fiscal Documentation

eign stock exchange subject to similar rules, are exempt from the 3 percent tax.[20] To determine whether a foreign stock exchange is governed by similar rules, the following factors must be considered:

- conditions required to be listed (i.e. legal status, minimum size);
- the fraction of capital which must be owned by the public;
- the volume and frequency of transactions required in order to be listed;
- the required disclosure to the stock exchange regulatory authority of the identity of the main shareholders;
- the equality of treatment of the shareholders; and
- the public disclosure obligations.[21]

5. International organizations, sovereign states and public agencies

International organizations, sovereign states and public agencies, including, for France, public institutions, are exempt from the 3 percent tax.[22]

6. Pension funds and other not-for-profit organizations

Pension funds which carry out non-remunerative activities and other not-for-profit organizations of a social, philanthropic, educational or cultural nature are exempt from the tax if they establish that the pursuit of their activities in France or abroad justifies their owning immovable property in France.[23]

C. Taxable property

The 3 percent tax is levied on the market value of developed and undeveloped property in France, as well as on any real estate rights attaching to such property owned at 1 January of the year of taxation. The uses made of the property and whether or not the property is leased are irrelevant.[24]

The value of the immovable property assigned by the taxpayer or interposed persons to their own professional activities, other than real estate business activities, is excluded from the tax base.[25] Real property held as inventory by legal entities that are property dealers by trade is exempt.[26]

Where the property is held through an interposed legal person, other than a co-ownership company falling within the scope of CGI Section 1655 ter,[27] the tax base is reduced in proportion to the ratio of the participation held by the taxable legal entity in the interposed legal entity.[28] If the real estate is owned through a transparent co-ownership company falling within the scope of CGI Section 1655 ter, the tax base is the market value of the assets attaching to the interest owned by the person subject to the 3 percent tax.

III. DECLARATION AND UNDERTAKING OBLIGATIONS

Under CGI Section 990F(3) persons liable to the 3 percent tax must file with the tax authorities a declaration containing the location, description and value of all real estate owned, directly or through one or more interposed legal entities, at 1 January. This declaration must be filed by 15 May. In order to be exempt[29] from the tax persons falling within CGI Section 990E(2) and (3)[30] must fulfil the following obligations:

(1) legal entities who benefit from an administrative assistance clause in a tax treaty must file Form No. 2746;
(2) legal entities whose effective place of management is located in France or who, by virtue of a treaty, may not be subject to more burdensome taxation than that imposed on French companies will be exempt if they provide the requisite information or undertake to do so.

The following information must be provided by legal entities falling in either category:

- the names and addresses of shareholders, partners or other members at 1 January; and
- the number of shares or interests held by the shareholders, partners, etc.

No particular manner is prescribed for the undertaking, except that it must be in the form of a sworn statement signed by an authorized representative of the legal entity.[31] The undertaking must be given within two months of the date of acquisition of the property or rights.

Entities falling under (2) above must also undertake to produce, at the request of the tax authorities, evidence in support of the residence of their shareholders, partners or other members, and such evidence must clearly establish the tax residence of the persons concerned.[32] The administration has indicated that evidence of tax residence should be required

20. Guideline, para. 47.
21. Guideline, para. 49.
22. Guideline, para. 44. Prior to the 1993 amendments the exemption applied to international organizations, foreign sovereign states and foreign public institutions.
23. Guideline, paras. 44-48.
24. Guideline, para. 49.
25. Debts and, in particular, loans raised for the acquisition of the real property are not deductible from the tax base. Guideline, para. 53.
26. Guideline, para. 50.
27. Co-ownership companies falling under CGI Sec. 1655 ter are used to hold real estate and are one of the few totally transparent French legal forms. They are not subject to the 3% tax. See Guideline, para. 4.
28. Guideline, para. 54.
29. The guideline originally provided that resident and non-resident companies wishing to claim an exemption from the 3% tax for 1993 had to file the undertaking by 7 January 1994 at the latest. A press release of 7 January extends the deadline to 31 March 1994.
30. These taxpayers are legal entities whose seat is in a country which has concluded a tax treaty with France for administrative assistance for the prevention of fraud and tax evasion and legal entities whose effective place of management is in France, or which, by virtue of a treaty, should not be subject to more burdensome taxation.
In the Guideline, paras. 29-33, the French authorities hold that the following French companies meet this test:
- transparent real estate entities which lease their assets or which place such assets at the disposal of their shareholders;
- certain real estate public companies, i.e. time-share companies, companies whose purpose is to share the right to use real estate between shareholders on a time basis.

If these companies have fulfilled the declaratory obligations they are not liable for the 3% tax.
31. A model statement is found in Annex IV to the Guideline.
32. The evidence may be in the form of a certificate issued by the competent tax authorities of the country of fiscal domicile, or a notice of assessment provided it is sufficiently explicit. Guideline, paras. 33-34.

© 1994 International Bureau of Fiscal Documentation

primarily when such persons do not have their domicile or seat in a country which has concluded a tax treaty with France containing an administrative assistance clause to combat fraud and tax evasion.[33]

The undertaking need not be renewed for subsequent purchases. If an entity has filed an undertaking with the competent tax centre in respect of certain real estate, and it subsequently purchases other real property outside the jurisdiction of that centre, a new undertaking need not be filed at a second centre. However, the company must inform the second tax centre that an undertaking has already been provided, specifying the date of filing, the address of the real property for which it was made and where it was filed.[34]

If the authorities request that a legal entity (or its representative) which has given an undertaking provide information and supporting documents, the entity has 60 days from the date of receipt of the request to provide the information and supporting documents. If the legal entity fails to adequately respond to the request by the end of the 60-day period, the authorities will issue another request to complete its response within an additional 30-day period.[35] If the legal entity fails to provide a timely written answer to the notice, or if its answer remains unsatisfactory, the entity is deemed to have failed to fulfil its commitment and the authorities will require that the entity file a return and pay the tax within 30 days.[36] The tax is due on account of the fiscal year in which the commitment was breached and preceding years which are not covered by the statute of limitations. If the entity fails to file the return within the 30-day period, it may be taxed automatically (after prior notice has been given).[37]

A company which is liable to the 3 percent tax because of its failure to fulfil its commitment, or failure to provide a satisfactory answer may recover its right to an exemption by filing with the tax authorities all of the information and supporting documents it had undertaken to provide, and by giving new undertaking. The exemption applies from 1 January of the year in which the declaration obligations were fulfilled. Tax due for previous years, however, remains payable.[38]

IV. PAYMENT AND COLLECTION

A. Payment

Payment of the tax must be effected by 15 May of each year, and it must be accompanied by the declaration. Failure to make a timely filing and payment triggers an interest charge in the amount of 0.75 percent per month.[39]

B. Collection

The rules applicable to registration duties apply equally to the collection of the 3 percent real estate tax.[40] Thus the claim of the tax authorities is preferential and may be recorded on any immovable property the taxpayer owns in France.

Any third party through which the property is held is jointly liable with the taxpayer for payment of the tax. Further, the tax authorities may require entities carrying on business in France to appoint a representative for the transfer of immovable property. This representative is personally liable for paying the withholding tax due on the capital gains made by the company, and also liable for payment of the 3 percent tax outstanding at the date of transfer of the property.[41]

Thus in case of a transfer of immovable property owned by a company between 1 January and 15 May of a given year, the approved representative designated in the capital gains return will be personally liable to pay the tax, which will become payable on 15 May of the relevant year. If the tax is not paid, the representative's liability remains the same in case of a transfer occurring after 15 May of the year in question. The representative is also liable for any supplementary tax for said year for which notice to pay would have been given as a result of a tax adjustment. However, the representative may not be sued for payment of the tax which would not have been paid by the legal entity and which would be due on account of previous years not covered by the statute of limitations. For the representative to be legally bound, the undertaking to pay he gave on the capital gain return must expressly refer to the 3 percent tax.[42]

Finally, the statute of limitations for the 3 percent tax is three years plus the current year; however, if no declaration was filed the period is extended to ten years. For this reason, strict attention should be paid to the formalities.

33. Guideline, para. 35.
34. Guideline, para. 38.
35. Guideline, para. 59.
36. Declaration Form No. 2746 must be filed, and it must include the information discussed in the text *supra*.
37. Guideline, paras. 60 and 69.
38. Guideline, para. 64.
39. Guideline, para. 65-67.
40. See CGI Secs. 223 *quinquies* A, 1727, 1728 and 1929-I.
41. The tax authorities may request that a legal entity chargeable to the 3% tax appoint a representative in France who is authorized to receive any communications in connection with the undertaking, the tax base, collection of the tax and litigation, if any. Unless vested with special powers, such a representative has no personal liability for payment of the tax, and may not be held jointly and severally liable for the payment, as is the case for a representative designated for a transfer of real property.
42. Guideline, paras. 70-79.

© 1994 International Bureau of Fiscal Documentation

MALAYSIA:

THE 1994 BUDGET AND RECENT DEVELOPMENTS – THE PATH TO SUSTAINABLE GROWTH

Veerinderjeet Singh

Associate Professor, Division of Accounting,
Faculty of Economics & Administration, University of Malaya, Kuala Lumpur

I. INTRODUCTION

The Honourable Minister of Finance, Dato Seri Anwar Ibrahim presented the 1994 Budget on 29 October 1993. The Budget was presented at a time when the international economic situation remains uncertain. However, Malaysia's rapid economic growth is expected to continue with the Gross Domestic Product expanding by 8.2 percent compared to 8 percent in 1993. Another notable achievement is that for the first time, the country has attained a balanced budget.[1] With the country recording impressive economic performances for six years in succession despite global economic gloom, a well-balanced and healthy current account, and inflation at 3.7 percent for the first nine months of 1993, the emphasis is on sustainable economic growth which involves the continuing process of tax reform and measures to curb inflation. As such, the budget strategy focuses on ensuring strong, vibrant and sustainable economic growth, reducing inflation, enhancing skills and technological competence, and fostering a balanced and equitable society.

The momentum of economic growth is to be sustained through tax reduction and fiscal prudence. The reduction in taxes will involve a revenue loss of M$ 1.899 billion but this is a strategy to promote investment and growth in the economy and hence increase revenue in the future.

This article examines various measures introduced in the Budget and the Finance (No. 2) Bill 1993[2] with regard to direct and indirect taxation, as well as other recent tax developments.

II. BUSINESS TAXATION

A. Corporate tax rate

Currently, the income tax rate applicable to companies is 34 percent. As hinted by the Minister in the previous budget, the tax rate has been lowered to 32 percent with effect from the year of assessment 1994.[3] The rate will be lowered to 30 percent with effect from the year of assessment 1995.[4]

The reduction in the corporate tax rate is expected to result in a revenue loss of M$ 472 million. This would be offset by the increase in revenue through the buoyant economic growth and the savings from the abolition and reduction in investment incentives announced in previous budgets. Another factor taken into consideration in lowering tax rates to 30 percent is that in 1995, the country will be approaching the implementation of the Sales and Service Tax which is expected to strengthen the tax base considerably and generate additional revenue to offset the losses arising from the reduction of direct taxes.

With the eventual reduction to 30 percent, Malaysia's corporate tax rate would be fairly competitive. It is anticipated that with the eventual shift towards indirect taxation and the withdrawal of incentives, the corporate tax rate may be in the region of 25 to 28 percent which would be very competitive.

B. Franking of dividends

Malaysia adopts the imputation system whereby the income tax chargeable on a resident company is available to frank dividends paid, credited or distributed to its shareholders. In line with the reduction in the corporate tax rate from the year of assessment 1994, the rate of tax deductible from dividends is 32 percent. This applies to dividends paid, credited or distributed from 1 January 1993.[5] As such, dividends paid before budget day on which tax at 34 percent has been deducted will be recalculated as follows:

Shareholder's position	*M$*
Gross dividend	1,000
Less: Tax deducted at 34%	*340*
Net dividend received by shareholder	660

1. In 1993, Government revenue is expected to increase to a high of M$ 41.231 billion while total expenditure, both operating and development, is expected to amount to M$ 41.036 billion. The Minister also expects to achieve a balanced budget in 1994 based on past revenue and expenditure performance.
2. Recently enacted as the Finance Act 1994.
3. Amendment to para. 2 of Part I to Schedule 1 of the Act.
4. The table below compares Malaysia's corporate income tax rate with those in the other ASEAN countries.

Corporate Income Tax Rates of ASEAN Countries

Country	*Rate (percent)*
Singapore	27
Brunei	30
Thailand	30
Malaysia	32
Indonesia	35
Philippines	35

5. Via introduction of Sec. 108(2C) and (4C) as well as Sec. 110(1C).

© 1994 International Bureau of Fiscal Documentation

Re-grossing of net dividend:	
$^{100}/_{68}$ x 660	970.59
Less: Tax deemed deducted at 32%	*310.59*
Net dividend received by shareholder	660.00

Company's Section 108(6) account

With the distribution of a gross dividend of M$ 1,000, the Section 108(6) account would be as follows:

	Previous M$	*Current M$*
Balance of tax credit b/f (say)	10,000.00	10,000.00
Less: Tax deducted/deemed deductible from dividend	340.00	310.59
Balance of tax credit c/f	9,660.00	9,689.41

With the change, the tax deducted of M$ 310.59 would be allowed as a set-off (under Section 110 of the Income Tax Act, 1967) against the tax chargeable on the shareholder.

When the corporate tax rate is lowered to 30 percent with effect from year of assessment 1995, a further recalculation will be made. This is due to the fact that the 30 percent rate has not been incorporated in the legislation and would probably be included when the 1995 Budget is presented in October 1994.

C. Contributions to approved schemes by employers

Contributions by an employer to an approved scheme (such as the Employees Provident Fund (EPF)) qualified for deduction subject to a maximum of 15 percent of remuneration. In the previous budget, the mandatory contribution to the EPF was increased from 11 to 12 percent for the employer and from 9 to 10 percent for the employee (with effect from 1 January 1993). This had affected companies who were contributing 11 percent to the EPF and 4 percent to an approved scheme for the benefit of its employees. The total contributions from January 1993 thus amounted to 16 percent (1 percent above the limit of 15 percent). In line with the increase in the mandatory contributions to the EPF, the maximum rate of deduction has been increased to 16 percent of remuneration with effect from year of assessment 1994.[6]

D. Approved donations

The definition of "organization" for approved donation purposes has been extended to include an organization established exclusively for the conservation or protection of the environment.[7] As such, cash donations to such organizations approved by the Director General of Inland Revenue are tax deductible from 1 January 1994.

Further, with effect from year of assessment 1994, donations to the Government Low-Cost Housing Fund managed by the Central Bank of Malaysia would be eligible for a deduction. However, a double deduction would be given for donations made during the period from 1 November 1993 to 31 January 1994.[8] This aims to encourage the corporate sector to play a role in alleviating the housing shortage faced by the low income group.

It was also announced that all contributions made to the National Translation Institute of Malaysia would be given a tax deduction. This is to encourage the financing of translation of books into the national language. However, no amendment has been made to the legislation. As such, this is likely to be enacted via a gazette order. The effective date of this change was also not stated.

E. Industrial building allowance

(1) Provision of living accommodation for employees

With effect from 1 January 1994, the qualifying expenditure incurred on the purchase or construction of buildings used for accommodation of employees in the manufacturing sector will be treated as expenditure on an industrial building at any time the building is occupied by an employee. However, the term "employee" does not include a director, an individual having control of the business or a member of the management, administrative or clerical staff engaged in the manufacturing business.

The allowance is 10 percent per annum on the qualifying expenditure incurred. There is no initial allowance available in the first year. Further, the qualifying expenditure in the case of a purchased building is the purchase price of that building.[9]

This change is intended to encourage employers within the manufacturing sector to provide accommodation to employees. Previously, industrial building allowance was only allowed if the building was constructed by the employer who already had an existing industrial building in use for his business. This change thus allows a manufacturer the option of purchasing or constructing the building and obtaining a full write-off over ten years (unlike the usual case where it may take 30 years or more).

(2) Provision of child care facilities for employees

To encourage employers to establish child care facilities for their employees so as to increase the participation of women in the work force, expenditure on the construction or purchase of a building for the provision of such facilities will be treated as expenditure on an industrial building at any time the building is used by the employees.[10] This change is effective from 1 January 1994.

The industrial building allowance will be 10 percent per annum. The qualifying expenditure in the case of a purchased building is the purchase price of that building. Employees exclude directors or an individual having control of the business or an individual who is a member of the management, administrative or clerical staff engaged in the business.

6. Amendment to Sec. 34(4).
7. Amendment via Sec. 44(7)(h).
8. Amendment to Sec. 44(6).
9. Via introduction of para. 42A(1) to Schedule 3.
10. Via introduction of para. 42A(2) to Schedule 3.

© 1994 International Bureau of Fiscal Documentation

(3) Buildings used for research

With effect from year of assessment 1994, buildings or parts thereof used for the purpose of research by approved research companies and institutes within the meaning of Section 34B(4) of the Income Tax Act, 1967 qualify for industrial building allowance.[11]

F. Operational Headquarters Company (OHC)

The Income Tax Act, 1967 provides fiscal incentives such as a reduced rate of tax at 10 percent for a period of up to ten years for approved OHCs established in Malaysia providing qualifying services to their offices or related companies outside Malaysia. Companies carrying on a business of finance or the provision of professional services were specifically excluded from eligibility for the OHC incentive.

In a move to widen the scope of this incentive, it will be made available to commercial and investment banking companies. The definition of qualifying services has been expanded to include the provision of treasury and fund management services. However, where such services include provision of credit facilities, the funds for providing such facilities must be obtained from outside Malaysia.[12]

This change took effect retrospectively from 1 January 1993 and seeks to further accelerate the establishment of OHCs in Malaysia. Overall, it is felt that further changes may be necessary to make Malaysia more attractive for OHCs such as liberalizing the granting of work permits for expatriate personnel of such organizations.

G. Venture Capital Companies (VCC)

Subject to certain conditions, VCCs are currently exempt from tax on gains arising from the disposal of shares in a venture company. The Income Tax Act, 1967 defines a VCC as a resident company approved by the Minister of Finance and having a 100 percent investment in a high risk and new technology project (i.e. holding the shares in an unlisted venture company).

In line with the objective to encourage the financing of high risk and new technology projects, the definition of a VCC is amended from 1 January 1994 to include a company with at least 70 percent of its investment in a high risk and new technology project.[13] Further, the qualifying criteria under the guidelines[14] whereby VCCs were required to invest not more than 10 percent of its funds in a single company and not more than 25 percent in any industry is abolished.

H. Incentives for approved overseas investments

Tax incentives are available for approved overseas investment including a 50 percent abatement of income remitted into Malaysia for a period of five years after a company commences operation and earns profits.

In addition, for overseas construction projects a 50 percent exemption on income remitted into Malaysia is given for a period of five years effective from the date of commencement of the project. However, this incentive is restricted to construction projects that commenced during the period 21 October 1988 to 31 December 1993.

It was proposed that the rate of exemption be increased from 50 to 70 percent. Thus, only 30 percent of the remitted income would be taxable. It was also proposed to abolish the present restriction of a five year exemption period and to remove the restriction that construction projects must commence during the period 21 October 1988 to 31 December 1993. Thus, companies which commence a construction project overseas will enjoy an indefinite period of exemption.

The Government had agreed in principle to allow a 50 percent exemption on income remitted to Malaysia for companies which export services in the oil and gas industry. The guidelines on this are being prepared. It appears that, in line with the proposals made by the Minister, the exemption level would also be increased to 70 percent.

The above-stated proposals are to take effect from the year of assessment 1994. These would be enacted via a gazette notification (i.e. amending the existing exemption order). The changes are intended to provide a further push towards reverse investment by Malaysian companies. However, it should be borne in mind that foreign income not remitted to Malaysia is not subject to Malaysian tax and a 70 percent exemption may not be sufficient to achieve the intended results.

I. Reinvestment allowance

A Malaysian resident manufacturing company will enjoy tax exemption on a portion of its profits if it incurs capital expenditure prior to 1 January 1996 on a factory building and/or qualifying plant and machinery in respect of an expansion, modernization or diversification project.

The tax exemption was granted in the form of a claim for reinvestment allowance which was equivalent to 40 percent of the qualifying capital expenditure. The rate was increased to 50 percent in the case of a small-scale company. To encourage existing companies to expand their activities through the reinvestment of profits, the rate of reinvestment allowance has been increased from 40 to 50 percent so that the rate is standardized in respect of qualifying capital expenditure incurred on or after 1 January 1994. The reinvestment allowance has been extended indefinitely after 31 December 1995.[15] There is also a commitment that sufficient notice will be given should the Government decide to withdraw the reinvestment allowance.

III. PERSONAL TAXATION

A. Income tax rates

In line with reduction in the corporate rate of income tax, the rate of income tax imposed on non-resident individuals, trust

11. Amendment to subpara. 37B(a) to Schedule 3.
12. Amendment to Sec. 60E(7).
13. Amendment to Sec. 60D(5)(b).
14. See V. Singh, "The 1993 Budget and Recent Developments", 47 *Bulletin for International Fiscal Documentation* (January 1993), at 32.
15. Amendments to paras. 1 and 2(b) of Schedule 7A.

© 1994 International Bureau of Fiscal Documentation

bodies, executors of estates of deceased persons who died domiciled outside Malaysia and receivers has been reduced from 34 to 32 percent with effect from year of assessment 1994.[16]

There was no reference to a corresponding tax rate decrease for resident individuals. Thus, for year of assessment 1994, the highest rate of tax for these individuals remains at 34 percent although companies will be taxed at 32 percent. From a technical viewpoint, it is essential that the top marginal rate of income tax for individuals be in line with the corporate income tax rate. In the absence of this, the disparity would lead to individuals with income above a specific threshold to carry out their businesses through incorporated companies. It may be possible that the rates will be lowered in the next budget depending on the fiscal position of the Government and taking into account the proximity of general elections.

B. Rebates

Prior to year of assessment 1994, a tax rebate of M$ 60 was given for an individual and M$ 30 for the wife where the individual's chargeable income did not exceed M$ 10,000. In order to reduce the tax burden of lower income groups, the rebate has been increased to M$ 90 for the individual and M$ 50 for the wife.[17] This change took effect from the year of assessment 1994. With this change, the Ministry of Finance has estimated that around 60,000 taxpayers will be spared from paying income tax.

C. Contribution to approved schemes and life insurance premiums

The maximum tax relief for contributions to approved schemes (or provident funds) and life insurance premiums has remained at M$ 3,500 for many years. In order to encourage savings and to stimulate the insurance industry, the maximum tax relief has been increased to M$ 5,000 with effect from year of assessment 1994.[18]

D. Relief for children at institutions of higher education

Prior to year of assessment 1994, a maximum relief of up to four times the normal child relief of M$ 800 was allowed for a child who was over 18 years of age and studying full-time at a university, college or other establishment of higher education in a place outside Malaysia and Singapore. A similar deduction was available to residents in East Malaysia in respect of a child receiving education in a school, university, college or other establishment of higher learning in Peninsular Malaysia or Singapore.

To encourage the pursuit of higher education locally and to reduce the outflow of foreign exchange, the maximum relief for children over 18 years of age receiving full-time education in universities and institutions of higher learning in Malaysia has been increased to four times the normal relief effective from year of assessment 1994. On the other hand, for children pursuing tertiary education abroad, the maximum relief has been reduced from four times to twice the normal relief.[19]

However, the maximum relief of up to four times the normal relief is preserved under the following circumstances:

- for students who commenced receiving further education outside Malaysia before 1 January 1994; and
- for a resident of East Malaysia whose child has commenced full-time education at a school or other educational institution in Peninsular Malaysia before 1 January 1994.

It will be observed that in the case of a university or other establishment of higher education in Singapore, twice the normal relief would be allowed. Subject to the foregoing, residents in East Malaysia would no longer be able to claim enhanced child relief (of up to four times the normal relief), in respect of children being educated in Singapore (except as stated above).

This change is laudable provided there are adequate opportunities for higher education in Malaysia. It comes at a time when a number of local institutions have commenced twinning programmes with foreign universities. Under such programmes, students will study in Malaysia for one or two years and spend the remaining time in the foreign country. As such, child relief would be a maximum of four times the normal child relief while the child is studying in Malaysia and would be reduced to a maximum of twice the normal relief when the child is studying overseas.

E. Tax exemptions

The 1994 Budget introduced the following changes[20] in respect of income received by a resident individual:

- the tax exemption on payment received from the translation of academic and literary works into the national language has been increased from M$ 6,000 to M$ 12,000 per annum;
- the tax exemption on royalties received from academic and literary works has been increased from M$ 12,000 to M$ 20,000 per annum;
- tax exemption on payments received for original paintings is granted up to M$ 20,000 per annum;
- tax exemption on payments received by music composers is granted up to M$ 12,000 per annum.

These changes took effect from the year of assessment 1994 and are intended to encourage creativity among academics and artists and to further enrich the nation's literary and academic works.

In addition to the above exemptions, the Minister also proposed that a tax exemption be granted on fees received from meetings and conferences to increase knowledge in the sciences and humanities and presentation of working papers at seminars and conferences in the national language. However,

16. Amendment to para. 2 of Part 1 to Schedule 1.
17. Amendment to Sec. 6A(2)(a) and (b).
18. Amendment to Sec. 49.
19. Amendment to Sec. 48(3).
20. Amendments to paras. 32, 32A and 32B of Schedule 6.

© 1994 International Bureau of Fiscal Documentation

this proposal has not been incorporated in the legislation. It is likely to be gazetted as a separate exemption order.

F. Exemption on interest earned on savings bonds

With effect from 16 February 1993, interest paid or credited to any individual in respect of Malaysian Savings Bonds (Bon Simpanan Malaysia) issued by the Central Bank of Malaysia are exempted from income tax.[21] This had been announced in the 1993 Budget and has now been legislated.

G. Withholding tax on gains and profits derived from interest-free banking schemes

Withholding tax exemption is given on interest derived from saving deposits with banking institutions of up to M$ 50,000 and to profits and gains derived from saving deposits of up to M$ 50,000 with Bank Islam, which practises an interest-free banking scheme.

With effect from 1 January 1994, the withholding tax exemption has been extended to profits and gains derived from saving deposits of up to M$ 50,000 placed with all banking institutions which practise the interest-free banking scheme. This change is merely a move to standardize the treatment. The relevant exemption order would be amended accordingly.

H. Schedular tax deduction scheme for employees

Currently, tax on employees in Peninsular Malaysia is deducted by the employer according to directions issued by the tax authorities.

The 1994 Budget proposed that, with effect from 1 January 1995, the deduction of tax be based on schedules or tables as done in East Malaysia (i.e. the states of Sabah and Sarawak), whereby the amount of tax to be deducted is predetermined according to certain standard circumstances pertaining to the taxpayer. It should be noted that individuals in Sabah and Sarawak are currently paying tax on a Pay As You Earn (PAYE) basis whereas individuals in Peninsular Malaysia pay tax on income earned in the preceding calendar year.

It is observed that the proposed change which is intended to simplify the tax collection system does not intend to bring individual taxpayers in Peninsular Malaysia onto the PAYE scheme. The availability of schedules or tables would make it easier for employers to deduct tax from salaries without waiting for directives from the tax authorities.

IV. INVESTMENT INCENTIVES

A. Incentives for industries located in the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak

Currently, companies granted pioneer status are given an abatement of 70 percent of their statutory income for five years. Companies granted the investment tax allowance (ITA) enjoy an allowance of 60 percent of qualifying capital expenditure and the amount of ITA which can be abated for each assessment year is restricted to 70 percent of statutory income. During the tax relief period, the effective tax rate would be about 10 percent. These incentives are granted to eligible companies irrespective of the location of their business within Malaysia.

To encourage a balanced growth between regions and to attract more investments to less developed states located in the Eastern Corridor of Peninsular Malaysia (Kelantan and Trengganu and areas to be designated by the Minister in the State of Pahang and North Eastern Johore not beyond the district of Mersing), Sabah and Sarawak, it was proposed that, with effect from 29 October 1993, projects eligible for pioneer status that are located within these areas be given an abatement of 85 percent (instead of 70 percent) of the statutory income. For companies eligible for ITA, the rate of allowance is increased from 60 to 80 percent and the amount of allowance which can be utilized for each assessment year is to be increased from 70 to 85 percent of statutory income. The effective tax rate would then be reduced to about 5 percent.

These proposed incentives are basically locational incentives and are a variation of the incentives which existed under the now-repealed Investment Incentives Act, 1968. Further, under the promotion of Investments Act, 1986 there was an abatement of adjusted income for location of a factory in a promoted area (generally a less developed area in the country). These proposals are expected to be legislated via amendments to the Promotion of Investments Act, 1986.

B. Incentive for environmental protection

Presently, the Minister of International Trade and Industry with the concurrence of the Minister of Finance may declare any activity or product which is of national and strategic importance to Malaysia to be a promoted activity or promoted product entitled to the following incentives:

- pioneer status with full tax exemption of statutory income for a period of ten years; or
- ITA of 100 percent of qualifying expenditure incurred in a five-year period.

It was proposed that a forest plantation project be recognized as a strategic project of national importance and hence be eligible for the foregoing incentives. This proposal is to be effective for applications received after 29 October 1993.

The proposal is intended to encourage the conservation of the environment for the protection of natural forests. However, it is unclear as to what is actually meant by the term "forest plantation project". It would appear that the ITA incentive may be preferred over the pioneer status as unutilized allowances can be carried forward indefinitely for utilization in future years.

C. Research allowance

In an effort to encourage the growth of research and development (R&D) especially in the manufacturing sector, the Government in the 1991 Budget announced several incentives:

21. Introduction of subpara. (d) to para. 35 of Schedule 6.

© 1994 International Bureau of Fiscal Documentation

(1) Approved research companies/institutes
- approved research companies or institutes which are established to undertake R&D for a particular industry would be eligible for a five year income tax exemption. This exemption would enable these research companies and institutes to distribute exempt dividends to their shareholders;
- accumulated losses of approved research companies and institutes incurred during the tax exemption period would be allowed to be carried forward for set off against post-exemption profits;
- plant and machinery, materials and samples used for approved research projects by research companies or institutes would be eligible for import duty, excise duty and sales tax exemptions;
- cash contributions to approved research institutes would qualify for double deduction.

(2) Companies that undertake the use of approved research companies/institutes
- double deduction would be available in respect of expenses incurred by companies which undertake to use the facilities and services of approved research companies or institutes.

(3) New technology based firms (NTBF)
- NTBFs would be eligible for a tax exemption of five years.

To achieve the objective of being an industrialized country in line with Vision 2020 and to maintain as well as to strengthen the competitiveness of local producers, it was proposed that, with effect from 29 October 1993, a research allowance be claimable under the Promotion of Investments Act, 1986.

Approved research companies carrying out R&D projects for their holding, subsidiary and associated companies would be granted a research allowance of 100 percent of the qualifying capital expenditure incurred within a period of ten years. The above allowance will be abated from the statutory income but restricted to 70 percent of the statutory income for each year of assessment.

The holding, subsidiary and associated companies concerned will not enjoy double deduction for payments made to such an approved research company. However, the approved research company may choose to forgo the incentive and allow the said companies to enjoy double deduction incentives in respect of payments made for R&D carried out by that research company.

Companies that carry out in-house R&D may be granted research allowance of 50 percent on qualifying capital expenditure for a period of ten years. The above allowance will also be deducted from the statutory income but restricted to 70 percent thereof for each year of assessment.

The above proposals would be incorporated in amendments to the Promotion of Investments Act, 1986. To date, such amendments have not been drafted.

In addition, industrial building allowance would be available to approved research companies or institutes (as mentioned earlier under "Business Taxation"). An approved research company or institute had been defined as a company or institute approved by the Minister of Finance to wholly carry on research in a specified industry. This definition has been amended, with effect from 1 January 1994, by replacing "wholly" with "mainly" thus enabling such a company or institute to participate in other minor activities.[22]

V. PETROLEUM INCOME TAX

A. Tax rate

The rate of petroleum income tax applicable to persons chargeable under the Petroleum (Income Tax) Act, 1967 (PITA) has been reduced from 45 to 40 percent with effect from the year of assessment 1994.[23]

The upstream petroleum industry has been requesting a reduction for several years. The tax structure was last reviewed in 1975. When the corporate income tax rate started to fall some years ago, the petroleum income tax rate remained at 45 percent. This was largely due to the significant contribution of petroleum income tax to the nation's tax revenue. The decision to lower the rate has been made in order to encourage further exploration and development of new fields as well as to enhance the investment climate for the petroleum industry. This has been found to be necessary due to the decline in crude oil prices and escalating costs.

B. Malaysia–Thailand Joint Authority (MTJA)

On 21 February 1979, Malaysia and Thailand signed the memorandum of understanding on the exploitation of resources of the sea-bed in the defined area of the Continental Shelf of the two countries in the Gulf of Thailand. This was followed by an agreement between both countries on 30 May 1990 which dealt with the constitution and other matters relating to the establishment of the MTJA under the Malaysia–Thailand Joint Authority Act, 1990.

Various amendments[24] have been made with regard to the MTJA and the Joint Development Area (JDA) in the Gulf of Thailand. All of these changes have retroactive effect from 23 January 1991. The changes are:
- the MTJA is to be included as a chargeable person for purposes of PITA;
- the definition of JDA in PITA follows the meaning under the MTJA Act, 1990;
- a person deriving income from petroleum operations carried out in the JDA is to be subject to the following tax rates:
  - zero percent on chargeable income ascertained from income for any of the first eight years of production; or
  - 10 percent of the chargeable income ascertained from income for any of the next seven years of production; or

22. Amendment to Sec. 34B(4)(a) and (b).
23. Amendment to Sec. 23(1) of PITA.
24. Amendments to Secs. 2, 4, 13A, 23 and Schedule 2 of PITA as well as introduction of Sec. 65B.

© 1994 International Bureau of Fiscal Documentation

- 20 percent of the chargeable income ascertained from income for any subsequent year of production.
- the MTJA is to be included as a party able to enter into a petroleum agreement with any other person for the exploration and prospecting of petroleum. Presently, only the National Petroleum Corporation, i.e. Petroleum Nasional Berhad (Petronas) is included in the definition of a petroleum agreement.
- previously, where a person (other than Petronas) carried on petroleum operations under more than one petroleum agreement, that person was treated as a separate chargeable person for each of those agreements. The amendment to Section 2(2) of PITA excludes MTJA from the aforesaid treatment;
- PITA provides that agreement areas operated by a partnership
  which would otherwise be contiguous with each other shall be treated as contiguous with each other notwithstanding that any part of those agreement areas has been surrendered to Petronas. Similar treatment will be accorded to a surrender of any part of such agreement areas to MTJA;
- the date of production in relation to a petroleum agreement
  signed with the MTJA will be the date of first commercial production of petroleum under that agreement;
- where under an agreement between Petronas and another chargeable person who has incurred qualifying expenditure in respect of any asset used in the petroleum operations, and the asset is vested in Petronas, the disposal value of that asset is treated as gross income of Petronas when the asset is disposed of. Similar treatment will be accorded to assets vested in MTJA under petroleum agreements between MTJA and other chargeable persons.
- the Minister is given the power by statutory order to grant tax exemption to give effect to any agreement entered into between the Malaysian Government and the government of another country for the joint exploration and exploitation of petroleum in overlapping areas.

The person so exempted is not absolved from complying with any requirement to submit tax returns, statement of accounts or any other information under the provisions of PITA.

VI. INDIRECT TAXATION

A. Import duties

In line with one of the budget strategies of reducing inflation, the Minister of Finance announced the reduction and abolition of import duties on more than 500 items including infant and baby food, medical equipment/components, building materials and construction equipment, motor vehicle spare parts and motorized homes.

To promote tourism, import duties on motorized homes were reduced from as high as 300 percent to 35 percent. This would provide a more economical form of accommodation for tourists.

Certain dutiable goods brought into Malaysia (excluding Labuan and Langkawi) on or with any person or in the baggage of such person intended for personal use were subject to 50 percent import duties. As the import duty rates of most goods now range from 30 to 40 percent, the rate has been correspondingly reduced to 30 percent.

In contrast with previous years' budgets which principally focused on increasing import duties on items such as alcohol and tobacco, this year's budget has "spared" these items and instead has increased import duties on only one luxury item, "superbikes", i.e. the import duties on motorcycles with cylinder capacity of 500 cc and above is increased from 60 to 120 percent.

These changes were effective from 4:00 pm on 29 October 1993.

B. Export duties

It was proposed that the rate of export duty on crude oil be reduced from 25 to 20 percent for exports made on or after 1 January 1995. This is part of the incentive to encourage further development of the petroleum industry.

C. Excise duties

To enhance the competitiveness of the local manufacturers who were affected by the reduction of import duties announced in the previous budgets, excise duties on goods such as food seasoning, dry batteries and tyres for motor vehicles have been reduced with effect from 29 October 1993.

D. Sales tax

To encourage production and increase the competitiveness of locally-made machines, it was announced that sales tax on parts/components for the production of machines (which are not taxable) is abolished with effect from 29 October 1993.

To encourage efforts to protect and conserve the environment, the Minister had also announced exemption of import duty and sales tax on catalytic convertors for motor vehicle assemblers; and a price differential of three sen per litre between leaded and unleaded petrol through a price reduction of unleaded petrol by three sen per litre effective 1 January 1994.

E. Expansion of scope of service tax

Service tax of 5 percent is charged on and paid by any person who carries on a business of providing taxable services or selling or providing taxable goods either in any prescribed professional establishment or prescribed establishment.

Pending the implementation of the Sales and Service Tax, the scope of service tax has been further widened, with effect from 1 January 1994, to cover the following services:

- parking space services operated by companies, firms, sole proprietors, government and semi-government agencies providing parking space for motor vehicles;

© 1994 International Bureau of Fiscal Documentation

- services provided by courier service firms having an annual turnover of M$ 150,000 and above;
- services provided by dentists having an annual turnover of M$ 300,000 and above; and
- services provided by veterinary doctors having an annual turnover of M$ 300,000 and above.

These changes are in line with the gradual extension of the scope of services which attract service tax. This process started on 1 January 1992.

The expanded service tax base is a prelude to the introduction of a comprehensive consumption tax through the intended integration and restructuring of the existing sales and service taxes into the Sales and Service Tax.

F. Sales and Service Tax

No further details were revealed about this proposed tax. The Minister did state that the Government will hold discussions with the private sector and consumer associations in early 1994 to facilitate the implementation of the tax. The discussions are likely to be driven by the findings of the recent mission to Malaysia by the International Monetary Fund.

G. Stamp duty

(1) Stamp duty payable on contract notes

Stamp duty is payable on contract notes for the sale and purchase of shares at the rate of M$ 1 on every M$ 1,000 or fractional part of M$ 1,000 of the value of any shares, stock or marketable securities.

The stamp duty has been increased by 50 sen to M$ 1.50 for every M$ 1,000 or fractional part of M$ 1,000 of the value of any shares, stock or marketable securities transacted from 1 January 1994. This change appears to be a move to counter the loss of revenue that would arise from the implementation of scripless trading. Under scripless trading, share transactions are recorded as movements in accounts maintained with the Central Depository System thus eliminating the need for dealing with and handling share certificates.

(2) Settlement of compound duties by a banker, stockbroker or insurer[25]

An authorized banker, stockbroker or insurer is allowed to settle the compounded duties on unstamped cheques, contract notes and certificates of insurance within eight days from 1 January and 1 July of each year. With effect from 1 January 1994, the compounded duties payable to the Collector of Stamp Duty can be paid within 14 days of 1 January, 1 April, 1 July and 1 October of each year.

(3) Stamp duty payable on share certificates[26]

Stamp duty which was payable at the rate of M$ 2 on the issue of a share certificate has been abolished with effect from 1 January 1994.

VII. OTHER CHANGES

A. Increase in penalties

Amendments were made to the Income Tax Act, 1967 to specify the minimum fine (in some cases) and to increase the maximum fine upon conviction of certain offences such as failure to submit income tax returns, filing incorrect returns, evading tax, leaving Malaysia without payment of tax, failure to observe tax obligations imposed on employers, etc. These are expected to assist in improving compliance with the various provisions.

B. Cash award to civil servants

To show its appreciation to civil servants, the Government has announced a cash award of half a month's salary. Of course, the award or "bonus" will remain taxable.

C. Small and medium-scale industries (SMIs)

In order to overcome the moderating inflow of foreign investment, the Government has initiated the Domestic Investment Initiative to improve investment especially by SMIs. Efforts will be intensified to develop SMIs through various incentives including provision of sites and infrastructure, loan schemes, promotion and marketing assistance and advisory services.

D. Corporatization of the Inland Revenue Department (IRD)

No further comments were made in the 1994 Budget on this area. It was speculated in the media that the IRD would be converted into a Statutory Board in January 1994. However, it is understood that the IRD is awaiting approval from the Treasury on its corporatization. As such, it is likely to be implemented later in the year.

25. Amendments to the Stamp Act 1949.
26. *Id.*

© 1994 International Bureau of Fiscal Documentation

VIII. RECENT DEVELOPMENTS

A. Operational Headquarters Incentive

Earlier in 1993, the Ministry of Finance identified the types of services and activities which are within the scope of this incentive. The list of activities was effective from 1 January 1993.[27]

B. Double tax treaties

At the end of 1993, Malaysia had concluded 37 double tax treaties (inclusive of the limited treaty with the United States). During 1993, the three new treaties that were signed were with the Islamic Republic of Iran, Papua New Guinea and Saudi Arabia.

C. Labuan

Licensed Labuan offshore banks and insurance firms were earlier allowed to operate from the management offices in Kuala Lumpur until 31 December 1993 with the prior written approval of the Central Bank of Malaysia. While the infrastructural facilities in Labuan are being upgraded, this period has been extended to 31 December 1994. The period may be further extended beyond 31 December 1994 on a case-to-case basis by the Minister of Finance on the recommendation of the Central Bank.

D. Promotion of Investments (Amendment) Act 1993

In the 1992 Budget, the Minister of Finance had proposed several major changes to the incentives under the Promotion of Investments Act, 1986. The legislation giving effect to these changes received the Royal Assent on 8 September 1993 and generally came into force retroactively on 1 November 1991.

IX. CONCLUSION

Overall, the 1994 Budget has been well-received by all sectors. Except for the extension of the service tax and the imposition of additional stamp duty on contract notes, there were no new proposals to raise revenue. Instead, the tax changes are expected to cost the Treasury about M$ 1.9 billion, which is much larger than the revenue forgone in previous Budget exercises.

Nevertheless, the Government is confident that with strong economic growth, the proposed introduction of the Sales and Service Tax and the increase in the efficiency of tax administration, the revenue position will be further strengthened. The Government will then be in a better position to further reduce individual and corporate taxes which will serve to make Malaysia more competitive. In the final analysis, the budget is well-planned and with careful monitoring of the situation, the projected growth rate would be achieved.

REFERENCES

- 1994 Budget Speech.
- Finance (No. 2) Bill 1993.
- Malaysian Association of Certified Public Accountants, *1994 Budget Commentary & Ready Reckoner*, Kuala Lumpur, 1993.
- Speech by Tan Sri Dato' Mohd. Sheriff Kassim (Secretary General to the Malaysian Treasury) at the Post-Budget Panel Discussion organized by the Malaysian Economics Association on 30 October 1993, Kuala Lumpur.
- Ministry of Finance, Malaysia, *Economic Report 1993/94*, Kuala Lumpur.

27.

Service	*Selected Activities*
(i) Sea and air services	Transport services by sea and air (except cabotage)
	Passenger transportation by sea and air (except cabotage)
	Freight transportation
	Rental services of sea-going vessels
	Towing and pushing services
	Cargo handling services
	Storage and warehousing services
	Vessel salvage and refloating services
(ii) Communication services	Postal services
	Courier services (air and land)
	Telecommunications services
(iii) Tourism services	Travel agent, hotel and other lodging services
(iv) Professional and	Legal services
	consulting services
	Accounting and auditing services
	Taxation services
	Market research
	Management consulting services (including economic and financial)
	Architectural services
	Engineering services
	Computer services including software development

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

Africa

NASHASHIBI, K.; BAZZONI, S.
Alternative exchange rate strategies and fiscal performance in Sub-Saharan Africa.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/68. pp. 45.
(B. 13.479)

South Africa

Ernst & Young.
PRACTICAL GUIDE TO VAT.
Cape Town, Juta & Co, Ltd and Divaris Stein Publishers. 1992, pp. 129.
This paperback book is designed to lead the uninitiated taxpayer through the VAT system. It covers the following topics: outline of VAT registration, taxable supplies, output VAT, importation of goods and services, export and zero rating, input tax credit and tax invoices, VAT return. Selected definitions and the VAT return are included, as well as a detailed index.
(B. 13.480)

Zimbabwe

INTERNATIONAL TAX AND BUSINESS Guide: Zimbabwe.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 133.
Guide including information on Zimbabwe tax system, foreign investment, corporate and individual income taxes, accounting and auditing, withholding tax, sales tax and other related subjects.
(B. 13.474)

ASIA & THE PACIFIC

THE CONTROL AND MANAGEMENT of government expenditure: issues and experience in Asian countries.
Bangkok, UN Economic and Social Commission for Asia and the Pacific. 1993.
Development Papers, No. 13. pp. 496.
Research report describing the issues involved in the control and management of government expenditure. The experience of selected Asian economies are summarized. Nine country case studies are also included.
(B. 57.926)

SHOME, P.; ESCOLANO, J.
The state of tax policy in the central Asian and transcaucasian newly independent states (NIS).
Washington, IMF International Monetary Fund. 1993.
IMF Paper on Policy Analysis and Assessment PPAA/93/8. pp. 21.
(B. 57.923)

Australia

BUSINESS PROFILE SERIES: Australia. 4th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1993, pp. 60.
Business information guide including economic overview, facts and figures, foreign investment policy, foreign exchange control, individual and corporation tax.
(B. 57.925)

Japan

FINANCIAL STATISTICS OF JAPAN 1993.
Tokyo, Ministry of Finance. 1993, pp. 98.
(B. 57.908)

Nepal

RUP BAHADUR KHADKA
Economic liberalization in Nepal.
Nepal, Seijo University. 1993.
Economic Papers No. 122, October 1993. pp. 17.
(B. 57.930)

Thailand

BUSINESS PROFILE SERIES: Thailand. 7th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1993, pp. 56.
Revised and updated guide giving information on foreign investment, exchange controls, import- and export controls, labour relations, employment of foreigners, taxation, patents and trade marks etc. in Thailand.
(B. 57.899)

EUROPE

Belgium

SPRUYT, André J.J.
Inleiding tot het belastingrecht. Supplement 1992-93.
Brugge, Uitgeverij Die Keure NV, Oude Gentweg 108, 8000 Brugge, Belgium. 1993, pp. 23.
1992/93 Supplement updating the 1992 handbook on Belgian taxation up to 31 August 1993.
Price of the handbook including this supplement is 975.- Bfrs.
(B. 113.141)

BELASTINGHEFFING IN BELGIE OP activiteiten van Nederlandse ondernemingen.
Brussels, Nederlandse Kamer van Koophandel voor België en Luxemburg, Congresstraat 18, 1000 Brussels. 1993, pp. 95.
Report covering taxation in Belgium of activities performed by Dutch companies.
(B. 113.125)

ANNUAIRE FISCAL 1993.1
Diegem, CED Samsom. 1993 pp. 678.
Annual reference tax handbook covering description of corporate and individual income taxes, value added tax, similar taxes and death duties. Relevant addresses and telephone numbers of tax administration offices are appended.
(B. 113.134)

POPPE, GUY; ROEYEN, Wim van.
Tewerkstelling van buitenlandse kaderleden in België.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 232. 1476.- Bfrs.
Book covering the legal aspects of expatriates working in Belgium.
(B. 113.094)

DESTERBECK, F.
Fiscale Wenken: Privé vermogen en fiscus. Normaal beheer van het privé vermogen.
Diegem, CED Samsom. 1993, pp. 102. 1700.- Bfrs.
Book on the tax treatment of the normal transactions in the daily course of the management of private property.
(B. 113.093)

HENDRICKX, N.; JANSSENS, Th.; Stappen, D. van; VERLAET, J.
Personenbelasting.
Diegem, CED Samsom. 1993, pp. 402. 860.- Bfrs.
Concise and practical 1993 guide to personal income tax.
(B. 113.022)

LIBER AMICORUM MAECKELBERGH. Fiscaliteit op de vooravond van de XXIste eeuw.

© 1994 International Bureau of Fiscal Documentation

Brussels, Fiscale Hogeschool, Stormstraat 2, 1000 Brussels. 1993, pp. 534.
Essays by various tax experts compiled and published in honour of W. Maeckelbergh.
(B. 113.156)

EEC

ALLEN, Derek.
Tax and giving in the European Community.
London, The Directory of Social Change; The Europhil Trust, Garsdon Manor, Malmesbury SN16 9NJ, England. 1993, pp. 32. £ 9.95.
A guide to the tax treatment of charitable bodies in the European Community and of donations made to such bodies.
(B. 113.149)

THÖMMES, Otmar; GEHRE, Horst; Sieling, Arnd.
EG-Recht in der Steuerberaterpraxis.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 126. 42.- DM.
The influence of EC law on tax consultancy. Topics covered include the role of EC institutions and EC measures, professional aspects of the freedom of establishment for tax advisers, key issues of EC tax law, a checklist of German tax law affected by EC law and procedural law for claiming application of EC law.
(B. 113.167)

Finland

BUDGETPROPOSITIONEN 1994.
Regeringens proposition till riksdagen om statsbudgeten för 1994.
Helsinki, Government Printer. 1993, pp. 550.
Government Bill for 1994 budget. (This is part of regeringens proposition No. 126/93.)
(B. 113.135)

France

GAMBIER, Claude; MERCIER, Jean-Yves.
Les impôts en France. Traité pratique de la fiscalité des affaires. 25th Edition. A jour au 1er août 1993.
Paris, Editions Francis Lefebvre. 1993, pp. 670. 198.- Ffrs.
Annual updated summary of the taxes levied in France. Appended are exercises and solutions on corporate income tax.
(B. 113.182)

MERCADAL, Barthelemy; MACQUERON, Patrice.
Le droit des affaires en France. Principes et approche pratique du droit des affaires et des activités économiques. A jour au 1er août 1993.
Paris, Editions Francis Lefebvre. 1993, pp. 550. 212.- Ffrs.
Monograph on French business law.
(B. 113.180)

GATUMEL, Denis.
Le droit du travail en France. Principes et approche pratique du droit du travail. 4th Edition. A jour au 1er août 1993.
Paris, Editions Francis Lefebvre. 1993, pp. 550. 197.- Ffrs.
Monograph on labour law in France.
(B. 113.181)

Germany

NEUES STEUERRECHT VON A-Z.
Lexikon-Kommentar und Kommentar-Zeitschrift zum gesamten Steuerrecht 27. Ausgabe.
Bielefeld, Erich Schmidt Verlag.
Loose-leaf service. Approx. 6000 pages. Basic price: 178.- DM. Subscription price for updates per year 237.60 DM.
Loose-leaf service in five binders containing a commentary to all taxes levied in the Federal Republic of Germany. It is updated twice monthly by a periodical. The NSt periodicals of the second quarter of 1993 (Hefte 7-12/1993) contain various subjects such as: basic principles of double taxation convention, EC internal market from 1993, the value added tax on deliveries and buying of new cars, survey of fiscal treatment of a fiscal unity (Organschaft), decisions and regulations concerning the excise taxes in the years 1990 to 1992. The third quarter periodicals numbers 13 to 18 of 1993 contain subjects such as: the fiscal stimulation for owner-occupied houses, the European Council of Justice, losses by limited liability, Art. 15A of the Income Tax Law, and in every periodical up-to-date information on legislation, administration and court decisions.

SCHOOR, Hans Walter.
Die GmbH & Still im Steuerrecht.
Herne, Verlag Neue Wirtschafts-Briefe. 1992, pp. 128. 48.- DM.
The limited liability company with silent partner. Includes a description of the treatment of this type of entity under German commercial and tax law. Description of the situations in which this entity can be used to reduce the tax burden.
(B. 112.504)

BEU, Jorg-Dieter; HELIAS, Siegfried; SEDELKY, Irmgard.
Subventionen in den neuen Bundesländern. Ein Leitfaden für Berater, Investoren und Interessenten an öffentlichen Förderhilfen. 2. Auflage.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 600. 98.- DM.
Guide to public incentives (including direct money or tax incentives) for consultants, investors and other interested persons.
(B. 112.924)

STEUERGESETZÄNDERUNGEN 1993/1994.
Einschliesslich Standortsicherungsgesetz und Föderales Konsolidierungsprogramm (Solidarpakt). Bearbeitet von H. Cattelaens, W. Niermann und W. Tausch.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 359. 58.- DM.
Tax law amendments 1993/94 including acts to improve the business environment in Germany as well as the Federal Consolidation Act (Solidarity Pact). The book includes a collection of amendments to German tax law for 1994 in order of the texts of the laws, time tables and tables.
(B. 113.103)

WINTER, Willy; POSDZIECH, Ortwin.
Das Standortsicherungsgesetz.
Cologne, Peter Deubner Verlag GmbH. 1993. Steuer Telex Sonderinformation. pp. 88. 38.80 DM.
An overview of the amendments to the German Tax Reform Act 1993 (business location improvement act, federal consolidating programme).
(B. 113.154)

LOY, Hartmut.
Finanzierungen unter Einsatz von Lebensversicherungen.
Cologne, Peter Deubner Verlag GmbH. 1993. Steuer Telex Sonderinformation. pp. 100. 38.80 DM.
A discussion of the tax treatment of life assurances used as an aid in financing.
(B. 113.153)

Ireland

TAX ACTS 1993-94. INCOME TAX, corporation tax, capital gains tax. Editor Alan Moore. 3rd Edition.
Dublin, Butterworth (Ireland) Ltd., 26 Upper Ormond Quay, Dublin 7, Ireland. 1993, pp. 2045
Annual reference guide containing: the Income Tax Act 1967 (as consolidated into Finance Act 1993), the Capital Gains Tax Act 1975 (as consolidated into Finance Act 1993), the Corporation Tax Act 1976 (as consolidated into Finance Act 1993), the non-amending sections of the Finance Acts from 1967 to 1993, the text of the recent tax amnesty legislation and the major statutory instruments for each tax. Contains up-to-date Irish case law and extensive new cross-reference features.
(B. 113.208)

COONEY, Terry; MCLAUGHLIN, Jim; TAGGART, Pascal.
Taxation summary 1993/94 Republic of Ireland.
Dublin, The Institute of Taxation in Ireland, 19 Sandymount Avenue, Dublin 4. 1993, pp. 327.
Annual publication providing a unique technical and detailed summary of all significant taxes in the Republic of Ireland. This 1993 edition is fully updated to reflect all the changes made by the Finance Act 1992 in the law effecting income tax, corporation tax, capital acquisitions tax, residential property tax, stamp duties, value added tax and tax amnesties 1993.
(B. 113.130)

VAT ACTS 1993-94.
Value added tax. Editors Alan Moore and James D. Somers.
Dublin, Butterworth Ireland Ltd. 1993, pp. 776.
This is a companion volume to Butterworth Ireland Tax Acts and it contains the VAT legislation of Ireland. It is annotated with

© 1994 International Bureau of Fiscal Documentation

regard to amendments, defined words, statutory instruments, statements of practice and case law (both Irish and European). It includes comprehensive tables of cases and detailed index guides.
(B. 113.148)

Monaco

MACK, Gerd R.
Standort Monaco. Leitfaden für unternehmerische und private Aktivitäten.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1992, pp. 154. 68.- DM.
Guide to private and business activities in Monaco.
(B. 113.160)

Netherlands

KATER, J. de; REUVERS, M.R.
Verrekenprijzen bij grensoverschrijdende transacties (intercompany pricing) 4th Edition.
Deventer, Kluwer; The Hague, Fenedex. 1993.
Fiscale en Juridische Documentatie voor Internationaal Zakendoen, No. 2. pp. 90.
Mr Reuvers describes in a very clear way the issuess that arise in practice when corporate income tax authorities judge transfer prices used in cross-border situations. Many examples of situations in which "at arm's length" price is not used are presented and explained. Mr De Kater explores the customs and free trade concept of the determination of transfer prices. His study includes critical remarks on the definitions of the value of goods contained in GATT and the EC Customs Code (Regulation 1224/80).
(B. 113.207)

DUTCH CORPORATE LAW & corporate income tax.
Editor Raymundo H.D. Debrot.
Amsterdam, New Amsterdam Law Books, P.O. Box 53294, 1007 RG Amsterdam. 1990.
Kingdom of The Netherlands Law Series, Volume 1. pp. 210. 125.- Dfl.
A practical guide for attorneys, civil law notaries, tax practitioners, accountants and executives involved in international transactions with the Netherlands. Updated texts in the English language of basic laws, rulings, Dutch corporate forms and tax system.
(B. 113.147)

VERVLOED, J.L.M.J.; BOD, W.B.
Wegwijs in de BTW. Theorie en praktijk. 4th Edition.
Lelystad, Koninklijke Vermande BV. 1993, pp. 358. 62.50 Dfl.
Changes in the treatment of intra-Community transactions which resulted from the implementation of the Single European Market effective 1 January 1993.
(B. 113.146)

BREDERODE, R.F.W. van.
De bijzondere positie van de landbouw in de omzetbelasting.
Deventer, Kluwer. 1993, pp. 317.
Doctoral thesis on VAT treatment in the agricultural sector. An examination of the rationale behind the farming scheme, the progress of VAT harmonization in general in the context of European integration and links with the common agricultural policy. Includes an explanation of how the VAT farming scheme was devised and the changes it went through. The transitional VAT regime for the agricultural sector (i.e. intra-Community transactions) is also discussed. The author examines the arguments in favour of a special scheme for farming at both the European level and at the domestic level in the Netherlands.
(B. 113.185)

SMIT, J.A.
De algemene wet bestuursrecht in het belastingrecht.
Deventer, Kluwer. 1993.
Fiscaal Actueel. pp. 97. 46.- Dfl.
Monograph explaining the general law on government in tax law (to enter into force on 1 January 1994) which will affect objection and appeal procedures.
(B. 113.123)

ONG A SWIE, S.R.
Sfeerovergang van fiscale controle naar opsporing.
Rotterdam, Stichting Moret Fonds, G.H. Betzweg
1, 3068 AZ Rotterdam. 1993.
Moret Scriptie Reeks. pp. 56.
Thesis discussing the areas from administrative fiscal control with respect to criminal investigation with respect to tax laws.
(B. 113.108)

STEVENS, L.G.M.; DOOL, R.P. van den.
Rapport afschaffing vermogensbelasting?
Rotterdam, Fiscaal Economisch Instituut Erasmus University. 1993.
Brochure No. 29. pp. 70.
Report considering the abolition of the net wealth tax.
(B. 112.732)

GRUNDMANN-VAN DE KROL, C.M.
Uitgifte en levering van aandelen op naam. De nieuwe regeling ingevolge de Wet van 3 september 1992 inzake overdracht van aandelen op naam.
Arnhem, Gouda Quint BV. 1993.
Actualia Ondernemingsrecht, No. 4. pp. 88. 32.50 Dfl.
Monograph describing the new law of 3 September 1992 concerning the issuance and delivery of name shares of listed and unlisted companies (NVs and BVs).
(B. 113.107)

BERGEIJK, P.A.G. van; SINDEREN, J. van; WAASDORP, P.M.
De dynamiek van belastingverlagingen.
The Hague, Ministry of Economic Affairs. 1993.
Overdruk 9303, pp. 32.
Reprint of comparative study on the effects of tax reductions in the Netherlands and the USA.
(B. 112.854)

United Kingdom

NOAKES, Patrick; MACKLEY-SMITH, Gary B.
Tolley's capital gains tax 1993-94. 16th Edition.
Croydon, Tolley Publishing Company Limited.
1993, pp. 531. £ 26.95.
A comprehensive detailed guide to capital gains tax and the charge to corporation tax in respect of chargeable gains. Includes the legislation and relevant case law up to the date of the Finance Act 1993.
(B. 113.200)

ROWES, Peter.
Taxation. Incorporating the Finance Act 1993. 12th Edition.
London, DP Publications Ltd., Aldine Place, 142/144 Uxbridge Road, Shepherds Bush Green, London W12 8AW. 1993, pp. 513.
A thorough basic discussion of income tax, corporation tax, taxation of chargeable gains, inheritance tax and value added tax.
(B. 113.151)

THE FINANCE ACT 1993.
London, Touche Ross & Co. 1993, pp. 172.
(B. 113.161)

HARDMAN ON TAX IN BUSINESS 1993/94. A practical guide to the taxation of companies and those who work for them.
Edited by Mark Cripps.
London, Gee (a division of Professional Publishing Ltd.). 1993, pp. 524.
This edition is based on the law and practice in force on 1 August 1993 and incorporates the changes made by the Finance Act 1993. Part I includes the system of corporation tax, advance corporation tax, losses, groups of companies, close companies, tax implications of trading overseas, reorganizations and venture capital. Part II contains a discussion of VAT. Part III covers payroll procedures and taxes. Part IV covers taxation of directors and employees (including benefits in kind), inheritance tax, employee share ownership and share schemes.
(B. 113.205)

SAUNDERS, Glyn; SMAILES, David; HARVEY, Eric L.
Tolley's income tax 1993-94. 78th Edition.
A comprehensive detailed guide to income tax including the legislation and relevant case law to the date of the Finance Act 1993.
Croydon, Tolley Publishing Company Limited.
1993, pp. 762. £ 29.95.
(B. 113.198)

WAREHAM, Robert; BOWEN, Nicholas.
Tolley's value added tax 1993-94. 10th Edition. A comprehensive detailed guide to value added tax including the legislation and relevant case law to the date of the Finance Act 1993.
Croydon, Tolley Publishing Company Limited.
1993, pp. 724. £ 26.95.
(B. 113.199)

© 1994 International Bureau of Fiscal Documentation

NOAKES, Patrick; MACKLEY-SMITH, Gary B.
Inheritance tax 1993-94. 8th Edition.
Croydon, Tolley Publishing Company Limited.
1993, pp. 263. £ 23.95.
A comprehensive detailed guide to inheritance tax including the legislation and relevant case law to the date of the Finance Act 1993.
(B. 113.196)

INTERNATIONAL

KAPL, Helmut.
Die internationale Pension mit Steuersystemen.
Vienna, Wirtschaftsverlag Carl Ueberreuter, Alser Strasse 24, Postfach 306, A-1091 Vienna, Austria. 1992, pp. 263. 880.- AS.
Description of international pension planning in 15 countries (Europe and USA). Premiums and payments to social security systems and private pension plans.
(B. 112.642)

MARTINA, Alan.
Lectures on the economic theory of taxation. Economic reform, socially optimal piecemeal consumption taxation structures and information.
Berlin, Springer Verlag GmbH. 1992.
Lecture Notes in Economics and Mathematical Systems, No. 384. pp. 311. 90.- DM.
(B. 112.948)

SHOME, P.
Technical assistance on tax policy. A review.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/65. pp. 30.
(B. 113.144)

OECD

NATIONAL TREATMENT FOR FOREIGN controlled enterprises.
Paris, OECD – Organisation for Economic Co-operation and Development. 1993, pp. 185.
The book provides a comprehensive explanation of the scope and nature of the OECD National Treatment Instrument which provides a multilateral framework for promoting further progress towards liberal international investment policies.
(B. 113.120)

LATIN AMERICA

Mexico

INTERNATIONAL TAX AND BUSINESS Guide: Mexico New York, DRT International; 1633 Broadway, New York, NY10019, USA. 1991, pp. 137.
Fundamental information for foreign investors about the Mexican business environment, including the factors a foreign investor should consider in deciding whether to acquire an existing Mexican company or to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 18.779)

13 ANOS DE IVA EN MEXICO.
Guadalajara, Indetec. 1993, pp. 235.
13 Years of VAT in Mexico. A study of the Mexican value added tax system.
(B. 18.784)

THE NORTH AMERICAN FREE Trade Agreement – NAFTA. Its scope and implications for North America's lawyers, businesses and policymakers.
Washington, American Bar Association. 1993, pp. 500.
This course publication includes articles on the economic impact of NAFTA, investor-host state investment dispute settlement procedures, intellectual property provisions and government obligations and private rights.
(B. 113.183)

REFLEXIONES TECNICO-JURIDICAS respecto a la procedibilidad del pago del impuesto sobre nóminas a cargo de las instituciones de crédito y sociedades de seguros.
Guadalajara, Indetec. 1993, pp. 86.
Technical-legal analysis of the payment of payroll tax by credit institutions and insurance companies.
(B. 18.801)

ASPECTOS ORGANIZACIONES PARA la administración del gasto en las entidades federativas.
Guadalajara, Indetec. 1993, pp. 133.
Organizational aspects for administration of expenditures in the federative entities (i.e. the states forming the Mexican Federation).
(B. 18.802)

MIDDLE EAST

Syria

INTERNATIONAL TAX AND BUSINESS Guide: Syria.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 61.
Guide to provide potential investors with information about investing in Syria. These include information on tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 57.901)

NORTH AMERICA

Canada

CORPORATE TAX STRATEGY.
Supplement 1993-94.
Update to Corporate Tax Strategy 1992-93.
Amsterdam, Price Waterhouse. 1993, pp. 30.
(B. 113.026)

THE NORTH AMERICAN FREE Trade Agreement – NAFTA. Its scope and implications for North America's lawyers, businesses and policymakers.
Washington, American Bar Association. 1993, pp. 500.
This course publication includes articles on the economic impact of NAFTA, investor-host state investment dispute settlement procedures, intellectual property provisions and government obligations and private rights.
(B. 113.183)

REPORT OF PROCEEDINGS OF THE Forty-Fourth Tax Conference convened by the Canadian Tax Foundation at the Royal York Hotel, Toronto, November 23, 24, 25, 1992.
Toronto, Canadian Tax Foundation. 1993, pp. 1800. $ 160.-.
A report of the conference proceedings, including papers delivered at the various sessions and the questions posed and responses given at the Revenue Canada round table.
Topics covered: emerging income tax issues; real estate tax planning; personal tax planning; corporate tax planning; business and property income; tax planning for closely held businesses; GST developments; and international taxation.
(B. 113.195)

USA

BOLES, Ernest.
Gesellschaften im US-Einkommensteuerrecht.
Munich, Verlag C.H. Beck. 1993.
Münchener Schriften zum Internationalen Steuerrecht, Heft 16. pp. 178. 88.- DM.
A description of the taxation of companies in the USA.
(B. 113.176)

REVENUE RECONCILIATION ACT OF 1993. Analysis and Planning by Arthur Andersen & Co. Text of Act. Conference Committee Report.
New York, Matthew Bender & Company, Inc. 1993, pp. 741.
(B. 113.202)

PAYNE, James L.
Costly returns. The burdens of the US tax system.
San Francisco, ICS Press, 243 Kearny Street, San Francisco, CA 94108, USA. 1993, pp. 264. $ 14.95.
(B. 113.104)

THE NORTH AMERICAN FREE TRADE Agreement – NAFTA. Its scope and implications for North America's lawyers, businesses and policymakers.
Washington, American Bar Association. 1993, pp. 500.
This course publication includes articles on the economic impact of NAFTA, investor-host state investment dispute settlement procedures, intellectual property provisions and government obligations and private rights.
(B. 113.183)

© 1994 International Bureau of Fiscal Documentation

BERGEIJK, P.A.G. van; SINDEREN, J. van; WAASDORP, P.M.
De dynamiek van belastingverlagingen.
The Hague, Ministry of Economic Affairs.
1993.
Overdruk 9303, pp. 32.
Reprint of comparative study on the effects of tax reductions in the Netherlands and the USA.
(B. 112.854)

Looseleaf Services

Received between 1 and 30 November 1993

AFRICA

FIDAFRICA
release 10
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 18 and 19
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
- Rulings and guidelines
  release 140-142
- Legislation
  releases 68 and 69

Butterworths, North Ryde.

AUSTRALIAN STAMP DUTIES LAW
Tolhurst - Wallace - Zipfinger
release 125
Butterworths, North Ryde.

SUPERANNUATION AND RETIREMENT BENEFITS IN AUSTRALIA
Brown - Edstein
release 27
Butterworths, North Ryde.

AUSTRIA

STEUERLICHE TABELLENSAMMLUNG
release 79
Anton Orac Verlag, Vienna.

BELGIUM

COMMENTAAR OP HET WETBOEK VAN DE INKOMSTENBELASTING
release 4
Ministry of Finance, Brussels.

COMMENTAIRE DU CODE DES IMPOTS SUR LES REVENUES
release 4
Ministry of Finance, Brussels.

IMPORT-EXPORT. GUNSTREGELINGEN EN PROCEDURES IN DE BTW EN DOUANEREGLEMENTERING
Brassine - Koedijk - Marckx
release 87/88
Kluwer Rechtswetenschappen, Deurne.

VAKCURSUSSEN
release 219
Kluwer Rechtswetenschappen, Deurne.

WETBOEK VAN DE INKOMSTENBELASTING
release 96
Ministry of Finance, Brussels.

CANADA

CANADA'S TAX TREATIES
release 47
Butterworths, Toronto.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 861 and 862
Prentice-Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Moms
  release 6
- Skattenyt – Kronologisk
  releases 23 and 24
- Skattebestemmelser – Systematisk
  release 11 and 11A

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 336

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – DROITS D'ENREGISTREMENTS ET DE TIMBRE
release 4
Editions Francis Lefebvre, Paris.

JURIS CLASSEUR– DROIT FISCAL – CODE GENERAL DES IMPOTS
release 71
Editions Techniques, Paris.

REGLEMENTATION SOCIALE PRATIQUE/SECURITE SOCIALE LEGISLATION DU TRAVAIL
release 4
Editions Francis Lefebvre, Paris.

GERMANY

ABC FÜHRER LOHNSTEUER
release 36
Verlag Schäffer & Co., Stuttgart.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBILIEN-KAPITALANLAGEN
release 56
Peter Deubner Verlag, Cologne.

NEUES STEUERRECHT von A bis Z
releases 13-18
Erich Schmidt Verlag, Bielefeld.

STEUERRICHTLINIEN
release 76
C.H. Beck Verlag, Munich.

UMSATZSTEUERGESETZ (MEHRWERTSTEUER)
Hartmann - Metzenmacher
releases 4 and 5
Erich Schmidt Verlag, Bielefeld.

LUXEMBOURG

CODE DE LA LEGISLATION FISCALE
volumes 6 and 7
Imprimerie Saint Paul, Luxembourg.

NETHERLANDS

BELASTINGWETGEVING
- Inkomstenbelasting 1964
  releases 245 and 246
- Omzetbelasting 1968 (BTW/1978)
  release 88
- Vermogensbelasting 1964
  release 48

Noorduijn BV, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Gemeentelijke belastingen e.a.
  releases 180 and 181

Kluwer, Deventer.

FISCALE MODELLEN
release 56
Kluwer, Deventer.

FISCALE WETTEN
releases 206 and 207
Fed, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Gecombineerde nomenclatuur
  release 81
- Tarief van invoerrechten
  release 104
- Algemene wetgeving inzake douane
  release 251

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
release 364
Kluwer, Deventer.

© 1994 International Bureau of Fiscal Documentation

KLUWERS TARIEVENBOEK
release 427
Kluwer, Deventer.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
release 168
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
releases 140 and 141
Gouda Quint/D. Brouwer, Arnhem.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel, releases 70 and 71
- AWBZ, releases 104-106
- Heffing over uitkeringen en loon release 45

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEF-RECHTELIJKE WETTEN
releases 290 and 291
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Inkomstenbelasting 1964 releases 878-882
- Loonbelasting releases 558 and 559
- Omzetbelasting releases 238-240
- Vennootschapsbelasting, release 311

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, release 10
Norsk Skattebetalerforening, Oslo.

PERU

IMPUESTO A LA RENTA
release 66
Editorial Economia y Finanzas, Lima.

IMPUESTO A LAS VENTAS
release 73
Editorial Economia y Finanzas, Lima.

SWEDEN

SKATT PA ARV OCH SKATT PA GAVA
Bratt - Fogelklou - Norrdell - Waller
release 11
Norstedts Förlag, Stockholm.

SWITZERLAND

DIE STEUERN DER SCHWEIZ/LES IMPOTS DE LA SUISSE
Tome I, release 89
Tome II, release 81
Tome III, release 79
Verlag für Recht und Gesellschaft AG., Basel.

UNITED KINGDOM

SIMON'S TAX CASES
releases 32-34d 31
Butterworths, London.

SIMON'S TAXES
release 193
Butterworths, London.

SIMON'S TAX INTELLIGENCE
releases 32-44
Butterworths, London.

VALUE ADDED TAX – DE VOIL
release 219
Butterworths, London.

USA

UNITED STATES TAX REPORTER
releases 33-46
RIA – Research Institute of America Inc., New York.

CUMULATIVE INDEX – 1994 No. 1

I. ARTICLES

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

International:
Pierre-Jean Douvier:
Choosing the right location for pooled services of a group of companies 7

Seth E. Terkper:
Improving the accountancy context of tax reform in developing countries 21

Qatar:
Finbarr Sexton:
Taxation regime for foreign entities following the fundamental reform of existing income tax regulations 14

United States:
Leonard W. Rothschild, Jr.:
California's new "water's edge" election enhances business opportunities for foreign investors: the US Supreme Court to rule in *Barclays* case 3

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41

IV. CONFERENCE DIARY 55

V. BIBLIOGRAPHY

- Books 45
- Looseleaf services 49
- List of addresses of the major publishing house appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 3 MARCH 1994

NEW ZEALAND:

THE NEW UNDERLYING FOREIGN TAX CREDIT AND FOREIGN DIVIDEND WITHHOLDING PAYMENT REGIMES 111

Kevin Holmes and Mark Russell

An amendment to the New Zealand Income Tax Act incorporates a new method for calculating foreign dividend withholding payments ("FDWP") imposed on New Zealand companies that receive foreign dividends. The purpose of the new law is to recognize the New Zealand company's proportionate share of the corporate taxes paid by the foreign company that remits the dividend, and this is achieved by providing an underlying foreign tax credit against the liability for FDWP. This article reviews the main provisions of the new law and analyses its effectiveness in achieving its objectives.

POLAND:

VAT IN POLAND – IMPLICATIONS FOR THE FOREIGN INVESTOR 123

Matthew O'Shaughnessy and Piotr Kowalski

As part of Poland's tax reform process, a goods and services tax has replaced the old turnover tax system. Although the new system is broadly similar to VAT systems in force in West European countries, there are some peculiarities which are especially important in respect of international transactions.

BELGIUM:

INTRODUCTION OF THE "ECONOMIC REALITY" TEST IN BELGIAN TAX LAW: YEARS OF UNCERTAINTY AHEAD? 127

Marc Dassesse

Until recently, one of the characteristics of Belgian tax law was the strict adherence placed by the courts on the taxpayer's right to fully utilize imperfections or loopholes in the law in order to arrange his affairs in the most tax efficient way. A Belgian law of 22 July 1993, however, introduced a general "anti-avoidance" provision whereby the tax authorities may recharacterize a transaction for tax purposes if it is established that the transaction was motivated by tax considerations, unless the taxpayer can show that the transaction is (also) justified by legitimate financial or economic reasons.

CUBA:

TAXATION OF FOREIGN INVESTMENT IN THE REPUBLIC OF CUBA 130

Annette T. Johnson

The legal infrastructure for establishing Cuban and foreign joint ventures is governed by Decree-Law 50-82, supplemented by the Commercial Code and several resolutions issued by State bodies. This article analyses the provisions of Decree-Law 50-82, as it represents for foreign investors the pivotal point of reference for taxation as well as the creation of legal rights to property in Cuba.

HONG KONG:

RECENT DEVELOPMENTS REGARDING THE SOURCE OF PROFITS 138

Jefferson P. VanderWolk

Hong Kong profits tax only applies to profits arising in or derived from Hong Kong. Neither the statutes nor case law provides comprehensive source rules to guide taxpayers. Two recent decisions concerning the source of profits illustrate the ongoing differences of opinion as to the proper approach to the determination of where profits arise for Hong Kong tax purposes.

ISRAEL:

TAXATION OF CORPORATIONS 141

This article overviews the salient features of Israel's corporate tax system.

© 1994 International Bureau of Fiscal Documentation

BIBLIOGRAPHY
- Books 150
- Looseleaf services 154

CONFERENCE DIARY 137

CUMULATIVE INDEX 156

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

NEW ZEALAND

THE NEW UNDERLYING FOREIGN TAX CREDIT AND FOREIGN DIVIDEND WITHHOLDING PAYMENT REGIMES

Kevin Holmes and Mark Russell

Kevin Holmes is a Chartered Accountant and Senior Lecturer in Taxation, and Mark Russell is a Researcher in Taxation at Victoria University of Wellington. *The authors acknowledge the financial assistance provided by the Victoria University of Wellington Research Fund to prepare this article.*

I. INTRODUCTION

The Income Tax Amendment Act (No. 3) 1993 received Royal Assent on 28 September 1993. It incorporates into the New Zealand Income Tax Act 1976 ("the Act") a new method for calculating foreign dividend withholding payments ("FDWP") imposed on New Zealand companies that receive foreign dividends. The purpose of the new law is to recognize the New Zealand company's proportionate share of the corporate taxes paid by the foreign company that remits the dividend. This is achieved by providing an underlying foreign tax credit ("UFTC") against the liability for FDWP. In some circumstances the UFTC is a statutorily deemed amount, and in other circumstances it is an amount calculated by reference to actual foreign taxes paid.

This article reviews the main provisions of the new law and analyzes its effectiveness in achieving its objectives.

II. FOREIGN DIVIDEND WITHHOLDING PAYMENTS

All foreign dividends received by New Zealand resident companies are exempt from New Zealand income tax. However, when those dividends are distributed to the recipient company's shareholders, they are taxable in the shareholders' hands.

Notwithstanding the intercorporate dividend exemption, New Zealand companies that receive foreign dividends on or after 1 April 1988 are required to deduct from the dividend received, and pay to the New Zealand Revenue, FDWP at the rate of 33 percent. The dividend received is required to be grossed-up for foreign withholding taxes paid before the 33 percent rate is applied. Those foreign withholding taxes are then allowed as a credit against the FDWP so calculated. Companies maintaining a "branch equivalent tax account"[1] under New Zealand's international tax regime can use credits in that account to offset any FDWP payable.

FDWP is a withholding payment.[2] Shareholders are allowed a credit against their own tax liability for any FDWP paid by the company on distributed dividends. Any excess credits are refundable to both resident and non-resident shareholders.

Example 1

Consider the impact of FDWP on a dividend flow from a foreign company to a New Zealand resident company, then on to a New Zealand resident shareholder. Suppose a New Zealand resident company has a wholly-owned foreign subsidiary. In the current year, the subsidiary earns a profit of NZ$ 100. Assume the corporate tax rate and non-resident withholding tax rate in the foreign jurisdiction are 33 percent and 15 percent, respectively. If all profits are repatriated, the tax impost is:

		$
Foreign Sourced Income		100.00
less Foreign Tax (33%)		(33.00)
Net Income After Tax		67.00
less Non-Resident Withholding Tax (15%)		(10.05)
Dividend received by New Zealand Parent Company		56.95
less FDWP [(33% x $ 67) – $ 10.05]		(12.06)
Cash dividend distributable by New Zealand Company		44.89
Cash Dividend received by Shareholder		44.89
plus FDWP credits		12.06
Shareholder's Gross Dividend for Tax Purposes		56.95
less New Zealand Tax (33%)	18.79	
less FDWP credits	(12.06)	
Net Tax Payable by Shareholder		(6.73)
		50.22
Cash available to Shareholder		38.16
Effective Tax Rate to Shareholder		61.84%

1. In simple terms, a branch equivalent tax account may be maintained by any New Zealand resident company to record income tax applicable to its attributed foreign income derived from a controlled foreign company. See Secs. 394ZZP and 245G of the Act.
2. It is necessary that FDWP is a withholding payment and not a tax *per se* so that New Zealand does not contravene its double tax agreements.

© 1994 International Bureau of Fiscal Documentation

One of the primary reasons for the introduction of the FDWP regime was to reduce the opportunities for taxpayers to defer or evade tax on foreign dividends. The deferral problem arose because shareholders are taxed only when dividends are actually distributed, which may be some considerable time after the New Zealand company has received the foreign dividend. Evasion of tax on foreign dividends may arise because those dividends do not give rise to imputation credits in New Zealand, which results in a tax liability falling upon shareholders. Consequently, there is an incentive for some taxpayers to not return those dividends. However, because shareholders can claim credits for FDWP, which may eliminate their tax liability, they presumably are more likely to return foreign dividends.

FDWP also filters out tax preferences not caught by New Zealand's international tax regime. Under that regime, a controlled foreign company ("CFC") is taxed in New Zealand on an accruals basis using New Zealand tax rules. Therefore, tax concessions available in New Zealand, such as the absence of a capital gains tax, are also available to CFCs. By imposing a further tax on dividends repatriated back to New Zealand, FDWP revokes any such tax preferences to which the New Zealand parent company would have been entitled.

Example 2

Assume that a New Zealand company has a subsidiary in a country which does not tax capital gains. That subsidiary makes a profit of NZ$ 100, of which NZ$ 40 are capital gains. If the tax rate in the foreign country is 20 percent, the tax impost will be:

	$
Taxable Income in Foreign Country	60.00
less Foreign Tax (20%)	(12.00)
	48.00
plus Non-Taxable Capital Gain	40.00
Cash Dividend remitted to New Zealand Parent Company	88.00
less FDWP (33%)	(29.04)
Cash dividend distributable by New Zealand Company	58.96

Clearly, the imposition of FDWP eliminates the New Zealand tax preference of exempting capital gains from the tax base when the gain is remitted to a New Zealand corporate shareholder by a foreign company.[3]

FDWP has been very controversial in New Zealand. Essentially, it constitutes a double taxation of corporate earnings. In particular, it is a very significant barrier to the repatriation of offshore profits, especially where it is desired that the New Zealand company invest the dividend proceeds rather than distribute them to shareholders. Accordingly, FDWP acts in a manner contrary to the Government's stated aim of making tax a neutral factor in economic decision-making. For example, a New Zealand company with offshore earnings may be deciding whether a new plant should be built in New Zealand or overseas. If the new plant is to be funded out of the offshore earnings, other things being equal, the company is likely to invest overseas because, depending on the level of any NRWT credit available to the company, FDWP will make the New Zealand option up to 49.25 percent more expensive.

That FDWP discourages companies from returning their overseas earnings to New Zealand appears to be supported by the amount of FDWP actually collected. The Treasury estimates that at 31 March 1991, New Zealanders held NZ$ 10 billion in overseas equity investments.[4] However, in the year to 30 June 1991 only NZ$ 18 million was collected in FDWP. Similarly, for the year to 30 June 1992, the collection was NZ$ 20 million. The amount of FDWP collected suggests that either foreign subsidiaries of New Zealand companies were not remitting dividends to New Zealand or that the FDWP was being circumvented.

The New Zealand Government preferred the view that the low amount of FDWP collected does not reflect a barrier to repatriation; rather, it indicates the success with which companies have been able to avoid FDWP. Consequently, in the 1992 Budget the FDWP regime was extended to include "non-dividend" transactions between New Zealand companies and their CFC subsidiaries, such as purchases of New Zealand property or loans to New Zealand residents. This too was a controversial move, with some commentators suggesting that it would lead to a reduced amount of capital investment in New Zealand.[5]

The Government also announced in the 1992 Budget that New Zealand's international tax regime was to be reviewed. It was widely anticipated that FDWP would be abolished. However, in October 1992 the Government announced that FDWP would be retained, but that dividends received from wholly-owned subsidiaries located in "grey list" countries would be exempt.[6]

However, the exemption system created new problems. For example, limiting the exemption to grey list countries penalizes investment in other regions, especially the developing Asian economies. Furthermore, the requirement that subsidiaries must be fully-owned before the exemption applies, creates a tax bias in favour of 100 percent takeovers. It also ignores the fact that a local partner is often needed when investing in foreign countries, either to regulatory requirements or because locals are better able to gain access to markets and handle social and cultural matters.

In November 1992 the Government released draft legislation for the new international tax regime. According to this legis-

3. It should be noted that, except for qualifying companies, non-taxable capital gains derived by any company, which are distributed to shareholders are taxable as dividends in the shareholders' hands, thus eliminating the tax preference at that point. For a detailed discussion of the qualifying company situation, see Holmes, K., "Taxation of Closely Held Companies: The New Zealand Model", 46 *Bulletin for International Fiscal Documentation* (October 1992), at 506-513.
4. Barber, D., "New Zealand: Howls of Protest Over NZ 'Double Tax'", *Business Review Weekly* (4 December 1992), at 37.
5. See Plunket, C., "Tax Change Brings Back Exchange Controls", *National Business Review* (24 July 1992), at 35, and "Tax Changes Sure to Scare Off Foreigners", *National Business Review* (10 July 1992), at 28.
6. The grey list specifies countries to which the CFC rules do not apply because the New Zealand Government considers that they have tax systems comparable to New Zealand's system. The countries currently on the grey list are Australia, Canada, Germany, Japan, the United Kingdom and the United States. See Schedule 15 of the Act.

© 1994 International Bureau of Fiscal Documentation

lation, companies were to receive a deduction instead of a credit for any foreign taxes paid. FDWP remained, as did the exemption system announced the previous month. Following intense lobbying, the Government announced in December 1992 that the legislative proposals would not proceed; instead, credits would be granted against FDWP for underlying foreign taxes paid, irrespective of whether the dividend was paid from a grey list country or elsewhere. Legislation introducing the UFTC regime was enacted on 28 September 1993. It applies to all foreign dividends received on or after that date.

III. UFTC REGIME

The UFTC regime aims to eliminate the double taxation of foreign profits by providing a credit for foreign taxes paid against a New Zealand company's liability to FDWP. This relief is in addition to any credit received for withholding taxes paid in the foreign country. The new regime does not purport to alter the tax position of the shareholder of a New Zealand company that receives a dividend from a foreign company. It merely impacts upon the New Zealand company's FDWP liability.

A. Eligibility

A UFTC can be claimed only if the New Zealand company receiving the dividend is liable to FDWP on that dividend. Further, the New Zealand company must have a *sufficient interest* in the foreign company paying the dividend. To have a sufficient interest, the New Zealand company must hold a voting interest[7] of 10 percent or greater in the foreign company. In any case where a market value circumstance[8] exists, the New Zealand company must also have a market value interest[9] of 10 percent or more. The policy intention behind this requirement is to allow UFTCs where the New Zealand company has a "controlling" interest in a foreign company. However, the overall objective of the legislation (i.e. to allow a UFTC to reduce a FDWP liability) is achieved in all circumstances where New Zealand companies are able to obtain the information necessary to calculate the UFTCs applicable to dividends paid to them, regardless of their voting interests in the foreign companies. In this context, the 10 percent threshold is no more than an arbitrary cut-off point.

In addition to the sufficient interest requirement, the foreign company must be one of the following:

- resident in a grey list country; or
- a CFC; or
- a foreign investment fund applying the branch equivalent method of income calculation.[10]

However, no UFTC is granted to the company in any of the following circumstances:

- if it is a qualifying company. Qualifying companies are prohibited from claiming UFTCs because, to the extent that no imputation credits are available, dividends paid from qualifying companies are exempt from tax in the hands of shareholders. If qualifying companies were allowed to claim UFTCs, their shareholders would derive a greater distribution after tax than shareholders in non-qualifying companies;[11]
- if it does not have a sufficient interest at the time the dividend is derived;
- if the dividend is paid on a fixed rate share. This is because the Government was concerned about the use of such shares in tax avoidance arrangements. Since, in substance, fixed rate shares are comparable to debt instruments, and interest received from overseas is assessable income, it is not consistent for dividends on such shares to obtain tax relief;
- if the company paying the dividend receives a deduction for it;
- if the dividend was sourced directly or indirectly from an amount received tax-free by the foreign company from another company, and the other company received a deduction for that amount.

B. Calculation of FDWP

To recognize the credit for corporate tax paid by overseas subsidiaries, the amount of FDWP required to be deducted from a foreign dividend is now calculated using the following formula:[12]

$$([a + b + c] \times d) - b - c$$

where:
a = dividend paid after deducting foreign withholding tax.
b = foreign withholding tax.[13]
c = UFTC.
d = New Zealand company tax rate (33%).

Example 3
Assume that a foreign subsidiary remits a dividend of $ 67 to its New Zealand parent company. No foreign withholding is deductible. The UFTC is $ 33. The FDWP payable when the dividend is paid to the New Zealand company is:

$$([67 + 0 + 33] \times 33\%) - 0 - 33 = \$\ 0$$

As expected, there is no FDWP to pay. It has been fully eliminated by the UFTC.

7. A *voting interest* is defined in Sec. 8C to be a shareholder's percentage share of the total shareholder decision-making rights in a company.
8. A *market value circumstance* is defined in Sec. 8B. Broadly, it is where a company has on issue shares with guaranteed dividends, options, floating rate debentures or debentures issued in substitution for shares.
9. A *market value circumstance* is defined in Sec. 8D to be a shareholder's percentage share of the total market value of a company's shares and options.
10. The branch equivalent method of calculating income is defined in Sec. 245J to be the amount of income which would have been calculated under the Act were the company at all times in the accounting period a New Zealand resident company.
11. The amount of the advantage is the tax payable by non-qualifying company shareholders on the distribution to them. Where the UFTC exactly eliminates the FDWP liability, the benefit is 67% of the UFTC.
12. See Sec. 394ZM(1) of the Act.
13. Foreign withholding taxes paid in countries specified in Schedule 17A of the Act cannot be recognized. At present, the only country listed in Schedule 17A is Western Samoa.

© 1994 International Bureau of Fiscal Documentation

C. Calculation of UFTCs

The manner in which the UFTC is calculated depends upon whether dividends are paid from a grey list company (i.e. a company resident in a country on the grey list) or a non-grey list company. Credits associated with dividends derived from non-grey list companies are based on the actual tax paid overseas. Dividends derived from grey list companies are deemed to have borne tax equal to the New Zealand tax applicable to the gross dividend.

D. Eligible accounting years

UFTCs are available only in respect of *eligible accounting years*. The calculation of the UFTC takes into account the foreign earnings and tax from all eligible accounting years. In relation to a particular dividend, an eligible accounting year is defined as (i) the year in which the dividend is paid, or (ii) the immediately preceding year.

Unfortunately, the definition of *eligible accounting year* is circular in that it also defines an eligible accounting year as "the year immediately preceding any eligible accounting year". This could mean that an eligible accounting year includes the year immediately preceding an "eligible accounting year" as defined under (i) and (ii) above. On this interpretation, the payment of any one dividend creates a maximum of three eligible accounting years in respect of which the earnings and tax can be taken into account. If this interpretation is correct, then the limit of three years is completely arbitrary. There is no conceptual reason why the calculation of the UFTC should be limited to three years. Further, the limit results in an inaccurate matching between earnings and tax. This is because while dividends may be paid out of retained earnings accumulated over a number of years, tax paid in only the last three years will be taken into account.[14]

Alternatively, the eligible accounting year definition could have been intended to set up a continuous backward loop from the time the dividend is paid until the time the taxpayer acquired a sufficient interest in the foreign company. In that case, all years in which the taxpayer has a sufficient interest preceding either the year in which the dividend is paid, or the year before the dividend is paid, qualify as eligible accounting years. This is a far more logical approach to the calculation of the UFTC as a more consistent tax earnings ratio will be employed. However, if the true intent of the legislation is to allow all previous years in which the taxpayer had a sufficient interest to be eligible accounting years, the section could simply have said that an eligible accounting year is either one in which the dividend is paid and all previous years in which the taxpayer had a sufficient interest, or the year immediately before the year in which the dividend is paid and all such previous years. As the legislation currently stands, the objective of this section is not apparent.

The taxpayer must have a sufficient interest in the company at all times during an eligible accounting year. This requirement prevents New Zealand companies with small holdings in overseas companies from temporarily increasing their holdings just prior to the payment of a dividend so that they can claim a UFTC. The desire to prevent such actions is most evident in respect of holdings in grey list companies because of the deemed credit system.[15]

Where the dividend is paid from a "low tax jurisdiction company",[16] an eligible accounting year must end on or after 28 September 1993. This is to prevent tax haven companies from distributing profits earned prior to the introduction of the UFTC regime. Nevertheless, an accounting year that ends on or after 1 April 1988, and throughout which the low tax jurisdiction company has been a CFC, is an eligible accounting year. This concession is permitted because such CFCs are taxed on an accruals basis on their worldwide income, thus reducing the scope for adopting avoidance arrangements.

A low tax jurisdiction company can also treat accounting years ending prior to 28 September 1993 as eligible accounting years if it provides to the Commissioner of Inland Revenue details of the earnings, tax paid and dividends paid in those years. However, in this case, only dividends received from companies not resident in low tax jurisdiction countries are recognized as earnings for the purpose of calculating the UFTC. Similarly, any tax paid by the company paying these dividends will be the only tax recognized.

Regardless of whether the company concerned is resident in a low tax jurisdiction or not, accounting years that begin before the "commencement date"[17] will qualify as eligible accounting years only if the taxpayer provides the Commissioner with information about the foreign company's earnings, tax paid and dividends.

E. Non-grey list countries

With respect to dividends received from non-grey list countries, a credit is given for the actual tax paid in the foreign country. The statutory formula that determines the amount of the credit in essence attributes credits to the dividend in the proportion of foreign taxes paid to foreign after-tax earnings. It, in effect, applies the average tax rate imposed on past earnings to a dividend distribution.

The formula in Section 394ZMC is complex because it takes account of a tier of companies behind the foreign company that pays the dividend to the New Zealand resident company. Here, the UFTC is:

$$a \times \frac{b + c - d - e}{f - g - h}$$

where:

a = dividend received (before the deduction of foreign withholding tax).

14. See UFTC formula under *Non-Grey List Countries*.
15. See under *Grey List Countries*.
16. Low tax jurisdiction companies are companies resident in countries listed in Part A of the Seventeenth Schedule to the Act. There are currently 61 countries on this list.
17. The commencement date is defined as the first day of the accounting year in which 28 September 1993 falls. See Sec. 394ZMA(1).

© 1994 International Bureau of Fiscal Documentation

b = aggregate tax paid or payable in all eligible accounting years.

c = tax deemed to have been paid in all eligible accounting years in respect of dividends received from lower tier companies.[18]

d = aggregate of all UFTCs granted in respect of all dividends paid during an eligible accounting year, other than the current year. For purposes of this calculation, all dividends not derived by the taxpayer are treated as if they had been derived by the taxpayer at a time when it had a sufficient interest, and all dividends derived before the enactment date are treated as if the UFTC regime applies at the time they were derived.

e = in respect of a grey list company, the aggregate of all deemed UFTCs granted in the current year.

f = the *greater* of:
- aggregate of after-income tax earnings of all eligible accounting years; or
- aggregate of all dividends paid by the company during the accounting year (other than dividends included in h), plus the amounts in g and h.

g = aggregate of dividends paid during an eligible accounting year, other than the current year.

h = aggregate of dividends paid in the current year which either do not qualify for a UFTC, or which give rise to a deemed credit by virtue of being paid from a grey list company.

In a simple single period case with no lower tier companies, the formula, for ease of understanding, can be represented as:

$$\text{UFTC} = (\text{dividend received} + \text{foreign withholding tax paid}) \times \frac{\text{foreign tax}}{\text{foreign after-tax earnings}}$$

The tax and earnings figures used here are for eligible accounting years to which the dividend relates. Once a portion of tax and earnings is applied to a dividend, this portion is eliminated from the "pool" of tax and earnings from eligible accounting years.

The conceptual basis behind the UFTC formula is to allocate the tax that has been paid in the foreign country in the proportion of the dividend to the total retained earnings in respect of which that tax has been paid. This can be seen more readily by manipulating the formula to read:

$$\text{UFTC} = \text{foreign tax paid} \times \frac{\text{gross dividend}}{\text{retained earnings}}$$

Example 4

Suppose that a New Zealand company establishes a wholly-owned subsidiary in a non-grey list country. In year 1, the subsidiary makes $ 100 profit before tax and pays income tax of $ 20. In year 2, the pre-tax profit is $ 300 and income tax is $ 75. Assume that both years are eligible accounting years so that the tax and earnings for both years are included in the calculation of the UFTC. If in year 2 a dividend of $ 100 is distributed to the New Zealand parent, the FDWP liability is:

$$\begin{aligned}\text{UFTC} &= (\text{dividend received} + \text{foreign withholding tax}) \times (\text{foreign tax/foreign after-tax earnings})\\ &= (100 + 0) \times (^{20+75}/_{80+225})\\ &= \$\,31.15\end{aligned}$$

$$\begin{aligned}\text{FDWP} &= ([a + b + c] \times d) - b - c\\ &= ([100 + 0 + 31.15] \times 33\%) - 0 - 31.15\\ &= \$\,12.13\end{aligned}$$

Interestingly, after-tax earnings are to be obtained from the foreign company's financial statements. Presumably, this is intended to reduce the compliance costs otherwise incurred if all foreign subsidiaries were required to restate their income using New Zealand tax rules. Where the financial statements are prepared in a foreign currency, the UFTC must be calculated in that foreign currency, and then converted into New Zealand currency at the spot rate applying at the close of trading on the day the dividend is paid.

The UFTC formula ensures that any timing differences which cause tax paid to differ from the accounting tax expense do not distort the calculation of the UFTC. This is because

(1) timing differences do not affect the amount of tax actually paid – they alter only retained earnings (and the accounting tax expense);

(2) the total UFTCs for all eligible accounting years can not exceed the total tax paid in those years (this is the effect of the subtrahend *d* in the (modified) expression, *b-d*, in the UFTC formula); and

(3) dividend payments are not dependent on retained earnings (because of the requirement to choose the greater of the alternative amounts offered in the determination of *f*).

Timing differences may, however, cause difficulties under the "three year limit" interpretation of eligible accounting years discussed above. If timing differences reverse in a year that is not an eligible accounting year, then taxpayers either will benefit or will be penalized for not being able to take that reversal into account. This could occur if a dividend is not paid within two years from the year in which the timing difference reverses. To avoid this potential problem, taxpayers can ensure that every year qualifies as an eligible accounting year by paying a dividend (no matter how small) at least once every three years.

Although compliance costs are reduced, the use of accounting profits to determine after-tax earnings does introduce a considerable degree of flexibility into the calculation, which could be used to manipulate the quantum of the UFTC. To mitigate against this, the legislation details a hierarchy of requirements relating to the nature of the financial statements to be used.

Firstly, the financial statements must be prepared under generally accepted accounting principles ("GAAP") in New Zealand, and they must be the subject of an unqualified audit report. Where the audit report is qualified, the financial statements are still acceptable if the matter giving rise to the qualification does not materially affect the calculation of UFTCs or if adjustments are made to eliminate any material distortions arising from that matter.

If such financial statements do not exist, then those prepared using the GAAP (or an equivalent standard for reporting profits in a "consistent and non-distorting manner") of the foreign country can be used. The same requirements as to

18. See under *Lower Tier Companies*.

© 1994 International Bureau of Fiscal Documentation

audit qualifications apply as for statements prepared under New Zealand GAAP.

Where no financial statements exist which meet either of the above requirements, statements used for reporting to any central or local government or agency are acceptable. Alternatively, financial statements prepared for non-associated creditors can be used. In each case, if the financial statements are audited, they must not be subject to a qualification.

Where none of the above options apply, the income tax paid by the foreign company in the accounting year for which no acceptable statements exist, and both the immediately preceding and succeeding accounting years, are deemed to be nil. The same rule applies when either the taxpayer or the Commissioner believes that the financial statements of the foreign company are not a fair representation of actual after-tax profit or loss of the company.

Regardless of which financial statements are used, the after-tax earnings must include the accounting provision for tax (i.e. not the statutory liability for tax) and extraordinary items. There is no specific guidance as to whether the after-tax income is to include equity profits. However, even if equity profits are included, the tax paid figure remains the same. The only impact is to increase the retained earnings balance, thus allowing a larger dividend to be paid.

Where financial statements are the subject of a qualified audit report, their acceptability turns on whether or not the matter subject to qualification is "material". As the legislation does not define what is meant by a "material effect", it is unclear what test is to be applied. It does not appear that the test is the same as that applied by the auditor in determining whether the financial statements show a true and fair view (or equivalent), because the legislation refers to a material effect on the calculation of the UFTC, not on net profit or balance sheet items.

An indication of what is a material effect may be taken from the guidelines on materiality that the Commissioner issued in relation to the taxation of financial arrangements. Usually, financial arrangements are taxed on a yield-to-maturity basis. However, the Commissioner may make determinations as to alternative methods that can be used. The Commissioner is also bound to accept any method of calculation that produces a result not "materially different" from that which would have resulted from the use of a determination. The Commissioner has stated that a material difference is one that produces a discrepancy of more than 5 percent of the amount calculated under the relevant determination of $ 500,000, whichever is lower.[19] The percent criterion is not dissimilar to the materiality test of between 5 and 10 percent commonly adopted by accountants.[20]

A further problem which arises with respect to the calculation of the UFTC relates to New Zealand companies that change their residence to another country. While resident in New Zealand, such companies will maintain an imputation credit account, which allows tax paid by the company to be credited against the shareholders' tax liabilities on dividends distributed to them. The UFTC formula prevents "double dipping" of credits by deducting from the income tax paid figure (which is defined to include New Zealand income tax) any UFTCs previously granted (item *d* in the formula) and subtracting from the after-tax earnings figure any dividends previously paid (item *g* in the formula). However, there is no provision in the formula for eliminating tax attributable to earnings that have been distributed in New Zealand as dividends with imputation credits attached. Therefore, a New Zealand company planning to move offshore could pay an imputed dividend before it moved, and then utilize the tax paid on those earnings to generate a UFTC once it was overseas. Not only would the payment of imputed dividends in New Zealand leave the tax paid figure in the UFTC formula constant, it would also reduce the after-tax earnings figure (since the dividend would still form part of element *g*), thus inflating the ratio of tax/earnings and consequently increasing the UFTC. Clearly, this would not have been intended by the Government.

F. Lower tier companies

Credits may also be claimed for tax paid by lower tier subsidiaries, so long as the New Zealand company has a sufficient interest in the lower tier company after tracing through the interposed companies. This is achieved by deeming the first tier subsidiary to have paid the tax of the lower tier subsidiaries. The extent of this deemed tax paid is the lesser of the amount calculated as if the dividend from the lower tier company was paid directly to the New Zealand company and the amount calculated by the formula:

$$([a + b + c] \times d) - c$$

where:

a = dividend paid after deducting foreign withholding tax.
b = UFTC calculated as if the dividend had been paid directly to the New Zealand company.
c = foreign withholding tax.
d = New Zealand company tax rate (33%).

The intention of this calculation is to limit the foreign tax credit to the amount of tax that would have been paid had there been New Zealand tax on that income. As a consequence, companies are limited in their ability to offset lightly taxed foreign income against highly taxed foreign income through the use of a tiered structure.

Although the above formula is appropriate for determining how much lower tier company tax should be deemed to have been paid by higher tier companies, the incorporation of lower tier profits into the UFTC calculations of higher tier companies produces absurd results when the higher tier companies do not distribute all of their retained earnings. This is demonstrated and explained in Example 7.

An important practical problem with the operation of the UFTC regime is the inability of smaller shareholders to acquire the information necessary to complete the calculations. This includes details such as tax paid, including tax

19. Inland Revenue Department, *Tax Information Bulletin*, Vol. 3, No. 1 (1993), at 4-5.
20. See the Appendix to the New Zealand Society of Accountants' *Statement of Standard Accounting Practice No. 6: Materiality in Financial Statements.*

© 1994 International Bureau of Fiscal Documentation

paid by lower tier companies. Furthermore, the compliance costs associated with the regime are likely to be significant. Indeed, it is understood that some companies have already decided not to avail themselves of the benefits of the regime for either one or both of these reasons.

G. Grey list countries

In general, dividends derived from grey list countries are granted credits to the extent of the tax that would have been payable had there been New Zealand tax on those dividends. Thus, dividends from grey list countries are effectively exempt from FDWP. This is a recognition by the Government that, in the majority of cases, were the actual tax paid used, as is done for non-grey list dividends, very little (if any) additional tax would be payable. Therefore, to reduce compliance costs for taxpayers with investment in grey list countries (which apparently comprises 85 percent of New Zealand overseas investment),[21] a deemed credit is given.

To qualify for a deemed credit, the grey list company:

- must have been liable to income tax in all eligible accounting years in any grey list country by reason of domicile, residence, place of incorporation or place of management. This requirement ensures that companies resident in non-grey list countries cannot change their residence to a grey list country and pass through dividends with deemed credits. It does, however, allow subsidiaries to be moved between grey list countries without impinging upon their ability to generate deemed credits.
- must not have calculated its income using any of the designated tax concessions that operate to disengage the grey list exemption from the CFC regime.[22] At present, one of the designated concessions is the exemption from income tax of any income derived from business activities carried on in another country. However, deemed credits may still be claimed if the only case in which this concession applies is in relation to business activities carried on in another grey list country. This recognizes that most grey list countries exempt foreign income only when it already has been taxed in a comparable manner overseas.
- must not have been a New Zealand resident company during the period from three years before the taxpayer first had a sufficient interest in the company to the date on which the dividend is paid. Alternatively, where the taxpayer had a sufficient interest in the company within three years of its incorporation, the company must not have been resident in New Zealand in the period between the date of incorporation and the payment of the dividend. These requirements are intended to prevent less than 100 percent-owned New Zealand resident subsidiary companies and associated companies from migrating to grey list countries to avoid paying tax on the distribution of dividends. Such dividend payments between resident companies are taxable in New Zealand. However, since intercompany dividends paid within the same wholly-owned group are exempt from New Zealand tax, the above "anti-migration" rules do not apply to dividends received from a wholly-owned subsidiary. The three year threshold is again arbitrary. It reflects the preference of administrative expediency over a precise determination of motive to police this part of the legislation.

Furthermore, the taxpayer must maintain a "tracking account" (see below) to record dividend flows occurring on or after the *effective date*. This date is the later of:

- 20 October 1992;[23]
- the first day of the first eligible accounting year; or
- the first day of such eligible accounting years as the taxpayer elects.

If all of these criteria are met, the amount of the UFTC is determined by the formula:

$$a \times (b/1-b)$$

where
a = dividend before deduction of withholding tax.
b = New Zealand company tax rate (33%).

In effect, this allows dividends to be paid from grey list countries without the imposition of FDWP.

Example 6
Assume that a New Zealand company owns a subsidiary in a grey list country. In the first year of its existence the subsidiary makes a profit before tax of $ 100 and pays income tax of $ 28. When the after-tax profits are distributed to the New Zealand parent, NRWT deducted by the grey list country is $ 11. The FDWP liability is:

$$\begin{aligned} UFTC &= a \times (b/1-b) \\ &= 72 \times (.33/1-.33) \\ &= \$\,35.46 \\ FDWP &= ([a + b + c] \times d) - b - c \\ &= ([61 + 11 + 35.46] \times 33\%) - 11 - 35.46 \\ &= \$\,0 \end{aligned}$$

There is no FDWP liability, i.e. no additional New Zealand tax is imposed on the dividend, notwithstanding that tax paid in the grey list country was actually $ 28. This is because the UFTC is deemed to equate the FDWP.

Where any criterion for claiming deemed credits is not met, a UFTC can still be claimed on the basis of actual taxes paid, in the same manner applicable to dividends received from non-grey list companies.

H. Tracking account

A prerequisite for claiming deemed credits is that the company maintains a "tracking account" for its subsidiaries in grey list countries. The purpose of the tracking account is to prevent income from non-grey list companies being routed through grey list companies so as to achieve a deemed credit at the full New Zealand tax rate. Tracking accounts are not mandatory; however, if they are not maintained, credits can be claimed only for the actual tax paid.

21. See Tax Education Office, *Newsletter No. 74* (13 September 1993), at 2 and 12.
22. These designated concessions are specified in Part A of Schedule 16 of the Act.
23. This is the date when the new policy was first publicly announced.

© 1994 International Bureau of Fiscal Documentation

The tracking account is a record of dividends received by grey list companies for which a deemed credit would not have arisen had those dividends been paid directly to the New Zealand company. Therefore, the account monitors dividends received by the grey list company from a non-grey list company (other than New Zealand) and dividends from other grey list companies in which the New Zealand company does not have a sufficient interest.

In cases where the taxpayer elects to maintain a tracking account in respect of a grey list subsidiary, a deemed credit can only be claimed to the extent that the dividend exceeds a credit balance in the tracking account. This is, in effect, an ordering rule that attaches UFTCs on the basis that dividends are first paid out of amounts received by the grey list company, which would not have given rise to deemed credits had they been paid directly to New Zealand. Formally, the extent to which a dividend is ineligible for deemed credits is determined by multiplying the amount of the dividend[24] by the lesser of one and the fraction:

$$a/b$$

where:

a = any credit balance in the tracking account on the last day of the accounting year.

b = aggregate of all dividends paid during the accounting year that qualify for a deemed credit (ignoring the application of the tracking account).

The dividend is then split into two separate dividends: one that qualifies for deemed credits and another one that can have credits attached for the actual tax paid.

The items to be recorded in the tracking account are:

Tracking Account	
Debit	*Credit*
– dividends paid on or after the effective date and before the start of the accounting year, which have given rise to a deemed credit (ignoring the application of the tracking account). – dividends paid by the company on or after the effective date and before the end of the accounting year to another company for which taxpayer maintains a tracking account, and the dividend is credited to that other tracking account.	The following payments received on or after the effective date and before the end of the accounting year, except payments made by a New Zealand company, or payments that would have been eligible for a deemed credit had they been paid directly to the New Zealand company: – any standard dividend in respect of which the grey list company is not liable for tax.[25] – any other dividend on which the grey list company is not liable for tax.[26] – equity distributions by a relevant associate to the extent that the relevant associate has retained earnings at the time of the contribution. – loans advanced to the company by a relevant associate to the extent that the relevant associate has retained earnings at the time of the advance. This does not apply where the taxpayer *anticipates* that the loan will be repaid within five years. – non-dividend payments to the company by a relevant associate, which are not taxable to the company but which have been taxable were the company resident in New Zealand. – in cases where the taxpayer decides to elect the eligible accounting year from which to maintain a tracking account, the amount of the grey list company's retained earnings at the end of the accounting year immediately preceding the elected eligible accounting year.

The term *retained earnings* is defined as the aggregate, at the time the relevant payment is made, of the shareholders' funds determined in accordance with GAAP, after deducting:

- paid up share capital; and
- the balance of any share premium account; and
- any amounts subscribed before that time for shares in a relevant associate where those amounts have been credited to the tracking account of that relevant associate; and
- any principal balance outstanding on a loan made to a relevant associate company, where that loan has been credited to that associate's tracking account; and
- any amount (which has not been deducted under the above heads) paid by the company prior to that time, which has been credited to another company's tracking account in accordance with the treatment of non-dividend payments in the ledger above.[27]

Clearly, the credits in the tracking account are aimed at blocking methods by which funds from non-grey list companies can be routed to New Zealand via a grey list country so as to take advantage of the deemed credit.

Example 7

Assume that a New Zealand company has an Australian subsidiary which in turn has a subsidiary in Hong Kong. In the first year of their operations, the foreign companies earn profits of $ 500 and $ 150, respectively, and pay taxes of $ 165 and $ 30. The Hong Kong company pays a dividend of $ 50 to its Australian parent (which is not taxed in Australia), which in turn pays a dividend of $ 200 to the New Zealand company.

Since the dividend received by the Australian company is not taxed in Australia, it will give rise to a credit in the tracking account of the Australian company. Therefore, deemed credits can only be attached to the dividend paid by the Australian company to the extent that this dividend exceeds the credit balance ($ 50) in the tracking account. Using the formula above, the actual portion of the dividend which may not receive deemed credits is:

Ineligible portion = dividend paid x $^{a}/_{b}$

= 200 x $^{50}/_{200}$

= $ 50

24. The legislation does not specify whether the dividend to be used in this calculation is to be gross or net. Conceptually, the gross dividend should be used.

25. Standard dividends comprise cash dividends, loans to shareholders that have been forgiven, distribution of property to shareholders for inadequate consideration, taxable bonus issues, returns or reductions of share capital and the income that a unit trust distributes to trust holders.

26. This does not include standard dividends, attributed repatriations or dividends deemed to arise because of the difference between the specified rate of interest for fringe benefit tax purposes and the actual rate of interest on a loan from a relevant associate. A *relevant associate* is defined as a company which either is resident in New Zealand or is a CFC, and which is associated with both the taxpayer company and the grey list company.

27. This does not include bonus issues or reinvestment of distributions made by the company, except to the extent that such amounts were:

- applicable payments made after the *effective date* to another company for which the taxpayers maintains a tracking account; or
- dividends to which FDWP applies; or
- taxable in the shareholders' hands.

© 1994 International Bureau of Fiscal Documentation

The New Zealand company is regarded as receiving two separate dividends: one of $ 150 which is eligible for deemed credits, and one of $ 50 which is eligible for credits on the basis of actual tax paid.

The UFTC on the $ 150 dividend is:

$$\begin{aligned} UFTC &= a \times (b/1-b) \\ &= 150 \times (.33/1-.33) \\ &= \$\ 73.88 \end{aligned}$$

With respect to the $ 50 dividend, it must first be determined how much of the income tax paid by the Hong Kong subsidiary can be attributed to the Australian company. This amount is the lesser of:

$$\begin{aligned} UFTC_1 &= \text{(dividend received + foreign withholding tax) x (foreign tax/foreign after-tax earnings)} \\ &= (50 + 0) \times (30/120) \\ &= \$\ 12.50 \end{aligned}$$

or

$$\begin{aligned} UFTC_2 &= ([a + b + c] \times d) - c \\ &= ([50 + 12.50 + 0] \times 33\%) - 0 \\ &= \$\ 20.63 \end{aligned}$$

Therefore, the UFTC attributable to the Australian company is $ 12.50.

To calculate the credit attributable to the $ 50 dividend:

$$UFTC = a \times \frac{b + c - d - e}{f - g - h}$$

$$= 50 \times \frac{165 + 12.50 - 0 - 73.88}{385 - 0 - 150}$$

$$= \$\ 22.05$$

Therefore, the FDWP liability of the New Zealand company is:

$$\begin{aligned} FDWP &= ([a + b = c] \times d) - b - c \\ &= ([(150 + 50) + 0 + (73.88 + 22.05)] \times 33\%) - 0 - (73.88 + 22.05) \\ &= \$\ 1.73 \end{aligned}$$

This result clearly demonstrates that the UFTC formula is flawed. With tax having been paid in Australia at a rate equal to that applicable in New Zealand, the only FDWP that should be payable relates to a lower rate of tax that was paid in Hong Kong. The New Zealand tax on the $ 150 derived in Hong Kong is $ 49.50, with a credit being given for tax already paid ($ 30), leaving a balance of $ 19.50. If this $ 19.50 is prorated over the $ 120 distributable earnings of the Hong Kong subsidiary, the tax attributable to the $ 50 dividend is $ 8.13, not $ 1.73.

The reason why the UFTC formula fails to produce the correct result can be seen from our manipulated version of the formula. Tax is allocated by the ratio dividends/retained earnings. This is appropriate where only the tax of a particular subsidiary is involved; however, where the subsidiary is deemed to have paid the tax of lower tier subsidiaries, that tax too is allocated in the proportion of dividends/retained earnings of the first tier subsidiary. Clearly, the proportionate allocation of lower tier company tax has already been made by the formula that determines how much tax is to be attributed to higher tier companies.

Moreover, the UFTC formula also combines the tax and earnings of lower tier companies with those of higher tier companies, thus averaging the tax rates across different companies. Accordingly, lower rates of tax applicable to non-grey list lower companies are inflated by the higher tax rates applicable to higher tier companies resident in grey list countries.

If the above calculations are performed on the basis that both the Australian and Hong Kong companies distribute all of their retained earnings, the dividends/retained earnings ratio of the Australian company is one. Further, there are no residual Australian earnings to inflate the Hong Kong tax rate because the entire part of the dividend sourced directly from Australian earnings (i.e. $ 335) qualifies for deemed credits, and is thus deducted in the denominator of the UFTC formula. Not surprisingly, the correct FDWP of $ 19.50 is produced.

A solution to both of these problems is for dividends sourced from lower tier companies to have UFTCs allocated to them in accordance with the formula currently used to determine how much lower tier company tax to attribute to higher tier companies. This equates the UFTC on such dividends to the actual amount of tax paid by lower tier companies (or the applicable New Zealand tax if that is lower). Referring to Example 7, the UFTC on the $ 50 dividend would then be $ 12.50, giving a correct FDWP liability of $ 8.13.

In addition to these problems with the UFTC formula, there are several contentious issues surrounding the tracking account. Firstly, the date from which the tracking account must be maintained appears to allow non-grey list income to qualify for a deemed credit in certain circumstances. Where the taxpayer pays dividends out of income earned before 28 October 1992, this becomes the *effective date*, and thus the taxpayer is required to maintain a tracking account from the date. Having done so, and provided the other requirements for paying deemed credits are satisfied, earnings derived in non-grey list companies prior to 28 October 1992 will be able to be passed through grey list companies and qualify for deemed credits because there will be no credit balance in the tracking account.[28]

Secondly, the tracking account balance that is required to be applied to dividends from grey list companies is that on the last day of the accounting year in which the dividend is paid.[29] Similarly, item *b* in the tracking account formula is the total of all dividends paid during the year which are eligible for deemed credits. If the dividend is paid before the end of the year, taxpayers clearly will not know the balance in the tracking account at the end of the year, nor the total amount of dividends that will be paid during the year by the grey list company. Consequently, there will be considerable uncertainty as to what UFTC to claim, especially in the case of dividends paid earlier in the account year (e.g. interim dividends). Where the taxpayer incorrectly estimates the amount of the UFTC, the remedies discussed under *Procedural*

28. This assumes that no credits have arisen in the tracking account subsequent to 28 October 1992.
29. See. Sec. 394ZME(2).

© 1994 International Bureau of Fiscal Documentation

Issues apply. Nevertheless, this state of affairs is hardly conducive to legislative charity, certainty and simplicity.

There appears to be no limit on the amount of debits to the tracking account. Although the legislation is unclear on this point, it seems to require that all dividends from grey list companies be debited to the tracking account. Therefore, if a grey list company pays a dividend in excess of the credit balance in the tracking account, the account will move into a debit balance in the subsequent year. In that year, the grey list company would be able to attach deemed credits to dividends paid from non-grey list earnings to the extent of the debit balance in the tracking account. The Government would not have intended such a consequence.

Unlike the specifications for the acceptability of financial statements that provide the earnings figures to calculate the UFTC, the definition of *retained earnings* for the purposes of the tracking account does not specify which territory's GAAP to adopt. Is it the GAAP in New Zealand, or the country of residence of the grey list company to which the payments are made, or the country of residence of the relevant associate company? If the GAAP of the relevant associate's country are to be used, what happens when that country does not have GAAP?

The exemption for crediting loans received from relevant associates where it is anticipated that the loan will be repaid within five years also creates problems. The legislation is silent about what will happen if a taxpayer excludes the loan on the basis that repayment is anticipated to occur within five years, but subsequently the repayment does not eventuate. There is no indication whether the FDWP assessment to be altered is the one in the year in which the loan was advanced, or the one in the year in which it becomes clear that the loan will not be repaid within five years.

Intuitively, one would expect that the alteration would be made in the year in which the loan was advanced. The complication with this is that there is a "statutory bar" that prevents the Commissioner from making any amendments to assessments for FDWP after the expiration of four years from the later of the date when the information required by the Commissioner was provided and the last date for the filing of such information. This bar will not apply when, in the Commissioner's opinion, the details provided by the taxpayer are fraudulent or wilfully misleading. Since in most cases the fact that a loan is not repaid within five years will not be discovered until the end of the fifth year, the Commissioner may be prevented from retrospectively assessing the taxpayer for additional FDWP.

The New Zealand Treasury and Inland Revenue Department do not seem to consider the anticipation of a loan repayment to be a problem. They claim that, because the companies involved generally are related it is very likely that it will be known whether repayment will take place within five years.[30] This view seems to place great reliance on New Zealand taxpayers' metaphysical interpretations of anticipation.

Finally, the tracking account clearly leads to significant compliance costs, which may in fact defeat the compliance minimization objectives behind the deemed credit. In some (if not many) cases, it is just as easy for companies to do away with the tracking account and make a claim for the actual tax paid. Similarly, New Zealand companies with a non-controlling interest in a grey list company may have difficulty in acquiring the necessary information to maintain the tracking account. Although it recognizes the potential difficulties, the Government believes that if the deemed credit mechanism was restricted to CFCs, there would be non-CFC taxpayers who could obtain the required information. These taxpayers then would be penalized. The Government considers that while some taxpayers may not be able to get the necessary information to maintain a tracking account, they can claim credits for the actual underlying taxes paid. However, this view ignores the fact that some taxpayers do also have difficulty in obtaining the information required for the calculation of the UFTC using *actual* taxes. It is not surprising then that some companies are ignoring the UFTC regime because the compliance costs do not justify the benefits.

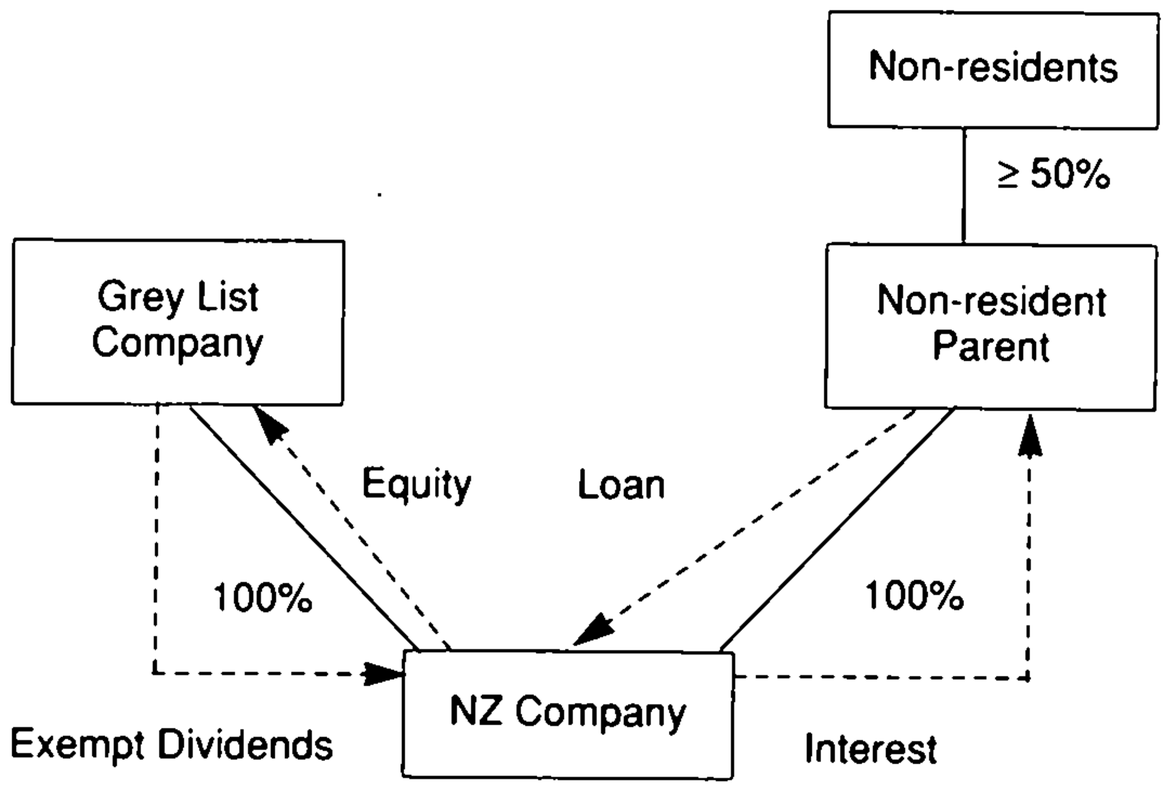
I. Conduit financing arrangements

The Government has enacted measures to prevent offshore companies using New Zealand as a conduit for investments into grey list countries. When a New Zealand company derives dividends which qualify for deemed credits, and that company makes interest payments to another company which is associated with both the New Zealand company and the grey list company paying the dividend, the New Zealand company is denied a deduction for the interest to the extent of the dividend received.

This anti-avoidance provision appears to be targeting situations where a foreign company establishes a New Zealand subsidiary, financed in most part by debt. The New Zealand company would then establish a subsidiary in a grey list country, which performs business on behalf of the ultimate owners. Utilizing the UFTC regime, the income derived by the grey list company could be remitted to New Zealand free of FDWP and income tax, and then it could be passed on to the parent by way of interest. The purpose of such an arrangement is to generate tax losses in New Zealand, which could be offset against other assessable income derived from New Zealand, or diverted to New Zealand, or through cross-border loss offsets if permitted by the foreign company's country of residence. This arrangement can be illustrated diagrammatically:

30. NZ Treasury/Inland Revenue Departmental Briefing Paper to the Finance and Expenditure Select Committee on the Taxation Reform Bill (No. 7) 1993, at 55.

© 1994 International Bureau of Fiscal Documentation



However, the objective of this provision does not appear to have been achieved. This is because the anti-avoidance provision does not apply where the grey list company is a CFC.[31] If the reason for this exemption is that where the grey list company is a CFC, its income will be taxed on an accruals basis (so that the income of the foreign subsidiary offsets the payment of interest by the New Zealand company to the parent company), it is not correct. In the type of arrangement described above, the grey list company will always be a CFC if it is under the control of five or fewer New Zealand residents.[32] Moreover, the income of the grey list subsidiary is not taxed in New Zealand because, according to Section 245P of the Act, there is no attributed foreign income in respect to CFCs resident in grey list countries.

When the UFTC was first announced it was stated that some form of interest apportionment would be required when determining the extent of the credit. Specifically, the (then) Minister of Finance said that "while the availability of foreign tax credits has been expanded, the determination of the quantum of the foreign tax credit has been made more accurate by requiring that some interest expense incurred by the New Zealand taxpayer must be apportioned to the foreign source income for the purpose – and only for the purpose of – of determining the amount of the foreign tax credit the taxpayer may claim".[33] However, the anti-avoidance measure that has been enacted in relation to interest deductions addresses quite a different issue. The Government has announced that it will establish a consultative committee to review the UFTC regime. This committee may examine the feasibility of an interest allocation mechanism.

IV. PROCEDURAL ISSUES

No credits will be granted unless the taxpayer furnishes all information specified by the Commissioner necessary to verify the calculation of the UFTC. This may include details of all the calculations in respect of the UFTC and, where applicable, details of the relevant tracking account. Furthermore, where the UFTC is based on the actual tax paid, the foreign company will be treated as having paid no tax in a given year unless the taxpayer is able to provide the Commissioner with proof of the tax that has been paid.

Because FDWP is payable on a quarterly basis, payment will often have to be made at a time when the taxpayer cannot be certain about the amount of the UFTC that will be claimable, because either the tax paid and/or the after-tax earnings of the subsidiary will not be known. In these circumstances, the taxpayer is required to make a "reasonable estimate" of the FDWP that will be payable. If this estimate is too low, a catch-up payment must be made, as well as a payment for "use of money interest".[34] Similarly, where the estimate of FDWP is too high, the excess FDWP is refundable, and the Commissioner becomes liable to pay the taxpayer use of money interest.

Further uncertainty arises when a subsidiary has a dispute with its local revenue authority, which results in legal proceedings. Alternatively, the local revenue authority may alter a previous income tax assessment of an overseas subsidiary. Such situations could prevent the smooth operation of the UFTC regime. Consequently, there is a bar on the Commissioner assessing a company for FDWP or additional tax to the extent that such assessments arise only because the Commissioner disputes details provided by the company. As previously stated, this bar applies from four years after the later of the date the details were provided, and the last date specified by the Commissioner for filing the details.

V. CONCLUSION

This article has reviewed the 1993 amendments to the Act, which introduced the concept of UFTCs into New Zealand's tax law. The objective of the UFTC is to reduce or eliminate a company's FDWP liability. FDWP has influenced corporate profit repatriation decisions and extinguished New Zealand tax preferences available to New Zealand resident corporate shareholders of foreign companies.

This paper has demonstrated that there are significant legislative shortcomings in achieving the objectives behind the introduction of the UFTC regime. It is, for example, far from clear what is meant by an eligible accounting year, materiality in financial statements and whether the tracking account in fact operates as intended. The legislation is also complicated, sometimes giving absurd results.

Furthermore, the compliance costs associated with maintaining a tracking account and the potential difficulty in obtaining, for the purpose of calculating UFTCs, the requisite information from lower tier companies and companies in which the New Zealand resident does not have a controlling interest may make it preferable to simply pay the FDWP. This is especially so if the New Zealand company anticipates dis-

31. See Sec. 394ZMH(1)(f).
32. See. Sec. 245C.
33. "Business Holds Judgement on International Tax Changes", *National Business Review* (4 December 1992), at 7.
34. Both the additional FDWP and the use of money interest must be paid within one year of 20 April immediately following the end of the accounting year of the company paying the dividend.

© 1994 International Bureau of Fiscal Documentation

tributing the dividend received to its shareholders. Additional high compliance costs are contrary to the Government's stated intention of identifying ways in which such costs can be reduced for taxpayers.

Application of the deemed UFTC means that no FDWP would be payable in respect of most dividends flowing from grey list companies. It has been estimated that 85 percent of dividends remitted to New Zealand are derived from grey list countries.

The complex legislation concerning the calculation of UFTCs and the tracking account is designed to thwart tax avoidance arrangements which route dividends from non-grey list companies to New Zealand via grey list companies. But are the (perceived or real) avoidance problems of such significance to warrant the difficult and confusing legislation now enacted? If dividends that are the subject of avoidance arrangements comprise only a small proportion of the 85 percent derived from grey list countries, the mere repeal of the FDWP provisions would have achieved essentially the same result in a simplified way, with little cost in terms of revenue forgone.

Repeal of the FDWP makes even more sense if most subsidiaries falling within the UFTC regime are CFCs. Other than those resident in grey list companies, these subsidiaries are taxed in New Zealand on an accruals basis using New Zealand tax law.

Any tax so paid can be credited to a branch equivalent tax account, and offset against any FDWP liability. Therefore, in many cases, there is no FDWP to pay, regardless of the new UFTC regime.

TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

- **Looseleaf in 10 volumes**
- **Updated 12 times a year**
- **38 countries covered**
- **Includes treaties**

Forms of doing business
Exchange control
Investment laws
Taxation of companies including special entities and businesses
Property and wealth taxes
Registration and licence (stamp) duties
Taxes on goods and services
Payroll taxes
Anti-avoidance provisions
Tax rates
Establishment and expansion of business, liquidation, amalgamation and mergers
Investment income
Group taxation
Tax-related incentives for investment
Tax treaties (full texts in English)
Bibliography

NLG 2,800, including basic volumes, binders, updates for 1994, postage by air and packing.
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD PUBLICATIONS BV
P.O. Box 20237 • 1000 HE AMSTERDAM • THE NETHERLANDS
Tel. +31 (0)20 626 7726 • Fax +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

POLAND

VAT IN POLAND – IMPLICATIONS FOR THE FOREIGN INVESTOR

Matthew O'Shaughnessy and Piotr Kowalski

Mr O'Shaughnessy is a graduate of the University of Warwick. He worked for two years in the treasury department of Eurotunnel in London, and subsequently for two years in the tax department of British Steel. In 1992 he joined Price Waterhouse in Warsaw as a consultant in the tax department.

Mr Kowalski is a graduate of the University of Warsaw. He was a research fellow at the London School of Economics and assistant professor of international law at the Polish Academy of Sciences. He holds a doctorate in international law. He joined Price Waterhouse Warsaw in 1992 as a manager in the tax department.

The authors gratefully acknowledge the assistance of Marek Jaroszewski and Krzysztof Dzuba.

From 5 July 1993 a major change has taken place in the Polish indirect taxation system. As part of Poland's tax reform process, from this date value added tax, known as the "Goods and Services Tax", replaced the turnover tax system. The system is broadly similar to systems in force in West European countries. However, there are some notable Polish peculiarities which are especially important in respect of international transactions. We have given special emphasis in this article to cross-border leasing as this activity, significant in view of the current state of the Polish capital markets, and the demands of a recovering economy, seems to be especially affected by the introduction of VAT in Poland.

I. GENERAL PRINCIPLES

A. Rate of tax

The basic rate of VAT is 22 percent and a reduced rate of 7 percent applies to certain goods and services. As in other countries, agriculture, heating (energy), transport, telecommunications and most tourist services are all subject to the reduced rate. Also products such as printed matter, children's goods, certain foodstuffs and farming items are subject to the 7 percent rate. A zero percent rate applies generally to exports of goods and services. However, a zero percent rate can also apply to the domestic sale of certain goods (books, pharmaceuticals) or even to the import of certain items (prescription drugs, certain government supplies). Some goods and services are also free from VAT for various social, political or technical reasons. Unprocessed foodstuffs are generally free from VAT.

In addition, certain types of transactions are specifically excluded from the scope of VAT. Excluded from VAT, for example, is the sale of an enterprise or its independent part. Not covered by the law and, therefore, not subject to VAT are sales of land without buildings and income from gambling.

B. Scope

The tax is levied on legal persons, individuals or other organizations which are resident in Poland and make taxable supplies. Foreign legal or natural persons who perform taxable activities in Poland (personally or through an authorized person or through an employee of a permanent establishment or a fixed place of production, trade or services or of any other device used for production, trade or service purposes) are also required to register for VAT.

Smaller taxpayers are exempted from the tax. As of 1 January 1994, any business entity exceeding 1,200 million zloty (approximately US$ 56,000) in turnover in the previous tax year will become liable to VAT.

C. Mechanism of taxation

The general principles allow taxpayers to deduct input VAT from output VAT but no refund of VAT is available. If the amount of VAT incurred by an entity (input VAT) is higher than the amount of VAT charged on sales by that entity (output VAT), the entity may carry forward the excess of input VAT to the following month and deduct this amount from VAT payable in that month.

Subject to certain exceptions, VAT can be refunded by the tax office only if a taxpayer's sales are subject to a lower rate of tax, i.e. either 7 percent or zero percent. In this case the refund is limited to the amount of the excess of 22 percent input tax paid in direct connection with sales of reduced rate items.

The other special instance when a refund is available is where VAT is paid on purchases of assets which are classified by the taxpayer as fixed assets and intangible assets subject to depreciation. The refund mechanism is straightforward and allows the taxpayer to recover the surplus of input VAT paid in purchasing the asset that could otherwise not be recoverable, using the general offset mechanism.

The amount of the difference which cannot be refunded on all other items is treated as input tax on "operating expenses" and is carried forward to the next month. The amounts of excess VAT can be carried forward but for no longer than 36 months.

© 1994 International Bureau of Fiscal Documentation

Currently taxpayers must calculate, file a reconciliation and pay VAT each month by the 25th day of the month following. However, after 5 July 1994 this deadline will be shortened to the 15th day of the following month. Taxpayers are required to register for VAT purposes before starting taxable activities.

Because no group structure is recognized for tax purposes in Poland the law provides unusually that, on permission from the tax office, divisions, plants or branches of a legal entity which prepare their own individual balance sheets may be taxpayers in their own right for VAT purposes. In these circumstances, transfers between divisions are treated as taxable sales.

D. Tax base

VAT is chargeable on the value of the consideration paid for the product or service (exclusive of VAT). If excise duty is levied (for example, on cigarettes and alcohol), it is included in the tax base. The tax base for imported goods is the dutiable value plus the customs duty and excise duty payable.

VAT must be calculated on transfers of goods or services for promotional purposes made free or at reduced rates, using the normal market price of these items. The personal use by an entrepreneur or his employees of company goods or services, the presentation of gifts and donations and the cash-free exchange of goods and services are all subject to VAT on the basis of appropriate market values.

E. Registration of foreign entities for VAT in Poland

Although the regulations clearly provide that foreign entities that undertake VATable activities in Poland are obliged to register for VAT purposes, the current policy adopted by the tax authorities is such that the registration of foreign companies for VAT is in practice sometimes restricted. We know of cases where the tax office has refused to register foreign companies and required that additional documentation be presented evidencing formal registration in Poland as a legal entity or branch office. The reason for this approach seems to be a certain misunderstanding on the side of the Polish tax authorities who imply that to register for VAT a foreign company must have some local (Polish) business vehicle. This policy seems to contradict the provisions of the VAT law which clearly allow a foreign company to register even if it does not have any formal presence in Poland.

II. PECULIARITIES OF THE POLISH VAT SYSTEM

A. Import of services

Services performed in Poland by foreign persons (personally or through an authorized person or employees or through a permanent establishment or a fixed place of production, trade or services) and payable abroad are regarded as "import of services" and as such are subject to Polish VAT. If the foreign person does not register for Polish VAT and does not collect VAT on the above- mentioned services, the tax obligation passes to the recipient of the service in the form of a self-charge. VAT paid by a Polish taxpayer on the basis of a self-charge is treated as output tax. In this case the taxpayer has no right to recover the self-charged tax as it is not input VAT.

The classification of "import of services" for VAT purposes clearly states that the services must be performed physically *in Poland*. This means that if a foreign person charges a Polish company for services performed outside Poland, such a transaction is not treated as an "import of services" and is free of Polish VAT.

Where a Polish company has the choice of buying either from a foreign entity which is not registered for Polish VAT or from a registered Polish entity, for tax purposes the company would be advised to buy from the domestic entity since 22 percent non-recoverable VAT would need to be added were the purchase to be made from the foreign party.

B. Export of services

The VAT law defines the export of services as services performed by a taxpayer outside Poland. This can be disadvantageous for many Polish service companies who sell to foreign customers since, in certain cases, even services "consumed" abroad are treated as if they were services performed in Poland. This restrictive approach creates an economically disadvantageous position for Polish software, architectural or consulting companies which have to charge VAT at the full rate to their foreign customers. Such a VAT charge is, in general, non-recoverable. To benefit from the zero percent rate applicable to exports, the Polish service company would need to physically perform work outside the country.

There are certain exceptions to this restrictive rule relating to services which are provided in direct connection with the export of goods. Contract manufacturing services provided by Polish companies to foreign registered entities are treated as export services. Such services are taxed at the same zero percent rate as the export of goods. In the case of export agency services the cost for such services must be incorporated in the selling price of the exported goods. A similar principle applies to transport services, warehousing and administrative services which directly support the export of goods.

In view of the detrimental effect on the export of services of the above regulation, the government recently decided to change the ministerial decree regulating the rates of VAT. According to these changes, with effect from 1 January 1994, certain consulting legal and planning services have been zero rated in cases where the buyer is a foreign domiciled company and not a Polish VAT taxpayer. In addition, to benefit from the zero rate, the services must be paid for in foreign currency and such payment must be evidenced by appropriate documents from the Polish foreign exchange bank. It remains to

© 1994 International Bureau of Fiscal Documentation

be seen how the seller of services may apply the zero rate if he cannot be certain, at the moment of issuing the VAT invoice, whether he will be paid in hard currency or, indeed whether he will be paid at all.

Legislation regarding the place of supply of services has not been brought fully into line with the EC 6th VAT Directive. Article 9.2(e) of this directive states that, in the case of, among others, advertising and consultancy services, when services are performed for customers established outside the Community or for taxable persons established in the Community but not in the same country as the supplier, the place of taxation shall be that in which the customer has established his business or has a fixed establishment to which the service is supplied. In the absence of such a place, the place where he has his permanent address or usually resides.

Poland has now signed an Association Agreement with the EC. In doing so Poland is obliged to bring its law into line with EC legislation. It may be expected, therefore, that the definition of the place of supply of services will be amended in accordance with the EC 6th Directive.

C. The effect of VAT on cross-border leasing transactions

Due to the situation on the Polish capital market and the high cost of local credit facilities, various leasing arrangements have become quite popular in Poland in the last two years. A substantial part of these leasing transactions take the form of a cross-border lease where a foreign investor (producer) supplies a local company with capital assets while retaining title to the goods. The introduction of VAT has effected, in many instances, the economic or tax feasibility of leasing.

(1) VAT on the import of leased goods
VAT on the import of leased goods is in most cases payable regardless of whether the goods are imported temporarily or not. The basis for calculation of VAT payable on the import of leased goods includes:

- only the customs value of the goods, if they are imported temporarily, or
- the customs value of the goods plus customs duty payable, if the goods are to remain in Poland.

In the case of a cross-border operating lease the law is not clear whether the VAT incurred on the import of an asset is deductible according to the standard procedures. This results from the wording of the VAT law which speaks of the "acquisition" of goods or services as a base for the recovery of VAT incurred. However, we note from practical experience that importers have treated this amount of VAT as recoverable. The fiscal authorities have finally decided to clarify this point and from 1 January 1994 VAT incurred at the moment of import is recoverable according to the standard procedure. It is, however, still uncertain how imports of equipment effected before 1 January 1994 should be treated since the VAT law, in its previous form, seemed to preclude the deductibility of VAT on the import of assets not "acquired" by the importer.

In the case of financial leasing the amount of VAT levied on imported leased goods shown in the customs clearance documents will be treated as input VAT for the importer. As under the VAT regulations, the tax treatment of financial leases is similar to the *purchase* of goods (acquisition of title to them), input VAT charged on the import may be refundable to the lessee according to the rules applicable to the purchase of fixed assets. That is, a refund is given by the tax office if the amount of input VAT in part attributable to the purchase of a fixed asset exceeds output VAT in a given month.

(2) VAT on cross-border lease payments – operating leases
Lease contracts concluded between a foreign lessor and a Polish lessee usually imply two types of transactions that are subject to VAT, namely:

- import of leased goods into Poland, and
- import of leasing services.

The import of services rule requires that Polish entities that import services payable abroad, in this case Polish lessees, must charge VAT on the consideration payable in return for the imported service. Consequently, where a Polish lessee leases property from a foreign entity (that is, imports a VATable service), the lessee will be obliged to calculate 22 percent VAT on the consideration payable to the lessor (that is, on lease payments) and to account for this amount as his output VAT. This is in keeping with the import of services rule which we described in the previous section of this article. According to this rule, the entire amount of lease rental payable under an operating lease, as a service charge, is subject to VAT. In this case, a certain proportion of the payment stream resulting from this transaction will be subject to double taxation at the moment of asset import and subsequent rentals. Paradoxically, VAT charged will firstly be an input VAT (import) and then output VAT (import of the service).

This disadvantageous VAT treatment will not arise if a foreign lessor registers for VAT in Poland and becomes entitled to issue a VAT invoice to the lessee. This enables the Polish lessee to treat VAT shown in the invoice as standard input VAT and to recover this against his output VAT.

The law states explicitly that the import of services is subject to VAT and we maintain that international lease transactions concluded between Polish lessees and foreign lessors involve the import of a service from abroad. However, existing regulations do not make any specific provisions related to VAT on lease payments. In other words, regardless of the fact that lease payments payable to a foreign lessor are unquestionably subject to VAT, there is no distinct mechanism (other than applicable to the general import of services) of charging VAT on such payments. Therefore, in the case of operating leases the same transaction is effectively double taxed.

(3) VAT treatment of financial leases
The Polish fiscal authorities apparently consider that VAT should be collected only at the border during customs clearance. The taxable base would be the entire value of leased goods increased by the value of any interest and profit element payable under lease rates. The above interpretation predicates that in the case of financial lease transactions no

© 1994 International Bureau of Fiscal Documentation

VAT should be payable on the transfer of lease payments if VAT has been paid on the full value of imported leased goods (that is, including interest and the lessor's profit element) during the customs clearance. This approach results from a general rule found in the VAT legislation under which a financial lease transaction has a similar VAT treatment as a purchase of a fixed asset. The dividing line in taxation between financial and operating leases is based on the accounting status of the leased object. If the lessee accounts for the asset in its books and has a right to depreciate it, a lease is treated for tax purposes as a financial lease.

The above method appears to be a pragmatic solution to the collection of VAT on lease payments and appears to be an advantageous method of payment of VAT from the lessee's point of view (as there is a possibility of a refund of excess VAT paid during the import). In our view, in most cases, the mechanism suggested by the fiscal authorities cannot be adopted in practice.

The reason for this is that under most circumstances there will be no feasible method to calculate in advance the interest element of lease charges. This results from the fact that the lease rates denominated in hard currency (as required by the Polish Foreign Exchange Law) become payable in the future and it is impossible to assess their future value in Polish currency at the date of customs clearance. Furthermore, as in most lease agreements the interest element is settled with reference to international interest rate indexes such as LIBOR and FIBOR. At the date of the customs clearance it is not possible to establish the interest rate that will prejudge the amount of interest payable in the future.

To summarize, we note that if VAT is to be imposed on the full value of the lease contract and collected at the date of customs clearance, the current legislation provides no method of calculating the VAT base.

Furthermore, as under Article 15.4 of the VAT Law "*the taxable base for imported goods is the customs value increased by the customs duties*", there are no legal grounds to impose VAT during the customs clearance on any excess of declared value of imported goods over the said limit, that is, customs value of goods at the date of the clearance.

(4) Possible solutions
In our view, the mechanism for charging VAT on financial lease payments should be based upon the distinction between the principal value of leased property which is taxed at the border, and the value of the financial service that is provided (which is subject to VAT at the time of payment of each lease instalment). Consequently, the amount of the lease rate shown on an invoice issued by a foreign lessor should indicate, or should be divided into, two elements which are to be paid by the lessee, namely:

- principal value of the leased goods, and
- value of the service (interest plus any other fee charged by the lessor).

As the lessee has already paid VAT on the principal value of the leased goods (collected on customs clearance) he will be obliged to calculate 22 percent VAT only on the value of the service. However, the lessee would need to account for this amount of VAT as his output VAT unless a foreign lessor agrees to register for VAT in Poland in order to provide local VAT invoices.

In the case of operating leases VAT might be charged only at the moment of rental payment to the foreign lessor and, consequently, there would be no VAT charge at the moment of importing an asset.

Please note that the above considerations reflect our understanding of very ambiguous provisions of the VAT law and as such cannot be understood as a precise interpretation of the legislation. However, the proposed solutions, in our view, represent the most likely and logical alternative to the current legal provisions.

(5) Recovery of VAT by foreign businesses
Regardless of the Poland EC association treaty, the provisions of the EC 8th and 13th VAT Directives have not yet been incorporated in the Polish VAT regulations. A foreign business can only recover VAT incurred in the course of its business if it is registered for Polish VAT and can effectively use either the general offset mechanism or special refund methods offered by the law. At present, according to the law, a business may only register for VAT if it makes taxable supplies in Poland. We expect that the Polish VAT system will be brought into line with EC legislation over the next few years and procedures for international VAT recovery will be put in place. It remains to be seen how quickly these amendments are introduced.

III. AMENDMENTS AND DEVELOPMENTS

The VAT law as introduced in 5 July 1993 has been reinforced and extended over the past six months by some 30 ministerial decrees and ordinances. From 1 January 1994 new amendments to the law itself were introduced resolving some of the contentious issues that were not addressed or unclear in previous legislation. One of such issues was the question of whether VAT incurred when importing fixed assets in order to make an in-kind contribution by a foreign shareholder to a Polish company's equity is deductible. Initially, the fiscal authorities took a firm view that such VAT may not be recovered according to the standard mechanism but must increase the value of the asset to be subsequently depreciated.

A debate ensued in which the legality of the position of the authorities was questioned by the legal profession and foreign investors. This has resulted in a recent change in the legislation which provides for equal treatment of foreign and domestic shareholders. That is, that VAT incurred on the import of fixed assets as a contribution in-kind may be classified as normal deductible input VAT. We can only hope that the remaining peculiarities will also be subject to alterations in the not too distant future.

© 1994 International Bureau of Fiscal Documentation

BELGIUM

INTRODUCTION OF THE "ECONOMIC REALITY" TEST IN BELGIAN TAX LAW: YEARS OF UNCERTAINTY AHEAD?

Marc Dassesse
Professor, Free University of Brussels (ULB)

Until recently, one of the characteristics of Belgian tax law was the strict adherence placed by the courts on the taxpayer's right to fully utilize imperfections or loopholes in the law in order to arrange his affairs in the most tax efficient way. A Belgian law of 22 July 1993, however, introduced a general "anti-avoidance" provision whereby the tax authorities may recharacterize a transaction for tax purposes if it is established that the transaction was motivated by tax considerations, unless the taxpayer can show that the transaction is (also) justified by legitimate financial or economic reasons.

I. BACKGROUND: THE *"BREPOLS"* AND THE *"VIEUX SAINT MARTIN"* CASES

In the past Belgium occupied a rather unique position in the field of tax avoidance: contrary to the situation, for example, in France, the Netherlands or the United Kingdom the courts (in the absence of any legal provision to the contrary in the tax code) took the view that a transaction, however economically "abnormal", could not be set aside by the tax authorities on the ground that it was (solely) entered into to avoid tax so long as all legal consequences flowing from the legal route chosen were fully accepted by the parties to the transaction.

This principle was established as early as 1961 by the Belgian Supreme Court in the celebrated *Brepols* case.[1] The relevant facts of the case were as follows: an industrial company converted itself into a financial holding company by contributing its industrial activities to a newly incorporated subsidiary. It then extended a very large loan to the (thinly capitalized) subsidiary with the result that all profits of the industrial subsidiary were "eaten up" by the interest payable to the parent company in respect of the loan.

The Brussels Court of Appeal upheld the decision of the tax authorities which had recharacterized the loan for tax purposes as a contribution in capital giving rise to payment of non-deductible dividends (and not tax-deductible interest) by the subsidiary to its parent.

It should be stressed that the tax authorities in this case acknowledged that the loan was not a sham since all legal consequences flowing from the transaction had been accepted by both lender and borrower. However, in the opinion of the tax authorities and the Court of Appeal, the loan could be ignored as *if* it had been a sham because the transaction had been entered into solely for the purpose of reducing the subsidiary's taxable profit. Thus, the taxpayer allegedly committed "a fraud on the tax law" by entering into a transaction devoid of any economic objective for the sole purpose of putting himself outside the reach of the tax law that would have been applicable had he followed a "more normal" course to put funds at the disposal of the subsidiary company.[2]

The Belgian Supreme Court reversed the decision of the Court of Appeal. It affirmed the principle that a transaction may not be treated as a sham, and, a fortiori, does not amount to tax evasion, "when the parties with a view to putting themselves in a more favourable tax position, make use of their right to freely arrange their affairs by entering into contractual arrangements of which they accept all legal consequences and which do not violate the law, *even if the route thus chosen is not the most normal one*".[3]

For the next 30 years, Belgian courts, as a rule, adhered strictly to the principle laid down by the Supreme Court in the *Brepols* case, and the Supreme Court itself reaffirmed this principle on a number of occasions.[4] The *Brepols* doctrine was also reflected in the very legalistic approach (rightly) taken by the Belgian courts when, after reforms introduced in 1980/1981, they started to be confronted with the novel task of dealing with criminal prosecutions for tax fraud.[5]

With hindsight all too foreseeable, a result of this jurisprudence was the development of ever more sophisticated legal constructions (largely) devoid of any economic justification, save that of putting the taxpayer outside the reach of the tax law which would normally have been applicable to the (economic) end result of the transaction if a less legally convoluted route had been followed to reach it.

The extreme point of that evolution was probably reached in 1990 in the *Vieux Saint Martin* case. In this case, the Belgian Supreme Court reinforced the principle affirmed in *Brepols*

1. Supreme Court, 6 June 1961, *Pasicrisie* (hereinafter "*Pas.*"), 1961, I, at 1082.
2. Court of Appeal of Brussels, 25 March 1959, R.F., 1960, at 213 (author's translation).
3. Author's translation.
4. Supreme Court, 19 October 1965, *Pas.* 1966, I, at 231; Supreme Court, 27 February 1987, *Pas.*, 1987, I, at 777; Supreme Court, 29 January 1988, *Pas.*, 1988, I, at 633.
5. Prior to 1980, criminal prosecutions for tax fraud were non-existent in Belgium (save for customs duties). The reason was that criminal prosecutions could only be initiated at the request of the tax authorities, who were of course more eager to reach a revenue-raising settlement than to initiate criminal proceedings against an insolvent taxpayer.

© 1994 International Bureau of Fiscal Documentation

by holding that even if a transaction (or series of transactions) is "*solely* entered into for the purpose of reducing tax"[6] the tax authorities may not set the transaction aside as if it was a sham.

II. LEGISLATIVE REACTION

The tax authorities may recharacterize a transaction which is motivated by tax considerations unless the taxpayer is able to prove that it was "also" entered into for legitimate economic or financial reasons.

As a result of a steadily worsening budgetary situation, the Belgian Government has come under increasing pressure from various quarters to counter the Supreme Court's approach which has been perceived as the main reason for the increasing number of "high-tech" tax-motivated schemes marketed to the public over the last few years.

Initially, the reaction was limited in scope: Parliament voted laws in 1991 and 1992 which substantially increased the number of cases where the tax authorities could set aside certain *specific* transactions occurring under (legally specified) conditions which suggested that they may have been largely tax-motivated, unless the taxpayer could prove that the transactions had another economic or financial purpose.

Along with this limited anti-avoidance provision, Parliament, at the same time, introduced the possibility for the taxpayer, before entering into such a transaction, to seek an "advance ruling" from the Belgian tax authorities that a proposed transaction meets a legitimate financial or economic requirement. If the ruling is favourable, the transaction (if carried out in accordance with the facts disclosed in the ruling application) may not later be set aside by the tax authorities on the ground that the transaction is purely tax motivated. If the ruling is unfavourable, the taxpayer may proceed with the transaction, but if it is later challenged by the tax authorities, the courts will be required to decide whether or not the transaction is purely tax motivated, and hence can be ignored by the tax authorities.

In practice, disclosing a proposed transaction to the tax authorities in order to obtain a ruling carries significant risks in that, if the ruling is unfavourable, the taxpayer is faced with the alternative of abandoning the proposed transaction or proceeding and facing the wellnigh certainty that it will be challenged by the tax authorities (which might not have been the case if no application for a ruling had been made in the first place).

The law of 22 July 1993 has gone much further: under Article 344, paragraph 1 (as amended) of the Belgian Tax Code/1992, the tax authorities may henceforth recharacterize for tax purposes *any* transaction or series of transactions entered into by the taxpayer if the authorities can establish (by presumption or other means of proof) that the transaction has been structured to avoid tax, unless the taxpayer can prove that the transaction was also entered into because of legitimate financial or economic needs.

If the taxpayer wishes to ascertain in advance that a proposed transaction will not be recharacterized by the tax authorities, he may request a ruling. However, recourse to that procedure may well be viewed by the tax authorities as evidence that the taxpayer himself has doubts about the existence of sufficient legitimate economic or financial needs justifying the transaction.

III. LIKELY IMPACT OF THE NEW LAW

The first commentators on the new anti-avoidance provision have been at pains to stress that it is of limited scope because:

(i) it is only applicable to direct taxes, to the exclusion of indirect taxes such as stamp duties, death duties and VAT;

(ii) the burden of proving that a transaction is tax-motivated (and hence within the scope of the new anti-avoidance provision) rests on the tax authorities; and

(iii) it is sufficient for the taxpayer to prove that the transaction, even though tax-motivated, was *also* justified by legitimate economic or financial needs. In other words, to remain outside the scope of the anti-avoidance provision it will suffice to establish that one of the motives for the transaction is a legitimate financial or economic need.[7]

The author must beg to differ with this optimistic assessment:

- as to (i): at the time of writing, the Government has already announced plans to extend the scope of the new anti-avoidance provision to encompass indirect taxes;[8]
- as to (ii): in the recently published administrative commentary on the new anti-avoidance provision, the tax authorities take a minimalist view of its burden of proof, i.e. when two (or more) legal routes are available to reach a given economic objective, and the taxpayer has chosen the most "tax efficient" one without any – apparent – economic justification, it is sufficient for the tax authorities to indicate the other, more "normal" but more tax-onerous legal route which could have been chosen to reach the same economic result in order to trigger application of the new anti-avoidance provision and allow the tax authorities to assess the tax which would have been due had the other legal route been chosen;[9]
- as to (iii): it is true that, in the above-mentioned administrative commentary, the tax authorities acknowledge that it is not necessary (in order to avoid recharacterization of the transaction) to establish that the *sole* motive for the legal route chosen is to meet certain objectives of a financial or economic nature. "It is enough for the taxpayer to prove the existence of an economic objective, even if

6. Supreme Court, 22 March 1990, *Pas.*, 1990, I, at 853; also published in *Journal Droit Fiscal* (1990), at 110 and casenote M.B.
7. See, for example, J.P. Bours, "Les personnes physiques face à la théorie de la réalité économique", Vanham & Vanham conference (Brussels, 30 September 1993); Th. Afschrift and R. Rayet, "La loi du 22 juillet 1993", *Journal des Tribunaux* (1993), at 833.
8. See AFT (1993), at 41/1 referring to the so-called "global plan", announced by the Belgian Government on 17 December 1993.
9. Administrative Circular N° 19/453.895 of 6 December 1993, at para. 22.

© 1994 International Bureau of Fiscal Documentation

there also exists a tax objective".[10] However, the tax authorities go on to stress that "the only motives which are acceptable are financial or economic ones".[11] This comment tends to suggest that the existence of a "financial or economic" motive, as opposed to motives of a strategic, regulatory or political nature, maybe construed narrowly and, conversely aggravate the burden of proof which rests on the taxpayer.

It is therefore likely, in the author's view, that the new provision will be used enthusiastically by the tax authorities in the first few years of its entry into force with the ensuing need for all Belgian taxpayers – including foreign firms operating in Belgium – to observe extreme prudence before embarking on any complex tax scheme until the dust has settled on the new "anti-avoidance" provision.

In the meantime, caution is certainly the watchword.

10. At para. 24. Author's translation.
11. At para. 24. Author's translation.

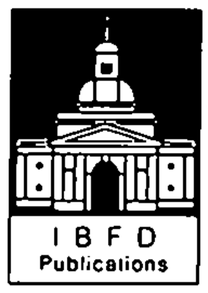
THE TAXATION OF COMPANIES IN EUROPE

A country-by-country survey, systematically examining the taxes applicable at each stage of the life of a company.
Covers the twelve EC countries, Austria, Cyprus, Finland, Norway, Sweden, Switzerland and Turkey.
Each country chapter follows the same outline in order to facilitate country comparisons:

- Basic company and accounting law
- Taxes on the establishment and expansion of a business
- Corporate income taxation: types of taxes, types of company taxpayers and taxable income, including computation of taxable income, anti-avoidance measures, exclusions, deductions, depreciation, incentives and disincentives, valuation, reserves and provisions, capital gains, losses and rates
- Miscellaneous taxes based on income, capital, payroll etc.
- Taxes on transactions and services
- International aspects
- Group taxation
- Mergers, spin-offs and divisions
- Full English texts of EC Directives (including drafts) on corporate and tax law, plus extensive bibliography

Five binders, updated six times a year
NLG 2,700 including binders, 1994 updates, packing and postage by air
Volume II of IBFD's 'Guides to European Taxation'
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV
PO Box 20237, 1000 HE Amsterdam
The Netherlands
Tel: +31 (0)20 626 7726
Fax: +31 (0)20 622 8658



© 1994 International Bureau of Fiscal Documentation

CUBA

TAXATION OF FOREIGN INVESTMENT IN THE REPUBLIC OF CUBA

Annette T. Johnson, LL M (Barrister)

Research Associate of the IBFD, Amsterdam

I. INTRODUCTION

The legal infrastructure for establishing Cuban and foreign equity joint ventures in the Republic of Cuba was created 12 years ago by Decree-Law 50 of 15 February 1982 ("Decree-Law 50-82"). This law is supplemented by the Commercial Code of Cuba[1] and several resolutions issued by the relevant State Central Administrative Bodies. These laws and resolutions effectively created a distinct tax and commercial law regime for the joint venture sector of the Cuban economy. Under the regime, joint ventures are governed by special tax provisions, are permitted access to finance from foreign and domestic banks, to import necessary inputs and export final products independently of the Cuban state and to remit profits in convertible currency. In addition, State entities' commercial transactions with joint ventures are subject to special price controls, the domestic legislation governing leases of immovable property does not apply to joint ventures and foreign nationals employed by joint ventures are permitted to remit up to two-thirds of their salary abroad.

As a result of the negative impact of the collapse of the Soviet bloc on the Cuban economy, the 1990s have seen the enactment of measures to compliment the economic re-orientation, which many would argue, began with the joint venture law. Of these, the most notable are the authorization of a number of State entities to import and export inputs and final products independently of the State, the decriminalization of foreign currency possession by Cuban citizens, the legalization of self-employment by Cuban citizens in over 100 occupations and the reorganization of the state agricultural sector into self-managed, self-financed Basic Cooperative Production Units.[2]

From the viewpoint of foreign investors, the most far-reaching change was the Cuban State's formal recognition of the property rights of joint ventures. The recognition of property rights was enacted by an amendment to the Constitution of the Republic of Cuba in August 1992.[3]

Against that background, this article analyses the provisions of Decree-Law 50-82 since, for foreign investors, it represents the pivotal point of reference not only as regards taxation but also as regards the creation of legal rights to property in Cuba.

II. EQUITY JOINT VENTURES AND PARTNERSHIP CONTRACTS

Decree-Law 50-82 contemplates two types of collaboration between Cuban State enterprises, consortia or other national organizations on one hand, and foreign legal entities or individuals on the other. The first is the equity joint venture ("EJV") which is a separate legal entity, in which the Cuban and foreign parties participate as shareholders. For the purposes of Cuban law, the EJV is regarded as a corporation with registered shares and is subject to the provisions of the Commercial Code. An EJV is considered to be domiciled in Cuba with a Cuban address for its registered office and may establish offices, representative agents, branches and subsidiaries in any other country.[4] The second type of joint venture is the so-called partnership contract which is often used for shared-risk operations and other activities for which an EJV is not necessary nor desired by the partners.[5] A partnership contract does not constitute a separate legal entity from the parties thereto.

Decree-Law 50-82 does not limit the period of existence of EJVs or partnership contracts: it merely states that the duration should be sufficient to enable both parties to earn a return on and recover the capital invested.[6]

1. The Commercial Code of Cuba, a virtual replica of the Spanish Commercial Code of 1885, became effective in Cuba on 28 January 1886. Although the Code has been amended by successive regimes between that date and the present, its basic substance very much resembles those operating in other Latin American countries. See Bundesstelle Für Aussenhandelsinformation, *Kuba Joint Venture-Gesetzgebung* (Köln: Berichte und Dokumente zum ausländischen Wirtschafts-und Steuerrecht, August 1992) 18.
2. The decriminalization of foreign currency possession was enacted by Decree-Law 140 of 13 August 1993. Under this law, Cuban nationals may exchange foreign currency for local currency at preferential rates with designated banks, open foreign currency accounts, purchase foreign exchange certificates or make foreign currency-denominated purchases in authorized establishments, ironically referred to as "dollar shops". The legalization of self-employment in numerous trades and professions was enacted by Decree-Law 141 of 13 August 1993 repealing Decree-Law 14 of 3 July 1978. Decree-Law 141 is supplemented by Joint Resolution 1 of 8 September 1993 of the State Committee for Labour and Social Security, which contains rudimentary provisions for levying income taxes on the self-employed.
3. The Amendment of the Constitution of the Republic of Cuba was published in the *Official Gazette*, Extraordinary Issue No. 7 of 1 August 1992.
4. Decree-Law 50-82, Arts. 6 and 7.
5. Decree-Law 50-82, Art. 1. According to official sources, partnership contracts are the preferred vehicle for petroleum and mineral exploration carried out in collaboration with foreign parties.
6. Decree-Law 50-82, Art. 4.

© 1994 International Bureau of Fiscal Documentation

The matters discussed below apply both to EJVs and, *mutatis mutandis*, to partnerships contracts.[7]

A. Pre-formation approval

The formation of an EJV or conclusion of a partnership contract must be authorized by an ad hoc Commission established by the Executive Committee of the Council of Ministers ("the Commission").[8] In authorizing the participation of the Cuban party, the Commission may further approve its equity contribution to the joint venture in the form of temporary use of land, industrial or tourist installations and other forms of immovable property which already exist or may be constructed in Cuban territory. In such cases, the domestic legislation governing leases will not apply and the EJV lessee will be required to insure the immovable property against fire and natural disasters in favour of the Cuban lessor.[9] As regards the foreign party, the Commission will in most cases require a guarantee (in cash or otherwise) that it will provide its share of the joint venture capital.[10] Cash guarantees are returned on approval with interest at the going rate; should approval not be granted within 60 days of the application, cash guarantees are automatically returned with interest. The Commission will also agree on the amount of the joint enterprise's mandatory contribution to the workers' incentive fund as well as the purpose and operation thereof.[11]

B. Incorporation, registration

An EJV is incorporated by subscribing to a Memorandum and Articles of Association and acquires juridical status on registration of these constituent documents in the Registry of the Cuban Chamber of Commerce. The Memorandum of Association should reflect the basic agreement between the parties as to the development and operation of the venture and should guarantee the participation of the Cuban partner in the management of the company. Additionally, it should contain a statement as to the market which each party is to guarantee in respect of the EJV's product or service.[12] Mechanisms for the resolution of internal disputes may be embodied in the Articles or the Memorandum of Association.

Further contents of the Memorandum of Association include the usual information regarding shareholders, share capital, corporate objects and corporate seat. Of these the most notable are:

- the name of the enterprise which must include the word SA (*sociedad anónima*);
- the registered office of the enterprise which must be in Cuba;
- the name, nationality, citizenship, age, home address of the signatories of the EJVs constituent documents and in some cases the nature and position of the same in respect of the powers which they exercise;
- the authorized capital, indicating the value which has been attributed to corporate assets and the basis of their valuation; and
- in appropriate cases, the names of any subsidiaries or branches in which the EJV has an interest or participation.[13]

The contents of the Articles of Association which govern the internal affairs of the enterprise are not the subject of specific provisions of Decree-Law 50-82. The Articles are usually prepared by the parties themselves (or their advisers) and should address matters such as the structure and power of the board of directors, the appointment and removal of managing officers of the company, voting rights, quorum for meetings, the precipitating events and procedure for liquidation of the EJV. More importantly, the Articles should reflect the agreement between the parties for the computation and distribution of profits between them.

All amendments to the Memorandum and Articles must be registered in the Chamber of Commerce. Once the enterprise has been established, the parties thereto cannot be changed except by the unanimous agreement of all the parties.[14] Any matters not covered in the constituent documents will be governed by the Commercial Code, on a supplementary basis.[15]

A partnership contract is created by registration of the constituent documents in the Registry of the Cuban Chamber of Commerce. These include the relevant details of the parties including the corporate statutes of the foreign party, the methods for profit computation and sharing and any other matters which are relevant to the proposed activities.

Public documents executed under the laws of another country must be protocolled in Cuba and accompanied by a consular certificate verifying their execution in accordance with the

7. Some of the original provisions for the joint venture sector were not specifically applicable to the Cuban parties of partnership contracts but recent legislation has explicitly brought them within the ambit of the special measures for EJVs. For example, Cuban parties no longer have to conform to the accounting methods embodied in the National Accounting Systems Manual but rather to the accounting methods enshrined in the partnership contract (Resolution 24 of 5 May 1983 of the State Committee for Finances, amending Resolution 71 of 26 December 1976).

8. Under the Cuban constitution, considerable executive power, particularly in respect of foreign trade policy and the state budget, is exercised by the Council of Ministers. The composition of the Council of Ministers is constitutionally determined and it is accountable to the elected National Assembly.

9. Decree-Law 50-82, Art. 18. See also Resolution 54-82 of the State Committee for Finances, published in the *Official Gazette*, Extraordinary Issue of 1 October 1982.

10. Decree-Law 50-82, Arts. 2, 3 and 17.

11. Broadly, the workers' incentive fund is a formalized system of bonus payments to workers in recognition of fulfilment of production targets, improvement in efficiency or increases in productivity, especially in labour intensive enterprises. EJVs which employ Cuban workers are required to establish such a fund and the premiums payable are calculated on the basis of the workers' base salary. See further Decree No. 50 of 19 October 1979 of the Council of Ministers.

12. Decree-Law 50-82, Arts. 8 and 10.

13. The modalities of incorporation and registration are governed by Resolution 6 of 15 September 1982 of the Chamber of Commerce of the Republic of Cuba, published in the *Official Gazette*, Extraordinary Issue of 1 October 1982.

14. While Art. 162 of the Commercial Code explicitly permits shareholders to transfer shares, this provision has been implicitly amended by Art. 11 of Decree-Law 50-82 to the extent that the latter provision prohibits any change in the parties to the joint venture parties other than by unanimous agreement of the shareholders.

15. Decree-Law 50-82, Art. 10. Certain modifications, such as a capital reduction, must be effected by deed issued by the EJV's secretary certifying conformity with the procedure established in Art. 168 of the Commercial Code.

© 1994 International Bureau of Fiscal Documentation

laws of the country of origin. In the absence of a consular certificate, public documents may be accompanied by a notarial deed containing a sworn declaration as to their authenticity by the party seeking to use them. Documents executed in a foreign language may only be registered after official translation.[16]

Registration of an EJV is subject to a fee of 500 Cuban pesos; 400 pesos is payable on registration of a partnership contract. All modifications and substitutions of registered documents are subject to a flat fee of 100 Cuban pesos.

C. Joint venture capital and finance

Foreign participation in the capital of an EJV is limited to 49 percent, though in exceptional cases the Executive Committee of the Council of Ministers may authorize greater participation.[17] Contribution to capital may consist of cash and other assets, including the temporary usufruct of land and other immovable property, raw materials and tools. All contributions to capital are quantified in freely convertible currency and on the basis of valuation agreed by the parties.[18]

Joint venture enterprises may secure foreign currency financing from domestic banks or from credit institutions outside of Cuba.[19] Loans from domestic banks are normally granted for periods of up to one year, although in specific cases and in accordance with international practice and the merits of the project, loans may be repaid over a longer period. In all applications, the domestic banks will attempt to ensure that the amount of the loan bears an acceptable ratio to the amount of capital which the joint venture enterprise already possesses. The law is silent on what constitutes an acceptable ratio in this regard.[20] The National Bank of Cuba and other domestic banks are authorized to offer a guarantee in respect of foreign-source loans in circumstances where a guarantee would facilitate access to foreign-source financing. The National Bank or other domestic banks are able to provide credit to joint ventures in order to assist their international sales and in such cases, the norms regarding credit for state enterprises for external business would not apply to joint ventures.

Interest is charged on loans at the going rates for the currency in which the loan is denominated, but in appropriate cases preferential rates may be considered for specific operations.

D. Reserves

Joint venture enterprises are required to create a contingency reserve to which a minimum of 5 percent of the annual profits must be allocated until the reserve is equal to 15 percent of the share capital in the case of manufacturing entities and 20 percent for service entities. The contingency reserve may only be used to cover losses and any amounts used must be replaced by applying 10 percent of the profits obtained in subsequent years.[21]

On the liquidation of an EJV, amounts held in the contingency reserve are distributed to the parties in proportion to their respective shares in the entity after payment of profit tax.[22]

Joint ventures may voluntarily create other reserves.

E. Accounting and audits

The parties to the venture may freely determine the system of accounting which best suits the purpose of the enterprise provided that it conforms to universally accepted standards and meets the requirements of Cuban fiscal law.[23]

EJVs and the Cuban and foreign parties to joint venture enterprises are required to submit financial statements in the Spanish language to the State Committee for Finances (hereinafter "SCF") for each of the first three quarters of every year within the one month of the end of each quarter. In addition, financial statements for operations carried out during the calendar year must be submitted within the first two months of the following year in accordance with the period for the payment of taxes. Financial statements should be in accordance with the form established for this purpose by the Vice President in charge of the SCF's revenue.[24] Apart from its yearly official audit, the SCF may at any time require EJVs to provide financial statements within specified time limits.

III. TAXATION OF JOINT VENTURES

A. Taxpayer registration

All EJVs and parties to partnership contracts are required to register in the Registry of State Taxpayers. Registration applications must be accompanied by a certified copy of the corporate statutes, proof of registration in the Chamber of Commerce and a certificate from the corporate secretary with details of the EJV's directors and their respective duties. Like other taxpayers, EJVs are issued with a taxpayer identity

16. Resolution 6-82, Arts. 15, 16 and 17.
17. Decree-Law 50-82, Art. 15.
18. Decree-Law 50-82, Art. 14.
19. It should be observed that under Art. 11 of Resolution 66 of 15 September 1982 of the National Bank of Cuba, domestic banks are not permitted to issue loans denominated in US currency, nor are parties operating in Cuba permitted to obtain financing denominated in US currency. These provisions mirror US Treasury Department regulations on economic contacts with Cuba and remain in effect for the period of validity of the US provisions.
20. Art. 10 of Resolution 660-82 of the National Bank of Cuba prohibits the National Bank or other domestic banks from providing loans to a foreign party of a joint venture for its contribution to the share capital of the joint venture. This would indicate that the Cuban authorities wish to discourage heavily leveraged or speculative investments.
21. Resolution 23 of 5 May 1983 of the State Committee for Finances (published in the *Official Gazette* of June 22 1983) confirms that the provisions regarding contingency reserves in Resolution 53 of 15 September 1982 of the State Committee for Finances, apply to both the Cuban and foreign parties of partnership contracts.
22. The amounts carried to the contingency reserve and other voluntarily created reserves are tax deductible. See III.C.5.
23. Decree-Law 50-82, Art. 30. The accounting method is usually stated in the Articles of Association, pursuant to the agreement of the parties.
24. Resolution 52-82 of the State Finance Committee, Art. 31. That the Cuban party of partnership contracts or shared risk operations is required to file statements in the form prescribed for EJVs is confirmed by Resolution 24 of 5 May 1983 of the State Committee for Finances and by Proceedings 11 of 5 May 1983 (published in the *Official Gazette* of 4 May 1983).

© 1994 International Bureau of Fiscal Documentation

number which must be quoted in all subsequent correspondence with the tax authorities.[25]

B. Tax legislation

The basic tax legislation of the Republic of Cuba is Law 998 of 10 January 1962 ("Decree-Law 998-62") as amended, *inter alia,* by Law 1213 of 27 June 1967 and specifically regarding joint ventures, by Decree-Law 50-82.

Decree-Law 50-82 creates a special direct tax regime for joint venture enterprises, by exempting them from the taxes levied by Law 998-62 and substituting a tax on annual net profits and a payroll tax on the total amount of wages paid to the joint venture's Cuban staff.[26] The regulations governing profit computation and compliance are contained in a Resolution of the SCF.

As regards indirect taxes, joint ventures remain subject to tariffs and other import duties, fees imposed on documents and motor vehicles used for transportation purposes which are levied under Law 998-62, as amended.

C. Computation of net annual profits

Resolution 52 of 15 September 1982 of the State Committee for Finances ("Resolution 52-82") contains detailed rules for the computation of annual net profits for the purposes of the profits tax. Resolution 52-82 follows the computational notions in existence in most market-oriented economies, with specific rules for the tax treatment of trading expenses, depreciation, research and development expenses and losses.

1. Gross income

Gross income, a defined term, includes all income in cash, in kind or any other form which produces an increase in the taxpayer's wealth, of which it may dispose without a corresponding obligation for restitution.[27]. As is the case in many other civil law territories, no distinction is drawn between trading income and capital gains, so that gains realized on the transfer or sale of assets are considered to be income in the taxable period of sale or transfer. Similarly, any gain accruing to the taxpayer as a result of a revaluation of assets is treated as income, unless the SCF specifically authorizes its exclusion from the tax base.[28]

Where the taxpayer cancels any debts owed to it, the amount of the debt is included in gross income in the taxable period of cancellation. Premiums from bonds or promissory notes are prorated over the period during which they are in circulation. Where a taxpayer reduces or liquidates any voluntary or obligatory reserve, the amount appropriated is included in taxable income for the year during which the reduction or liquidation is effected.

2. Deductions

All necessary expenses which are actually incurred, noted in the enterprise's accounts and which may be proved to have been incurred are deductible from gross income. An expense is necessary when it is appropriate as regards the type of activity being carried on and is within the usual limits for such activities. Dividends and discounts on the sale of the shares of the joint venture itself are not considered deductible expenses.[29] The Resolution contains a large number of specifically deductible items, the most notable of which are summarized below.

Expenses of repairing the taxpayer's fixed assets, including the replacement of spare parts, are specifically deductible unless the repairs are such as to constitute new assets or additions to existing assets.[30] Sums for the rental of installations and other assets are deductible as are the expenses of making improvements to rented property, as prorated over the number of years of the rental contract or the number of remaining years, up to a maximum of five years.[31] Any diminution in income resulting from decreases in production and the deterioration of merchandise and raw materials is deductible as long as this is within the normal limits for that business and can be proved.[32] A deduction is also allowed in respect of bad debts. Expenses for foreign travel undertaken by the managers of the joint venture in order to make arrangements on its behalf are deductible. The expenses of offices maintained by the joint venture are deductible by the joint venture to the extent that these expenses meet the usual criteria for deductibility.[33]

The salaries paid in any form to members of the board of directors or managers, including reimbursement of expenses and representation allowances are deductible from gross income to the extent that in addition to meeting the general requirements, they are agreed by the competent organs of the entity and are actually paid or credited to the recipients in the period to which they correspond.[34] Start-up costs are deductible, prorated over a period of five years. Interest on loans from foreign or domestic banks is deductible.[35] The expenses of issuing or discounting bonds, promissory notes, etc. are deductible, prorated over the period that they remain in circulation.[36]

All taxes paid to the Cuban state with the exception of the profits tax are deductible from gross profits, as are donations and gifts to the Cuban State.[37]

25. While Resolution 23 of the State Committee for Finances (see *supra* note 21) confirms the application of several other provisions to the Cuban parties to partnership contracts, it does not specifically state that the taxpayer registration provisions also apply to the individual parties to partnership contracts. *Quaere* whether for tax purposes, the partnership contract is considered to be fiscally transparent or taxed separately as a conduit for the parties' profits.
26. Law 998-62 levies, *inter alia*, a tax on gross corporate profits and a transfer tax on the transfer of real estate and commercial establishments.
27. Resolution 52-82, Art. 2.
28. Resolution 52-82, Art. 6.
29. Resolution 52-82, Art. 25.
30. Resolution 52-82, Art. 14.
31. Resolution 52-82, Art. 12.
32. Resolution 52-82, Art. 11.
33. Resolution 52-82, Arts. 17-20.
34. Resolution 52-82, Art. 21.
35. Resolution 52-82, Arts. 22 and 23.
36. Resolution 52-82, Art. 24.
37. Resolution 52-82, Art. 28.

© 1994 International Bureau of Fiscal Documentation

3. Depreciation

Taxpayers are granted a deduction for depreciation of tangible assets on a declining balance basis up to a maximum established in Article 13 of Resolution 52-82. Annual rates range from 25 percent for aircraft and agricultural vehicles, 20 percent for automobiles to 3 percent for buildings with a special 25 percent rate for hotels and other structures used in the tourism sector.[38] Land, wells, railways and manual tools are not depreciable although taxpayer may claim a deduction where the former are damaged or physically lost.[39]

All payments for the acquisition of intangible assets (patents, copyright, trade marks and secret process, etc.) are depreciable on a straight line basis, i.e. the amounts expended are deductible, prorating the costs (or the revalued cost if declared as income in the taxable period of revaluation) over the number of years of validity of the agreement.[40] In special cases where the useful life of the patent or trade mark is less than the legally binding useful life, an alternative amortization formula may be adopted with the SCF's authorization.

Research and development expenses are depreciable on a straight line basis, i.e. expenses are deducted by prorating the expenses over a maximum of five years.

4. Losses

Business losses may be carried forward for up to five years *but* must be deducted from taxable income in five equal portions during the five fiscal years immediately after the year in which they are incurred. Losses occasioned by physical damage are deductible in the period in which they occur after deducting any amounts received under an insurance policy. Where the precise amount of the loss and/or indemnity is not known at the end of the tax period, a provisional deduction is permitted, subject to a final adjustment to be determined subsequently.[41]

5. Reserves, reinvestment and contribution to workers' incentive fund

After deducting specific expenses and allowable costs, the following amounts are deducted from the remainder to arrive at taxable profits:

- profits reinvested to increase the capital of the entity;
- all amounts paid into a contingency reserve and such other reserves as have been created including those which are not obligatory by law; and
- profits destined for economic incentives for Cuban workers.[42]

D. Tax rates

The net profits tax is levied on annual net profits at a single flat rate of 30 percent.[43] No withholding taxes are levied on the distribution of dividends or profit shares of parties to partnership contracts other than that levied at the corporate level.

The result of levying no further taxes on distributions is that the complexities of mitigating economic double taxation by imputation or other means, do not arise in the Cuban context. However, at the shareholder level the position may not be wholly advantageous since, barring a claim for double taxation relief in respect of the underlying net profits tax, the dividends will bear the full rate of tax in the country of the shareholder's residence, making a gift of the Cuban taxes *not* withheld to the treasury of the shareholder's country of residence.

The workers' payroll tax is levied at 25 percent of wages paid to Cuban workers. This tax is stated to be inclusive of all social security contributions so that joint ventures have no additional social security liability in respect of their Cuban workers.

Import duties and tariffs are levied at various rates and are based on the Harmonized Commodity Description and Coding System which is recognized by over 150 countries. The taxes on documents and motor vehicles are levied at rates which are set periodically by the Central Planning Board.

Joint ventures may enjoy partial or complete exemption from net profits tax and import duties. No further guidelines have been issued regarding the criteria for qualifying for such exemptions, though Article 28 of Decree-Law 50-82 states that joint enterprises active in areas designated as of great importance to the tourism sector may benefit from a virtually tax-free environment with special labour regulations.[44]

The managers and other officers of joint ventures are exempt from the individual income tax levied by Law 998-62 and their Cuban-source salaries are tax free.

E. Treaties

Cuba is not currently a party to any comprehensive bilateral agreements for the relief of double taxation of income. Although Cuba was a member of the now defunct Council for Mutual Economic Assistance ("CMEA"), the records indicate that it was not a signatory to the CMEA multilateral conventions for the relief of double taxation. However, Cuba has concluded Air Transportation Agreements with the Netherlands and the Netherlands Antilles and these contain provisions for double taxation relief in respect of income and capital gains from air transportation.[45] Cuba has also concluded bilateral trade, investment and cooperation agreements with

38. See Resolution No. 22 of the State Finance Committee of 5 May 1983.
39. Resolution 52-82, Art. 14.
40. Much of Cuba's intellectual property legislation pre-dates the economic and political re-orientation of 1959. The most important is the Law on Industrial Property of 1936, as amended by Law 618 of 1959, which established a system of licences for the use of registered patents. In addition, Cuba is a party to the Paris Convention and the Madrid Agreement (suppression of false or deceptive indicators of source), the Lisbon Agreement (protection of appellations of origin) and the World Intellectual Property Organisation.
41. Resolution 52-82, Art. 26.
42. Resolution 52-82, Art. 29. See *supra* note 11 regarding the workers' incentive fund.
43. Decree-Law 50-82, Art. 26.
44. Decree-Law 50-82, Art. 28
45. The Agreements with the Netherlands and the Netherlands Antilles were signed on 3 February 1993 and 7 October 1993, respectively. Both agreements are provisionally applicable from the date of signature, pending ratification by the contracting states.

© 1994 International Bureau of Fiscal Documentation

numerous countries including Canada, Lithuania, Mexico, the People's Republic of China, the Republic of Namibia, Switzerland and the United Kingdom.

F. Tax compliance

The tax year is the calendar year and net profits tax is payable on a current year basis. EJVs and partnership contracts are required to submit returns in respect of their activities for the first three trimesters of each year, within one month of the end of each trimester. The returns for operations during the entire tax year must be filed in the first two months of the following year and taxes due in respect of that tax year are payable within that period.

The workers' payroll tax is paid by the joint venture to the Cuban party with which the employment of the Cuban workforce has been contracted along with the total amount of monthly salaries and remuneration paid to workers. The Cuban entity has the obligation to pay the tax to the Central government within ten days of receipt.

Joint venture enterprises which fail to make payment of profits or workers' payroll tax within the specified time limits are subject to a penalty equal to 10 percent of the outstanding amount. Joint venture enterprises which are in arrears are also required to register in the Register of Taxpayers in the municipality closest to their place of establishment, submitting copies of their constituent documents and confirmation of their registration in the Chamber of Commerce.

All taxes are payable in convertible currency, even if their amount is denominated in Cuban pesos.[46]

IV. SPECIAL IMPORT/EXPORT REGIME

Article 31 of Decree-Law 50-82 permits joint venture enterprises to import inputs and export final production independently of the Cuban state. Exporters and importers may make use of the consignment and bonded warehouses which have been established in Cuba since 1991.[47]

In order to carry out commercial imports, the joint venture must present the required documents to customs at the port where the goods are to enter Cuba, and these should include the original copy of the customs clearance certificate and the original invoice for the goods. Importers are required to pay the appropriate customs duties on removal of the goods or alternatively, present a certificate of exemption from customs duties from the SCF. Cargoes of dangerous or inflammable goods must be removed from the customs site within 24 hours of clearance and all other goods must be removed within ten days of the determination of applicable tariff and classification. Imports of specified goods such as explosives, arms and certain plants are prohibited.

Special rules apply to imports by post, temporary imports of goods for repairs and re-export, and non-commercial imports of samples, donations or gifts. A special regime governs imports of personal items such as motor vehicles by foreign employees of joint venture entities.

Joint ventures carrying out commercial exports are required to present the original export declaration, a copy of the invoice and waybill at the port or airport through which the export is to be effected. For non-commercial exports, the exporter is required to present authorization and an export permit to the Department of Mercantile Clearance of the General Directorate of Customs.

V. REMITTANCES AND EXCHANGE CONTROL

Foreign parties to joint ventures are provided with a guarantee for the remittance of profits and capital in convertible currency from the Cuban state. In addition, foreign employees of joint venture enterprises are permitted to make hard-currency remittances of up to two-thirds of their employment income and benefits.[48]

The official rate of exchange as determined by the National Bank of Cuba is applied to liabilities of joint venture enterprises such as wages, taxes and other transactions which are denominated in Cuban pesos.[49] The implementing regulations contained in Resolution 229 of 22 July 1989 of the National Bank of Cuba provide that the official rate is one Cuban peso to one US dollar, and for other currencies, the daily cross-rates quoted on the New York Exchange Market as re-published in local daily newspapers. These provisions apply only to transactions by joint ventures as such; foreign nationals who are non-residents or temporary residents remain subject to the general regulations established for domestic transactions.

The salaries of foreign employees are deposited in a current account in their names in the Cuban National Bank or another domestic bank and the permissible amounts are transferred abroad by completing the prescribed forms. The interest and principal on the amount deposited in the National Bank are freely at the disposal of account holders.[50]

Exchange control permission is required by joint ventures and foreign private companies engaged in business in Cuba to open foreign and local currency accounts in the National Bank of Cuba or any other domestic bank. Requests for approval for foreign currency accounts are submitted to the National Bank of Cuba on the prescribed form with proof of incorporation and any other documents required in respect of the applicant. On approval, the National Bank will clearly indicate the transactions which are covered by approval and the payments and deposits to be drawn from and made to the relevant accounts. Foreign currency accounts must be funded by transfers from foreign currency accounts situated abroad, capital contributions by joint venture partners, overseas sales

46. Decree-Law 50-82, Art. 27.
47. The independent import and export regime is governed by Resolution 1 of 15 September 1982 of the General Directorate of Customs. The establishment of bonded warehouses is governed by Resolution 61 of 1991 of the General Directorate of Customs.
48. Decree-Law 50-82, Art. 23. Remittances of foreign employees are governed by Resolution 659 of 15 September 1982 of the National Bank of Cuba.
49. Decree-Law 50-82, Art. 20.
50. Resolution 659-82 of National Bank of Cuba.

© 1994 International Bureau of Fiscal Documentation

of goods and services and other authorized deposits. Local currency accounts of joint ventures and foreign companies must be funded from amounts drawn down from foreign currency accounts, refunds denominated in local currency or such other sources as may be authorized by the National Bank of Cuba. Special authorization is required for joint ventures, Cuban private companies and State enterprises to hold foreign currency accounts in banks outside of the domestic banking system.

Cuban private companies and State enterprises may operate foreign currency accounts with prior permission of the Government.

Joint ventures and foreign companies are not permitted to charge for their goods and services in local currency. However, payments of wages, salaries and other remuneration for work to certain Cuban and foreign staff resident in Cuba, purchases of goods and services in the national territory and taxes, duties and tariffs must be made in Cuban pesos. Exceptions to the foregoing are the payment of goods and services by State enterprises authorized to conduct transactions in foreign currency and the remuneration of a labour force recruited through Cuban State Enterprises.

No exchange control permission is required for joint ventures and foreign private companies to draw on foreign currency accounts for payments related to their foreign transactions as well as certain local transactions. These include payments for goods, services, equipment, shipments, insurance, leases, rentals, loans and interest, remittances of profits and salaries of foreign staff temporarily based in Cuba.

Payments in Cuban territory must be made by cheque as cash payments are specifically prohibited. The directors and other officers of joint ventures and foreign companies are personally charged with ensuring that all parties with whom they transact business in foreign currency are in fact legally authorized to do so. Joint ventures and foreign companies are prohibited from carrying out foreign currency transactions with the general public, peasant cooperatives and unauthorized State enterprises.

VI. LABOUR RELATIONS

With the exception of managerial, administrative and highly specialized technical staff, all employees of joint enterprises must be Cuban nationals. EJVs and foreign parties to partnership contracts may contract foreign administrative and technical staff as required, subject to their meeting the conditions of domestic immigration laws.[51]

The requisite Cuban workforce is not employed directly by the joint venture itself or by the parties to the partnership contract: the Cuban party or an independent Cuban entity ("the Cuban employer") provides the joint enterprise with the necessary number of temporary or permanent workers for each occupational category, subject to the agreement of the joint enterprise. The Cuban workforce maintains its contractual relations with the Cuban employer but nevertheless remains bound by the disciplinary and structural rules established by the joint venture in consultation with the Cuban employer.[52]

Where a joint enterprise wishes to dismiss one or more members of its permanent staff because of proloriged absence from work, violation of work discipline or other just cause, it must communicate the particulars to the Cuban employer which will then take appropriate action in accordance with the provisions of the Labour Code. The Cuban employer is obliged to replace dismissed workers. Disputes regarding the labour rights of those in the employment of a joint enterprise must be settled by the Cuban employer in accordance with the Labour Code. The joint enterprise is required to comply with domestic legislation regarding work safety and hygiene, meeting any costs involved.[53] The National Labour Inspectorate may inspect joint ventures' work sites in accordance with the existing law.

The wages of the local workforce should conform to the scales established by domestic law except in the case of local managerial staff whose salaries should accord with those of their foreign counterparts. Payroll procedures for the local workforce are agreed between the Cuban employer and the joint enterprise during the initial stages of negotiation and are usually based on the tariffs and other regulations of the national salary system. The Cuban employer receives workers' wages and along with the 25 percent workers payroll tax from the joint enterprise on a monthly basis as a quasi-agent of the workforce. The 25 percent workers' payroll tax covers all social security obligations of the joint enterprise and the Cuban workforce enjoys all existing social security benefits.

Special labour regulations and policy govern zones of special interest for tourism development and these take account of the geographical, social and economic factors of each zone.

VII. PRICE CONTROLS

It should be observed that state enterprises are not subject to the price controls established by the State Committee for Prices in their commercial supplies of raw materials, fuel, telecommunication services, transportation, tools and equipment, spare parts accessories and consumer goods to joint venture enterprises.[54] The Foreign Sector Division of the SCF, in consultation with the relevant State entities proposes methodological rules for the control of prices in convertible currency for their transactions with joint venture enterprises.[55]

51. Decree-Law 50-82, Arts. 36 and 43.
52. Resolution 1647 of 15 September 1982 of the State Committee for Labour and Social Security contains detailed provisions regarding labour policy in the joint venture sector. Its provisions reflect the policy orientation of Labour Law 49 of 24 April 1985. It should be noted that in cases where the joint venture assumes control of a workplace already in existence, the selection of staff must respect the pre-existing salary and seniority scales.
53. Decree-Law 50-82, Arts. 39 and 40.
54. Decree-Law 60 of 19 April 1983 established the role of the State Committee for Prices in the direction, execution and control of the State and Government pricing policy. It should be noted that Art. 32 of Decree-Law 50-82 gives Cuban entities the first option on supplying joint ventures with raw materials, spare parts and accessories, fuel, shipping and marine insurance services, provided that their prices and conditions are competitive with those prevailing on the international market.
55. Resolution 108 of 18 September 1990 of the State Committee for Prices.

© 1994 International Bureau of Fiscal Documentation

VIII. ARBITRATION

As party to Convention on the Acknowledgement and Execution of Foreign Arbitral Sentences of 1958, Cuba is obliged to recognize and enforce arbitral determinations issued within the territory of other states which have ratified the Convention.[56] Moreover, foreign investors may submit disputes to the jurisdiction of the Foreign Trade Arbitration Court established in Cuba in 1976.[57]

IX. CONCLUSION

Although still in the process of evolution, the legal infrastructure for the joint venture regime of the Republic of Cuba is well established. The fact that it draws on prerevolutionary legal structure confers the stability necessary for longer term planning by EJVs and the parties to partnership contracts. As this article demonstrates, the State has periodically reviewed the legislation in order to eliminate some of the anomalies which so often beset processes of transition in both market and centrally planned economies.

The tax regime for the joint venture sector has many advantages, the most important of which from the viewpoint of the foreign investor, is the use of concepts and notions which are familiar to their international tax advisers. From the perspective of administration, the simplicity offered by a single flat rate at the corporate level, as opposed to progressive rates, provides the beginnings of a sound basis for an efficient tax system. In the long run, however, the Cuban revenue authorities may be forced to review the absence of withholding taxes on dividends and transfer pricing provisions if the inevitable loss of revenue occasioned by these factors is to be contained within acceptable limits. In this regard, the experience of the People's Republic of China is perhaps instructive.[58]

56. This Convention, also known as the New York Convention, was ratified by the Cuban government on 3 February 1975 and became binding as of the 13 May 1975.

57. The Foreign Trade Arbitration Court was originally established by Law No. 1091 of 1 February 1963 which also established the Cuban Chamber of Commerce. The rules governing the operation of the Court are contained in Law 1303 of 26 May 1976, implementing the recommendations of the Legal Affairs Conference of the CMEA which was approved by the CMEA Executive Council on 28 February 1974.

58. According to senior officials of the Chinese Ministry of Finance, a transfer-pricing clamp-down in the People's Republic of China has resulted in a 93% increase in taxes from foreign-invested joint ventures for the month of August 1993, compared with figures from the same month in 1992. At the end of 1992 over a third of the 84,000 foreign investment ventures in China were reporting losses, much of which has been attributed to transfer pricing manipulation. See "Around the World–China", 2 *Tax Management Transfer Pricing Report* (1 December 1993) at 417.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

MARCH 1994

International Estate Tax Planning, Amsterdam, 7-8 March 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Internal Consultant Development Programme, Bruges, 21-25 March and 18-22 April 1994 (English):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel. 32-2-516 1911, Fax: 32-2-513 7108.

International Tax Aspects of Permanent Establishments, Amsterdam, 24-25 March 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

U.K. and International Tax Structuring for Entertainers and Sportsmen, London, 25 March 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

APRIL 1994

Taxation one year after the start of the Single Market, Brussels, 13 April 1994 (English, French, German):

Confédération Fiscale Européenne, Postfach 13 40, D - 53003 Bonn, Germany, Tel.: 49-228-726 3944, Fax: 49-228-726 3952.

Licencing in Europe for 2002, Delft (Netherlands), 17-20 April 1994 (English):

Congress Office ASD, PO Box 40, 2600 AA Delft, The Netherlands, Tel.: 31-15-120 234, Fax: 31-15-120 250.

International Tax Planning Techniques, Amsterdam, 21-22 April 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MAY 1994

International Aspects of VAT, Amsterdam, 9-10 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

7th East West Tax Conference, Sofia, 26-27 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Tax Treatment of Transfer Pricing, Amsterdam, 27-28 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JUNE 1994

International Tax Planning Association Meeting, Monte Carlo, 9-10 June 1994 (English):

Elizabeth Husband, ITPA Convention Bureau, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-762 910, Fax: 44-732-763 762.

Tax Avoidance and Tax Treaties, Amsterdam, 13-14 June 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1994

Leyden–Amsterdam–Columbia Summer Program in American Law, Leyden, 3-29 July 1994 (English):

Mrs B. Zaaijer, University of Leyden, Faculty of Law, Columbia Summer Program, Hugo de Grootstraat 27, 2311 XK Leyden, The Netherlands, Tel.: 31-71-277 632, Fax: 31-71-277 600.

AUGUST 1994

Principles of International Taxation, Amsterdam, 22 August-2 September 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

HONG KONG

RECENT DEVELOPMENTS REGARDING THE SOURCE OF PROFITS

Jefferson P. VanderWolk
Lecturer, Faculty of Law, University of Hong Kong.

Hong Kong profits tax applies only to profits arising in or derived from Hong Kong.[1] Neither the taxing statute nor the cases lay down a comprehensive set of source rules to guide taxpayers: the Inland Revenue Ordinance contains a limited number of deemed-source rules (for example, regarding certain royalties and rents) and the court decisions and administrative pronouncements on source questions have lacked both consistency and reasoned analysis.[2] Therefore, source questions, which are crucial in determining tax liability, continue to be contentious.

Two recent decisions concerning the source of profits illustrate the ongoing differences of opinion as to the proper approach to the determination of where profits arise for Hong Kong tax purposes.

THE WARDLEY INVESTMENT SERVICES CASE

Facts

In *Commissioner of Inland Revenue v. Wardley Investment Services (Hong Kong) Limited*,[3] the taxpayer (hereinafter "WISL") was a Hong Kong-based investment adviser engaged in managing investment funds for customers. All of its offices and employees were in Hong Kong. It bought and sold securities on behalf of its customers using its own judgment and discretion as though it were the beneficial owner of the funds. Purchases and sales were made in Hong Kong and also in overseas markets through stockbrokers. The stockbrokers' commissions were paid by WISL out of the customers' funds.

WISL periodically received from each customer a management fee equal to a percentage of the funds under management. In addition, WISL was permitted, under the management agreements between it and its customers, to keep for its own benefit any rebates from stockbrokers employed by WISL to buy or sell securities. Often, portfolio managers such as WISL are able to negotiate successfully for a share of the commission charged by a broker whom they use. The rebate is essentially a finder's fee or sales commission paid to the portfolio manager in exchange for sending business to the stockbroker.

WISL reported rebates received from Hong Kong stockbrokers as taxable income arising in Hong Kong, but claimed that rebates received from stockbrokers elsewhere were not taxable because they did not arise in Hong Kong. The Commissioner assessed tax on the rebates relating to offshore transactions, saying that they arose in Hong Kong because they constituted consideration for management services performed in Hong Kong. WISL appealed to the Inland Revenue Board of Review.

Board of Review decision

The Board of Review held in favour of WISL, noting that the rebates represented "an actual share of the overseas agent's commission":

> The operations from which this particular income arose were the activities of overseas agents buying and selling investments in their own overseas market places. To find that such income originated in Hong Kong would be flying in the face of what a practical man would regard as the real source of the income.[4]

The Board of Review rendered this decision shortly before the Privy Council decided the landmark *Hang Seng Bank* case.[5] The Board made the following comment concerning the Commissioner's submissions:

> It appears to us that the stance of the Commissioner in Hong Kong has substantially changed in recent years with regard to what he considers is profit arising in or derived from Hong Kong. He appears to be very close to submitting that 'mind and management' or 'residence' as they are understood elsewhere in the world should be the tests for our territorial tax system. However, the Inland Revenue Ordinance has not been amended and it is therefore difficult to understand what is the justification for this apparent change in attitude.[6]

Soon after this statement was made, the Privy Council decided the *Hang Seng Bank* case in a manner which made it clear that the Commissioner's stance was untenable. Not surpris-

1. Inland Revenue Ordinance (cap 112, LHK), Sec. 14(1).
2. See e.g. J.P. VanderWolk, "Hong Kong Taxation of Profits from International Business: Recent Cases", 44 *Bulletin for Int'l Fiscal Documentation* (July 1990), at 340 and J.P. VanderWolk, "Hong Kong: The Privy Council Wanders in the Wilderness", 47 *Bulletin for Int'l Fiscal Documentation* (January 1993), at 33.
3. (1992) 1 HKRC para. 90-061 (High Court); 1 HKRC para. 90-068 (Court of Appeal).
4. (1990) 5 IRBRD, at 224-25.
5. (1990) 3 HKTC 351 (Privy Council). The *Hang Seng Bank* decision established, beyond all doubt, that a business which is managed and controlled in Hong Kong can nevertheless earn profits which arise outside Hong Kong through operations conducted by independent agents offshore. The Privy Council held that profits of a Hong Kong bank from the purchase and sale of securities in the London and Singapore markets did not arise in Hong Kong, even though the trading activity was managed and funded from Hong Kong and the taxpayer had no employees or dependent agents in London or Singapore. See I.W. Harris, "Hong Kong's Source Principle Established by the Privy Council", 45 *Bulletin for International Fiscal Documentation* (February 1991), at 67.
6. 5 IRBRD, at 222.

© 1994 International Bureau of Fiscal Documentation

ingly, the Board in WISL's case was chaired by the same chairman who had presided in the Hang Seng Bank's appeal to the Board, rendering a decision in that case which was fully supported by the Privy Council.

High Court decision

The Commissioner appealed WISL's case to the High Court. In a perplexing decision by Godfrey J., who misunderstood the facts of the case and decided that the rebates in question did not constitute income, the High Court reversed the Board of Review's decision, apparently on the basis that all off WISL's remuneration for services rendered to its customers had arisen in Hong Kong. WISL then appealed to the Court of Appeal.

Court of Appeal decision

In December 1992, the Court of Appeal held in favour of the Commissioner, with one judge dissenting. Each of the three Court of Appeal judges sitting in the case wrote an opinion. The first (Fuad V-P), in finding for the Commissioner, took as his touchstone for determining where profits arise the formulation stated by Lord Jauncey on behalf of the Privy Council in *Commissioner of Inland Revenue v. HK-TVB International Limited*: "One looks to see what the taxpayer has done to earn the profit in question and where he has done it".[7] Fuad V-P said that the Board of Review had erred in taking into account the operations of the overseas brokers, notwithstanding that they were acting as WISL's agents in the foreign markets. Rather, he felt that the Board should have looked solely at what WISL did:

> The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction.... In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed.... The profit to the Taxpayer was generated in Hong Kong from [the management] contract although it could be traced back to the transaction which earned the broker a commission.[8]

Fuad V-P did not attempt to distinguish WISL's case from that of the Hang Seng Bank, which had also done nothing abroad itself but rather had instructed overseas brokers from Hong Kong to execute particular transactions. His failure to do so was, perhaps, due to the failure of counsel for WISL to argue the point, but it is surprising nonetheless.

Penlington J. agreed with the analysis of Fuad V-P, adding that, in his opinion, WISL did not receive the rebates from the overseas brokers but rather from the customers in Hong Kong. He said that the operation giving rise to the profit in question was the debiting of the full commission from the customer's account and the retention of a portion of the debited amount. In effect, Penlington J. adopted a place-of-payment test for determining where profits arise. This was extremely surprising, as it was held in an earlier decision of the Court of Appeal that the act of payment is not a profit-generating operation for purposes of determining the source of a profit,[9] and the point has never been argued since.

In dissent, Cons V-P argued that what WISL did to earn rebates was "to put business in the way of an overseas broker".[10] This was obviously done from WISL's base in Hong Kong, but the brokers' commissions from which the rebates were derived did not arise in Hong Kong, and Cons V-P found it "difficult to see what [WISL] has done *vis-à-vis* the customer to earn that particular piece of remuneration".[11] He also was unable to accept that "a profit which has never even notionally reached the customer ... can be said in any way to emanate from him".[12] Therefore, he could not agree that the rebates arose in Hong Kong; rather, they appeared to him to have arisen from the offshore transactions.

WISL has not appealed to the Privy Council.

Commentary

As suggested above, the operations of WISL in relation to the profits in question were sufficiently similar to the operations of the Hang Seng Bank in relation to the profits at issue in its tax dispute that one would have expected the courts to uphold the Board of Review's decision in favour of WISL. Moreover, the Board's decision, based as it was on the tests of source endorsed in the *Dock* case (i.e. the operations test and the practical-man test),[13] clearly satisfied the standard of appellate review, i.e. there was no apparent or implied misconception by the Board of the relevant legal principles to be applied.[14] Thus the Board's determination should not have been disturbed. None of the Court of Appeal judges discussed the standard of review on appeal, even though Fuad V-P acknowledged the argument of WISL's counsel to the effect that the test of source applied by the Board was legally correct.

The Court of Appeal's disregard of the acts of the overseas brokers – who, the Board found, were acting as agents of WISL – is most troubling. Fuad V-P said:

> When addressing the question the Board had formulated for itself: "where did the operations take place from which the profits in substance arise", in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration. If the Board had been able to benefit from the decisions of the Privy Council in the *Hang Seng Bank* and the *HK-TVB* cases, I have little doubt the Board's general approach to the issues would not have been the same. I think that (counsel for the Commissioner) was right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. ... The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions ... to a broker in Hong Kong or to one overseas.[15]

The Court of Appeal failed to recognize that this line of reasoning was equally applicable in the *Hang Seng Bank* case, yet the Privy Council had held that Hang Seng Bank's profits arose outside Hong Kong. Like WISL, Hang Seng Bank was merely instructing brokers from its offices in Hong Kong. It

7. (1992) 1 HKRC para. 90-064 (PC), at 100,540.
8. 1 HKRC, at 100,602.
9. Commissioner of Inland Revenue v. Hong Kong & Whampoa Dock Company Limited (1960) 1 HKTC 85.
10. 1 HKRC, at 100,602.
11. *Id.* at 100,603.
12. *Id.*
13. *Supra* note 9.
14. See *Edwards v. Bairstow* (1955) 36 TC 207 (HL), in which the House of Lords articulated the standard of appellate review of decisions of tribunals regarding inferences of fact (such as the territorial source of a profit).
15. 1 HKRC, at 100,602.

© 1994 International Bureau of Fiscal Documentation

would have acted in the same manner, and in the same place, whether it was giving instructions to a broker in Hong Kong or to one overseas. The Privy Council, however, did not make the mistake of ignoring the maxim of statutory interpretation, *qui facit per alium facit per se* - he who acts through another, acts himself.

Reinvoicing: D 59/92

The Board of Review decided a source case in 1993 which is currently on appeal to the High Court. The case, D 59/92,[16] involved a Hong Kong company ("HK Co.") which was wholly owned by a foreign manufacturer. HK Co. entered into distribution agreements with unrelated foreign parties, under which HK Co. sold to the distributors certain products manufactured by affiliates of HK Co. outside Hong Kong. The distributors would place orders with HK Co. in Hong Kong, and HK Co. would simply relay the orders to the suppliers, who would ship the goods directly to the distributors. HK Co. sent invoices to the distributors, received payment from them and made payments to the suppliers from its office in Hong Kong.

The Board held that HK Co.'s trading profits arose outside Hong Kong, noting that "the profits which arose from the difference in the price at which the Taxpayer purchased the goods from a group company in Country A and sold the goods to the exclusive distributor in Country B have very little to do with Hong Kong".[17]

Interestingly, the Board dilated at length upon the meaning and effect of the Privy Council's decisions in *Hang Seng Bank* and *HK-TVB International*, as well as the Commissioner's interpretation of the charge to profits tax:

> Prior to the recent *Hang Seng Bank* case and *TVB* case we would have had no hesitation on the facts before us in finding that the profits which are the subject matter of this appeal did not arise in nor were derived from Hong Kong....
>
> It is quite apparent from this case, the *Hang Seng Bank* case, and the *TVB* case, that the Commissioner of Inland Revenue is seeking to give section 14 a much wider meaning than hitherto .... The question which the Commissioner seeks us to answer is "where did the operations of the taxpayer take place". Obviously the operations of the Taxpayer took place in Hong Kong. Hong Kong is the only place where the Taxpayer had its operations. It did not have any branch or office outside of Hong Kong. If that is to be the test then we have gone a long way away from asking the average person in the street where he would see profits arising. The "hard practical matter of fact" test of Lord Atkin [in *Rhodesia Metals Limited v. Commissioner of Taxation*[18]] and the many previous decisions based on it would have little relevance any more....
>
> We find great difficulty in rationalizing the decision of the Privy Council in the *Hang Seng Bank* case and the decision of the Privy Council in the *TVB* case...
>
> ...(The *TVB* case) is not only founded on a fallacy [i.e. Lord Jauncey's view that only in rare cases will the profits of a Hong Kong-based business arise outside Hong Kong] but also if applied generally would mean that Hong Kong would have to have a series of worldwide tax treaties and would no longer be a safe haven for the operations of multinational groups of companies....
>
> ....Lord Jauncey does not appear to understand the international nature and flavour of the business transacted through Hong Kong.[19]

The Board did not discuss the 1989 decision of the High Court in *Exxon Chemical International Supply S.A. v. Commissioner of Inland Revenue*,[20] which involved similar facts. Nor did the Board mention the practice note regarding the source of profits issued by the Commissioner in November 1992.[21] In fact, the Board did not set forth a reasoned analysis of the source of HK Co.'s income, based on the facts of the case; rather, the Board merely stated its conclusion and went on to criticize the Privy Council's decision in *HK-TVB International*.

The Commissioner has appealed against the Board's decision in D 59/92. At the time of writing, the appeal had not yet been decided. In the author's opinion it would be a pity if the Board's decision were reversed, for it seems clearly correct. The only problem with it is that the Board did not expressly recognize that taxpayer did, in fact, conduct trading operations outside Hong Kong, through the medium of its agents, the offshore suppliers who shipped the goods to the distributors on the taxpayer's behalf.

CONCLUSION

The Privy Council, in its decisions in *Hang Seng Bank* and *HK-TVB International*, did not discuss adequately the important question of how to determine the locality of income of a Hong Kong-based business that arises through the activities of agents or independent contractors outside Hong Kong. The Commissioner's practice note on the locality of profits also fails to provide much, if any, guidance in this regard. Therefore, the Hong Kong courts and the Board of Review are still wrestling with the question of the source of profits for tax purposes, and will probably continue to do so during the foreseeable future.

16. (1993) 1 HKRC para. 80-238.
17. 1 HKRC, at 91,457.
18. [1940] AC 774 (PC).
19. 1 HKRC, at 91,457-59.
20. (1989) 3 HKTC 57 (High Court). This case is discussed in J.P. Vander-Wolk, "Hong Kong Taxation of Profits from International Business: Recent Cases", *supra* note 2.
21. Departmental Interpretation & Practice Notes No. 21, "The Locality of Profits", 1 HKRL para. 52-700 (CCH).

© 1994 International Bureau of Fiscal Documentation

ISRAEL

TAXATION OF CORPORATIONS

This article is based on information contained in the chapters on Israeli taxation to be published in European Tax Handbook 1994 and Supplementary Service to European Taxation. The chapter was prepared by Avidor Avni and Leon Harris of Kesselman & Kesselman, Tel-Aviv.

I. INTRODUCTION

Corporate taxpayers in Israel are generally subject to company tax on taxable income and gains.

The basic governing tax legislation is the Income Tax Ordinance ("ITO") and its subsidiary regulations. In addition, the Income Tax (Inflationary Adjustments) Law, the Law for the Encouragement of Capital Investments, the Law for the Encouragement of Industry (Taxation), the Value Added Tax Law and other laws also contain tax legislation.

Significant emphasis is placed on investment incentives as outlined below, and foreign investment is actively welcomed. Indirect tax benefits are available through Israel's free trade agreements with the United States, the EC and EFTA.

II. CORPORATE INCOME TAX

A. Type of tax system

The Israeli corporate tax system is essentially a classical system, i.e. taxable corporate income is subject to company tax at applicable rates, and distributed profits are again taxable in the hands of individual and foreign shareholders. The regular rate of company tax in 1994 is 38 percent, while the regular rate of dividend withholding tax is 25 percent.

Regular branch operations of a foreign company are not, in principle, subject to any branch tax in lieu of dividend withholding tax. Special rules apply to "approved enterprises" and "approved properties" (see below).

B. Taxable persons

Entities subject to taxation in Israel include Israeli companies and foreign companies that have a taxable presence in Israel. Not-for-profit institutions may qualify for tax exemption subject to conditions contained in the law. Israeli and foreign business partnerships are generally not assessed to Israeli taxation, but rather, the partners are assessable on their respective share of partnership profits ("fiscal transparency"). "Family companies" controlled by a single family may elect to treat a family member with the largest (or joint largest) right to profits as the taxpayer. Certain closely held real property holding companies (controlled by five or fewer persons or their relatives) may elect to apportion their income directly to their shareholders; the Tax Commissioner is empowered to determine the method of apportionment.

Residence

An entity, including a company and a partnership, will be deemed to be Israeli resident for tax purposes if one of the following criteria applies:

- the entity is registered in Israel, its principal activity being in Israel. However, if the entity is registered in Israel as a foreign entity, it will not be deemed resident under this criterion, unless it so elects. This election cannot be revoked for three years, unless the Minister of Finance so permits;
- the control and management of the entity's business are exercised in Israel.

The taxation of non-resident companies is discussed in VIII below.

C. Taxable base

Subject to the provisions of any applicable tax treaty, Israel generally imposes taxation on Israeli-source income, i.e. income accruing or derived in Israel, or received in Israel from abroad. Income from an overseas business that is controlled and managed in Israel, is also taxable in Israel. Moreover, Israeli residents are taxable on worldwide capital gains.

In principle, the excess of income from taxable sources over deductible expenses represents "taxable income".

Expenses are generally deductible if they are incurred wholly and exclusively in the production of taxable income in a given tax year. Specific rules apply to certain expenses, e.g. research and development, vehicle and travel expenses. There are also provisions whereby expenses should be allocated between regular income, income subject to preferred rates of taxation and exempt income.

The Israeli tax authorities accept and require the use of generally accepted accounting principles in the computation of taxable income, except for items for which separate rules are expressly provided in the tax laws. In particular, the accrual basis of accounting is generally required, and only in limited cases is the cash basis of accounting accepted.

1. Depreciation

(a) *Standard depreciation rates*

The ITO and regulations issued thereto, prescribe standard annual rates of tax depreciation on a straight-line basis for

© 1994 International Bureau of Fiscal Documentation

specific asset types, at rates ranging from 4 to 20 percent depending on the asset. Depreciation is only allowed for assets used in the production of taxable income. Where a Government grant has been obtained in respect of assets, the amount of the grant is deducted from their cost for depreciation purposes.

(b) *Special depreciation rates*

Under the Income Tax (Inflationary Adjustments) Law ("IAL"), special tax depreciation rates are available to businesses which are primarily engaged in certain qualifying activities, namely, industry, agriculture, hotel operations, software production or construction.

Furthermore, businesses that use, in a qualifying activity, equipment that was first put into operation in Israel in the tax years 1993 or 1994, may elect to deduct tax depreciation thereon at 150 percent of the rates normally claimable under the IAL or under the standard depreciation regulations. Therefore, subject to certain conditions, businesses in industry may claim depreciation at rates ranging up to 30-60 percent per annum on a straight-line basis, or up to 45-75 percent per annum on a declining balance basis, depending on the number of shifts worked. Lower special rates apply to other sectors.

(c) *Approved enterprises*

Under the Law for the Encouragement of Capital Investments, 1959, an approved enterprise (see II.E.1.) may opt for accelerated depreciation in respect of machinery and equipment forming part of an approved programme of investments, at double the standard rates described in (a) above, during the first five years in which the assets are operated. Where there is unusual wear and tear on machinery or equipment due to operations on additional shifts or under extremely difficult conditions, the tax authorities may grant depreciation of 250 percent of the standard rate. In the case of buildings, depreciation of 400 percent of the standard rate may be claimed, but the rate is not to exceed 20 percent per annum.

Alternatively, an approved enterprise may opt for the special depreciation rates available to certain businesses as described in (b) above.

2. Value of stock

The law does not prescribe rules for determining the value of trading stock (inventory) for the purpose of computing business income. The value at which stock is stated in the books of account, if based on generally accepted accounting principles in Israel, is usually acceptable to the tax authorities. Therefore, stock is generally valued at the lower of cost or market value, cost being determined by the FIFO (first in, first out) or average methods but not by the LIFO (last in, last out) method.

3. Reserves and provisions

In principle, accrued expenses of a revenue nature are deductible, provided they conform to generally accepted accounting principles.

Provisions for bad debts are not deductible. A bad debt is deductible in the year in which it has become irrecoverable.

Employee-related severance pay, vacation pay, recreation pay, holiday allowances and sick pay are only deductible in the year in which they are actually paid to the beneficiary or to a recognized fund. Provisions for these expenses are not deductible, even if there is an obligation to make these payments. Regular monthly contributions to approved provident funds are deductible according to detailed rules.

Reasonable expense payments by an Israeli resident payer to a foreign resident that are subject to a withholding tax obligation (see VII) will generally be deductible if the payment is effected within the tax year. Alternatively, such payments may be deductible in a tax year if the applicable withholding tax is deducted within three months after the tax year-end and remitted to the tax authorities within seven days of the deduction, together with index-linkage differences and interest accrued since the year-end. Payments to affiliates should represent a reasonable arm's length consideration.

4. Inflationary adjustments or dollar reporting

The IAL contains a comprehensive set of rules which aim to neutralize the effects of inflation on the profit or loss in Israeli currency terms in a given tax year.

A special election is available to: companies in which the foreign investment exceeds 25 percent of the share capital and shareholders' loans, and foreign partnerships comprised solely of partners who are not residents of Israel, whose capital and loans are provided in foreign currency and who are approved as such by the tax authorities. These entities are entitled: (a) to submit Israeli tax returns based on books of account maintained in US dollars, in accordance with the rules of translation as prescribed in the tax regulations, or (b) to adjust their taxable income based on changes in the exchange rate of the US dollar *vis-à-vis* the *shekel*. Such an election is binding for a period of three tax years.

D. Capital gains

1. Scope

Residents and non-residents who derive capital gains relating directly or indirectly to assets in Israel are generally liable to Israeli capital gains tax, subject to any applicable tax treaty. Israeli residents are also taxable on overseas capital gains.

2. Computation

For tax purposes, capital gains are split into their real and inflationary components. Inflationary amounts are usually computed by reference to the Israeli consumer price index ("CPI"). A real gain is added to regular income and taxed at normal corporate or personal tax rates. An inflationary amount (or portion thereof) which accrues between the date of acquisition of an asset and 31 December 1993 is taxable at a rate of 10 percent. An inflationary amount (or portion thereof) which accrues on or after 1 January 1994 to the date of disposal is generally exempt from Israeli tax.

© 1994 International Bureau of Fiscal Documentation

Non-residents who acquired an asset with foreign currency may opt to use the relevant foreign currency exchange rate instead of the CPI; a nil rate applies to all of the resulting inflationary amount if the asset concerned represents shares held by a non-resident in an Israeli company, other than a real estate entity (see D.5).

In addition, in the case of a disposal of shares (except for real estate entities), part of the gain based on the investor's share of the retained profits of the company is treated as an additional inflationary amount. Residents and non-residents are taxable at 10 percent on the entire inflationary amount relating to retained profits.

3. Capital gains tax reliefs

Various capital gains tax deferrals and exemptions are prescribed, including:

(a) *Asset replacements*
Capital gains tax may be deferred where a new depreciable asset (except for a building) is acquired to replace a depreciable asset which has been sold, provided the new asset is acquired within 12 months after, or four months prior to, the sale of the asset being replaced.

(b) *Asset/share exchanges*
A charge to capital gains tax may be deferred where a capital asset (including shares in a company) is transferred by any person or entity to a company in exchange solely for shares in the company.

The deferral rules provide, *inter alia*, that for at least two years after the exchange, the transferor must hold at least 90 percent of *all the rights* in the transferee company and the transferee company must retain the transferred asset.[1] New share issues in the above-mentioned two year period generally may not result in more than a 49 percent dilution in total, or 25 percent for approved private placements, and must conform to other detailed rules. Transferee companies must be incorporated and resident in Israel, unless the Tax Commissioner approves otherwise. Special provisions facilitate asset transfers between fellow subsidiary companies with identical ownership or an approved share transfer to a parent company.

Only a newly formed transferee company may be used to receive partnership or jointly owned assets, or depreciable assets owned separately by up to ten individuals; the market value of one depreciable asset should not exceed four times the value of any other asset.

As a condition for receiving a tax deferral, the asset transferor(s) must notify the Israeli tax authorities of the asset/share exchange within 30 days after the transaction.

(c) *Publicly-traded securities*
Capital gains relating to Israeli securities traded on the Tel-Aviv Stock Exchange or a recognized overseas exchange are generally exempt from Israeli capital gains tax where they are derived by private individuals or by foreign residents not doing business in Israel. Holders of existing securities that become listed on a stock exchange will generally be taxable upon listing or upon the first sale thereafter, according to detailed rules; an exemption exists in the case of shares of Israeli industrial companies which are retained for five years after listing, subject to conditions. However, proposals for the repeal of this exemption are apparently under consideration.

Dealers in securities are assessable on their dealings at the regular rates applicable to revenue income. Moreover, other persons doing business in Israel may be taxable on gains derived from holding publicly-traded securities under detailed provisions in the IAL.

4. Capital losses

Capital losses may be set off against capital gains realized by the taxpayer in the current year or in the next seven years. Alternatively, a capital loss (in historical cost terms) arising from machinery and equipment used in a business, which was replaced in the tax year, may be deducted from income as a regular expense. The deduction may not exceed the cost of the replacement machinery and equipment.

5. Real estate

Provisions broadly similar to those discussed above apply to capital gains from Israeli real estate, and from "real estate entities" whose principal assets consist of real estate, under the Land Appreciation Tax Law. In addition, purchasers of real estate interests may be liable to an acquisition tax (transfer fee) of up to 5 percent of the transfer value. Special income taxation rules apply in the property construction and rental sectors.

E. Tax and other incentives

1. Approved enterprises

(a) *Introduction*

Under the Law for the Encouragement of Capital Investments, 1959, the Investment Centre at the Ministry of Trade and Industry is empowered to grant the status of "approved enterprise" to projects that meet relevant criteria. In general, projects are approved if the enterprise will lead to an increase in exports from Israel or, if they will generate a significant number of new jobs, especially for skilled immigrants from the CIS. Thus, the focus is on developing Israel's industrial, technological and tourism sectors.

The Investment Centre's authority to grant approved enterprise status and the various other provisions described herein expire at the end of 1994, and various proposals to modify and extend the benefits are understood to be under consideration. Readers are advised to ascertain the current situation in specific proposed instances.

Taxable income derived from an approved enterprise owned by a company is currently subject to company tax at a rate of

1. An article in an upcoming issue of the *Bulletin* will focus on this new legislation.

© 1994 International Bureau of Fiscal Documentation

25 percent for a period of benefits of up to seven years. Dividends paid to shareholders of an Israeli incorporated company from the profits of an approved enterprise, earned during the period of benefits noted above, are subject to withholding tax of 15 percent if paid during the seven-year period of benefits or in the following 12 years.

Some of Israel's tax treaties contain a "tax sparing" clause allowing treaty country taxpayers to claim a tax credit in their home country at regular Israeli tax rates rather than the reduced rates actually imposed on income derived from approved enterprises.

(b) *Taxation of "foreign investors' company"*

A foreign investors' company ("FIC") is essentially a company more than 25 percent of whose share capital (in terms of rights to shares, profits, voting and the appointment of directors) and of whose combined share capital and loan capital is owned by foreign residents. An FIC enjoys the following special company tax rates applicable to its approved enterprise income during a period of benefits of up to ten years:

Percentage of foreign ownership	*Company tax rate*
Over 25% but less than 49%	25%
49% or more but less than 74%	20%
74% or more but less than 90%	15%
90% or more	10%

Dividends paid by FICs from profits earned by an approved enterprise during its period of benefits are subject to withholding tax of 15 percent. However, there is no time limitation as to the date of distribution. Thus, the overall Israeli tax burden on distributed profits of a 90 percent-or-more foreign-owned FIC will be 23.5 percent (10 percent company tax plus 15 percent withholding tax on the balance of 90).

Approved enterprise branches of foreign companies are subject to a 15 percent branch tax in lieu of dividend withholding tax, subject to any applicable tax treaty. The Tax Commissioner may allow payment of the branch tax to be deferred until the relevant profits are remitted from Israel.

(c) *Alternative system of benefits*

Companies establishing an approved enterprise may elect to forego any entitlement to government grants (see (e) below) and to receive in lieu a total exemption (tax holiday) from corporate taxes on retained profits from the enterprise for two to ten years, depending on the location of the enterprise. Thereafter, the tax rates outlined in (a) or (b) above are applicable in any remaining part of the seven or ten year period of benefits.

If exempted profits are subsequently distributed as dividends, a liability to company tax and dividend withholding tax will then crystallize at the rates which would have been applicable if these alternative benefits had not been elected. Certain anti-avoidance rules apply to other payments to, or for the benefit of, shareholders.

(d) *Accelerated depreciation*

See II.C.1.

(e) *Financial incentives*

Various other incentive options are offered in respect of approved enterprises, including:

- state-guaranteed loans of 66.67 percent of approved project expenditure comprising fixed assets and working capital; or
- fixed asset cash grants of up to 38 percent for approved enterprises in certain areas (tourism enterprises – up to 29 percent); or
- composite benefits comprising both grants and state-guaranteed loans totalling 66.67 percent of approved project expenditure.

Loans guaranteed by the State (as collateral) are provided by designated financial institutions on controlled terms. The above-mentioned beneficial tax rates also apply, but the last two options involving grants may not be combined with the tax holiday outlined in (c) above.

2. Research and development

Research and development ("R&D") grants and beta site (for on-site production, prototypes) grants ranging up to 50 percent of approved expenditure (or 66 percent in certain instances) may be obtainable from the Office of the Chief Scientist at the Ministry of Industry and Trade, or from binational research funds which Israel has or is finalizing with Belgium, Canada, France, Germany, the Netherlands, Portugal, Spain and the United States. If commercial products result from the research, sales royalties are generally payable up to prescribed limits.

For Israeli tax purposes, R&D expenditure, net of grants received is deductible from taxable income over one to three years, subject to certain rules. Such deductions are also available to third party participants in R&D ventures. In addition, industrial enterprises may amortize their investment in patents, copyrights and know-how at the rate of 12.5 percent per annum on a straight-line basis.

3. Other incentives

(a) *Industry and commerce*

An industrial company is entitled to a deduction of share issue costs in respect of public issues, in three equal annual instalments commencing in the year of issue.

An overall tax rate of 15 to 25 percent for 30 years is available for an approved foreign-owned "Capital Intensive Company" ("CIC") and its shareholders, as well as exemption from capital gains tax upon a sale of shares in a non-resident CIC. A CIC must have a paid-up capital of at least US$ 30 million and undertake qualifying activities or investments relating to manufacturing, agriculture, tourism, transportation, construction, water, energy, communications infrastructure, computers or R&D in connection with any of these.

© 1994 International Bureau of Fiscal Documentation

Free port and free trade area status have been given to the Red Sea city of Eilat in the south of Israel. Free export processing zones elsewhere in Israel are also proposed.

Exemption from tax for ten years may be granted for international trading companies engaged primarily in overseas trade, as well as exemption for 20 years to non-resident shareholders thereof from Israeli taxes on dividends from the exempt income and on gains from the sale of shares in such companies.

Various non-tax incentives are available, including working capital finance for exporters, and support for export marketing, small businesses and trade-exposed reviving industries.

Hybrid equity/loan finance of up to 1 million ECU is available from the European Community Investment Partners ("ECIP") fund for EC-Israeli joint ventures. This finance may be supplemented by loans from the finance institution designated to administer the ECIP funding.

For consolidated tax returns by industrial groups, see I below.

(b) *Real estate*

Real estate incentives in Israel include the following:

(1) Approved properties

With a view to encouraging the construction of rental buildings, The Law for the Encouragement in Capital Investments, 1959, enables the Investment Center, in conjunction with relevant government departments, to confer "approved property" status. Approved properties span industrial, commercial or residential projects or combinations thereof, subject to certain conditions.

Beneficial corporate tax rates apply to approved property income, largely similar to approved enterprises, i.e. company tax rates of 10 to 25 percent, and dividend withholding tax (or branch tax) of 15 percent. Property tax exemptions may also be available.

Additional "approved enterprise" benefits apply to approved rental factories including state-guaranteed loans and grants or the tax holiday option.

(2) Foreign Investors' Real estate Association ("FIREA")

Foreign residents are exempted from land appreciation tax and transfer fees (acquisition tax) on sales and purchases of shares in a FIREA. A FIREA is a corporate real estate entity (see above), which is approved as such by the Income Tax Commissioner and which satisfies the following criteria:

- the FIREA owns at least 50 residential homes, and its principal activity is the construction, rental or sale of housing;
- all the shareholders are foreign resident individuals when they acquire their shares;
- there are at least 50 shareholders;
- none of the shareholders are classified as major (essentially 5 percent-or-more) shareholders.

(c) *Other sectors*

Tax deductions are available for investors in private and publicly-traded film production partnerships and financial assistance for certain film productions.

Preferential tax treatment for oil exploration and tax deductions for investors in publicly-traded oil partnerships are available. Approved agricultural enterprises qualify for tax and financial benefits. Exemption from Israeli tax applies for interest credited on a non-residents' foreign currency deposit with an Israeli bank, if the recipient does not engage in a business or profession in Israel.

F. Losses

Losses arising from a trade or business may be set off in the year in which they arise against income from any source (including interest, dividends and capital gains). Where losses are carried forward to subsequent years, they may be set off without time limit against income from a trade or business, or business capital gains and land appreciation, but not against income from any other source. Tax losses cannot generally be carried back. For the rules on capital losses, see II.D.4. above.

G. Rates

The prescribed rate of company tax on regular profits is 38 percent in 1994, 37 percent in 1995 and 36 percent in 1996 and beyond.

Beneficial tax rates and other provisions apply to "approved enterprises" (see II.E.1.). For withholding taxes, see VIII.

H. Assessment and collection of tax

In general, taxpayers are required to report on a calendar-year basis, but subsidiaries of companies traded on a foreign stock exchange and companies whose shares are traded on the Stock Exchange in Israel, or which are associated with such companies, are permitted to apply for a different tax year.

In principle, a form of self-assessment procedure applies. Companies must generally file a tax return within five months after the end of the tax year subject to obtaining an extension, accompanied by any balance of tax payable.

Companies are required to make advance payments of tax in the course of the year in which taxable income has been earned. The advance payments are generally fixed as a percentage of turnover, but sometimes are required for a fixed amount. Tax also must be withheld at source from various domestic remittances to suppliers in Israel. Such withholdings may be set off by the income recipients against tax advances in the following month. Supplementary tax advances are also payable when certain non-deductible ("excess") expenses are incurred.

© 1994 International Bureau of Fiscal Documentation

Upon the sale of an asset chargeable to capital gains tax, an advance of 30 percent of the (*shekel*) capital gain is payable within 30 days of the transaction. The assessing officer may accept the actual amount of tax if this is lower, provided a detailed return and computation of the tax due are filed within that period. A 50-day limit for reporting and remitting tax due generally applies to gains from Israeli real estate.

I. Groups of companies

1. Group treatment

Consolidated returns may be filed, subject to certain conditions, by an "industrial holding company" and subsidiaries in the same line of production, and by a productive parent company and subsidiaries which are at least two-thirds owned by the parent company and are in the same line of production.

2. Intercompany dividends

Dividends flowing between two Israeli companies from regular profits are in principle exempt from company tax for the recipient company. Accordingly, exemption from the regular dividend withholding tax of 25 percent may be requested from the tax authorities.

Dividends paid by a company from profits of an approved enterprise or approved property are generally subject to income tax withheld at source at the rate of 15 percent, being the final Israeli tax thereon. In the case of a company receiving a dividend as above and distributing it onward, the 15 percent tax withheld from the dividend receipt is recoverable.

Dividends received by an Israeli company from abroad are generally taxable in Israel, subject to the provisions of any applicable tax treaty, or special Israeli unilateral relief rules.

3. Thin capitalization

There are currently no thin capitalization rules for Israeli tax purposes, although normal arm's length principles should be observed in setting finance terms. Nevertheless, there is an equity requirement of 30 to 33.33 percent for approved enterprises and approved properties. Companies are generally prohibited by company law from redeeming share capital, except upon liquidation, but there are no such limitations on loan repayment. To obtain financing from non-residents, certain conditions must be fulfilled for currency control purposes, relating to notification and reasonableness of finance terms.

4. Transfer pricing

The governing principle of arm's length prices generally applies to transfer pricing of goods and services. For example, the sale of capital assets and the transfer of goods from inventory to fixed assets and vice versa is measured for tax purposes at market value.

As to transactions entered into by Israeli residents with foreign residents, the tax laws refer to the profits earned from the export of products manufactured in Israel, and to the profits from business undertaken by an Israeli resident with a non-resident who effectively controls the Israeli resident. In practice, arm's length principles will typically be applied and the terms of business in the sector concerned (or in other countries) may be relevant.

5. Reorganizations[2]

Effective 1 January 1994, special new provisions in the ITO facilitate tax-deferred reorganizations in certain circumstances. Stamp duties remain payable and acquisition tax of 0.5 percent will be imposed on real estate transfers. Reorganizations involving "real estate entities", whose principal assets consist of real estate, only qualify for relief in restricted instances. Aspects of this legislation are summarized below.

(a) *Mergers*

Under the revised rules, there will be no immediate charge to capital gains tax (or land appreciation tax) upon a sale of shares in, or assets of, a transferor company, pursuant to a court-ordered merger that results in the elimination, without winding-up, of the transferor company(ies).

Bona fide commercial reasons for the merger should exist. The holders of rights in the transferor and merged companies may only receive, in proportion to the market value of their pre-merger holdings, rights in the merged company, unless the court allows a minority totalling up to 25 percent to be bought out.

For two tax years after the merger certain limitations apply, including: rights holders in the merged company must retain at least 90 percent of all their rights therein; and over half the pre-merger assets (in market value terms) must be retained and used in the normal course of the same activity as before. New share issues in the above-mentioned two-year period may not result in more than a 49 percent dilution in total, or 25 percent for approved private placements, and must conform to other detailed rules.

Unutilized pre-merger losses will be pooled and may be set off against post-merger taxable income of the transferee company, provided the amount set off in any tax year does not exceed the lower of 20 percent of the losses of the transferor(s) or 50 percent of the transferee's taxable income. In the sixth year, any unutilized pre-merger losses may be set off without limitation. Other detailed rules are prescribed, and an optional advance ruling procedure has been instituted.

(b) *Divisions*

There are provisions facilitating tax-free corporate divisions in certain circumstances. For these purposes, a division is generally a transfer of assets and liabilities of the old company to one or more specially formed company(ies) which are

2. *Id.*

© 1994 International Bureau of Fiscal Documentation

(1) controlled by identical rights holders, or (2) 100 percent subsidiary company(ies). No consideration is permitted other than rights in the resulting companies, proportionate to existing holdings. Bona fide commercial reasons for the division should exist, and each resulting company should be a taxable business entity incorporated and resident in Israel, unless the Tax Commissioner approves otherwise.

For two tax years after the division certain limitations apply, including: the principal activity conducted by the old company in the two years preceding the division must continue; rights holders in the resulting companies must retain at least 90 percent of all their rights; over half the pre-division assets (in market value terms) must be retained and used in the normal course of each resulting company's business; and the companies involved in the division may not reallocate cash or assets nor give guarantees to conduct other transactions outside the ordinary course of their business. Additional rules govern new share issues in the two year period similarly to mergers.

Rules also govern the allocation of tax losses to post-division companies, essentially on the basis of net assets. Building rental losses will be allocated to the company owning the building. Loss utilization would generally be restricted in the first five tax years similarly to mergers.

Other detailed rules are prescribed, and advance consent from the Tax Commissioner is necessary for the corporate division to proceed on a tax-free basis.

(c) *Asset/share exchanges*

See above.

J. Double taxation relief

Israel has tax treaties with several countries which contain specific double tax relief provisions (credit or exemption) for companies and individuals.

Where no treaty applies, an Israeli resident may generally claim unilateral relief for tax on foreign-source income which is taxable abroad and in Israel, and which stems from a business controlled or managed in Israel, or from a profession or occupation generally exercised in Israel. In such a case, the Israeli tax is, in principle, the lower of:

- 25 percent of the taxable income before foreign taxes; or
- Israeli tax that results in a combined rate of tax in Israel and abroad equal to the regular Israeli company tax rate (38 percent in 1994) or the highest personal tax rate for individuals (50 percent for 1994). However, this cannot give rise to a refund of excess foreign taxes.

Foreign-source income of an Israeli resident which is assessable in Israel solely because it is received in Israel (remittance basis) is, in principle, taxable at the lowest of:

- Israeli tax at regular rates on the gross income, subject to any applicable tax treaty relief; or
- a rate not exceeding 25 percent of the amount after foreign tax received in Israel, increasing to 35 percent in the case of Israeli resident individuals on income from privately held foreign securities that are publicly traded on a recognized overseas exchange or from government issued or guaranteed bonds of certain countries, or from units in mutual funds regulated in those countries; or
- Israeli tax that results in a combined rate of tax in Israel and abroad equal to the regular Israeli company tax rate (38 percent in 1994) or the highest personal tax rate for individuals (50 percent for 1994). However, this cannot give rise to a refund of excess foreign taxes.

Separate unilateral provisions apply to Israeli residents who work abroad for an Israeli employer for a continuous period of more than four months.

The Minister of Finance may, on a discretionary basis, permit a partial or full refund of Israeli taxes where a foreign resident receives little or no double tax relief on Israeli source income in his country of residence. In practice, if such relief is granted the resulting rate of Israeli taxation will not generally be less than 25 percent.

III. OTHER INCOME TAXES

Financial institutions are subject to a 17 percent wage-and-profit tax in lieu of value added tax.

An annual 2.5 percent surtax (the "immigration absorption levy") is currently applicable to loans and other credit extended by a closely held company (controlled by five or fewer persons or their relatives) to its shareholders. Subject to the foregoing, there are no other taxes on the income of corporations.

IV. NET WORTH TAX

Israel does not have a general net worth tax. Property tax of 2.5 percent is imposed annually on vacant non-agricultural land, and land with a building the area of which does not exceed 20 to 30 percent (depending on building type) of the total permitted building area. Land which is business inventory for income tax purposes is liable to property tax of 1.2 percent of its value.

In addition, municipal property occupancy taxes and levies and other licence fees are levied annually according to the size and type of building.

V. PAYROLL TAXES

There are currently no payroll taxes on private sector business concerns. As mentioned above, financial institutions pay a 17 percent wage-and-profit tax in lieu of VAT.

VI. SOCIAL SECURITY CONTRIBUTIONS

National insurance (social security) contributions are generally payable on monthly employment income of up to NIS

© 1994 International Bureau of Fiscal Documentation

10,359, for the first quarter of 1994, subject to the provisions of any binational totalization agreement.

Israel has social security totalization treaties with Austria, Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

VII. WITHHOLDING TAXES

Israel has comprehensive withholding tax provisions.

A. Dividends

Subject to any applicable tax treaty, dividend withholding tax rates are as follows:
- regular profit distributions: 25 percent
- approved enterprise profit distributions: 15 percent.

These withholding rates represent the final tax due in the case of Israeli resident individual shareholders and foreign resident shareholders not doing business in Israel. For intercompany dividends, see II.I.

B. Interest

Interest payments to foreign residents are generally subject to Israeli withholding tax of 25 percent of the gross payment in the case of corporate lenders. Reduced withholding tax rates on interest payments may be permitted by the tax authorities in certain instances, such as:
- pursuant to the provisions of a tax treaty, where applicable; and
- where the foreign lender can demonstrate that finance or other costs are incurred.

In addition, the Israeli tax authorities have adopted a special policy with regard to loans from reputable overseas financial institutions to projects of macroeconomic importance. Under this policy, the tax authorities may, in appropriate instances, permit a tax withholding from interest remittances to overseas financial institutions of only 15 percent of the excess (if any) of actual interest payable over LIBOR, provided normal arm's length principles are upheld.

C. Royalties

Subject to any applicable treaty, royalty payments to non-residents are subject to a withholding tax of 25 percent.

VIII. NON-RESIDENT CORPORATIONS

A. Taxable presence

In general, non-residents are only taxable in Israel to the extent that income arises from sources in Israel, i.e. income derived, accrued or received in Israel. In addition, foreign residents are generally liable to Israeli taxation on capital gains derived from the sale of assets situated in Israel, and the sale of direct or indirect rights to such assets. Furthermore, non-residents may, in principle, be liable to Israeli taxes in the event that an overseas business is controlled and managed from Israel. In practice, this situation is not commonly encountered.

Israel's tax treaties provide that the business profits of a non-resident may be taxable in Israel if such profits are earned through a fixed base or permanent establishment in Israel. Where no tax treaty applies, Israel recognizes the conceptual distinction between doing business with Israel from abroad, and doing business in Israel and will generally only tax income from business conducted in Israel.

B. Withholding tax on overseas remittances

Israeli commercial banks are generally required to withhold tax from remittances to non-residents (other than payments for imported goods) at a rate of 25 percent for corporate recipients. The Israeli tax authorities may confirm a lower rate or exemption, e.g. for non-Israeli-source income, or pursuant to the provisions of a tax treaty, or where Israeli taxes are separately accounted for by a local branch or permanent establishment.

Reserve provisions exist for withholding tax at regular corporate tax rates from deemed Israeli-source remittances, including royalties (but not dividends). In practice, withholding tax at 25 percent of the gross remittance abroad is normally the final tax requested, provided the non-resident recipient is not deemed to have a taxable presence in Israel.

IX. VALUE ADDED TAX

A. Taxable persons

Value added tax ("VAT") in Israel follows broadly similar principles to VAT systems found in various other countries. Persons doing business in Israel are required to register as taxable persons, issue VAT invoices, collect output VAT from customers and report monthly to the VAT authorities. Taxable persons can credit input VAT on expenditure in calculating the amount due to the VAT authorities, and can claim a refund in respect of excess input tax paid over output VAT collected. Non-residents who carry on any part of their business activity in Israel must appoint a local VAT representative to act on their behalf.

B. Taxable base

VAT is imposed on transactions conducted in Israel. Transactions, including imports, are generally considered to be conducted in Israel in the following instances:

© 1994 International Bureau of Fiscal Documentation

An asset is regarded as being sold in Israel if it is situated in Israel at the time of its delivery to the purchaser or if it has been exported from Israel or, in the case of an intangible asset, if the seller is a resident of Israel.

A service is regarded as rendered in Israel in the following cases:

- it is rendered by a person or entity whose business is in Israel; a person who has an agent or branch in Israel is, for this purpose, regarded as a person whose business is in Israel;
- it is rendered to a resident of Israel, to a partnership most of the rights in which vest in partners resident in Israel or to a company which, for the purposes of the ITO, is regarded as resident in Israel;
- it is effectively rendered in relation to an asset situated in Israel or to Israeli residents or foreign residents in Israel.

C. Rates

The standard rate of VAT is 17 percent. Certain transactions are taxable at a zero rate – mainly export-related transactions – while certain other transactions are exempt from VAT.

X. CURRENCY CONTROL

Israel has a system of foreign currency controls which is gradually being liberalized. In brief, foreign currency remittances should be channelled through an Israeli commercial bank. Foreign residents may freely invest in shares in Israeli companies, and may repatriate abroad dividends and capital upon realizing their investment, after settling any Israeli taxes due.

Loans from abroad are generally permissible provided the terms and repayment dates are documented and appear reasonable to the Israeli receiving bank. Loan principal may be repatriated abroad, and so may loan interest after deduction of the appropriate withholding tax.

A foreign company may lawfully operate a branch in Israel but requires a special permit from the Bank of Israel to repatriate surplus profits; this is normally forthcoming in bona fide cases. Investment in overseas ventures by Israeli residents usually requires a special permit from the Bank of Israel, although exporters may open overseas sales offices in certain circumstances.

TAXES AND INVESTMENT IN THE MIDDLE EAST

SHED MORE LIGHT ON THE MIDDLE EASTERN MARKET WITH THIS UNIQUE PUBLICATION

◆ Company and investment law
◆ Imports and exports
◆ Full taxation law for businesses and individuals
◆ Special tax treatment
◆ Full text of tax treaties (in English)
◆ PLUS background political and economic information

COUNTRIES COVERED: Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates and Yemen

THE ONLY BOOK available on taxation and investment in the Middle East

CONVENIENT: looseleaf format with per country layout for easy comparisons **CURRENT:** 2 binders, updated four times a year

INITIAL SUBSCRIPTION ONLY NLG 990

includes binders, 1994 updates, postage by air and packing ◆ Annual renewal fee: NLG 450

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, The Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

South Africa

PRICE WATERHOUSE MEYERNEL.
The Standard Trust Income Tax Guide 1992-93.
Durban, Butterworth Publishers. 1993, pp. 230, 34.- R.
Guide to assist taxpayers with respect to their income tax returns. Material is based on the law as of 31 August 1992 and covers: individual income tax, income and benefits from employment, income and deductions from business and professions, estates and trusts, interest, dividends, property leasing, partnerships, corporate income tax, donations.
(B. 13.476)

A GUIDE TO MINING TAXATION IN South Africa (Based on the law prevailing after the amendments passed by the parliament in June 1993).
Johannesburg, KPMG Aiken & Peat, P.O. Box 7400, 2000 Johannesburg, South Africa. 1993, pp. 73.
Guide to assist mining executives with no financial background – providing an appreciation of the impact of tax on the success of a mining operation; mining tax advisors – providing a ready reference to the Act and the case law; potential investors in mining shares – providing a basic understanding of how the tax treatment of mining differs from that of other types of operation.
(B. 13.477)

ASIA & THE PACIFIC

Australia

INVESTMENT IN AUSTRALIA.
Amsterdam, KPMG International Headquarters. 1993, pp. 95.
An overview of many business considerations faced by overseas residents establishing and operating businesses in Australia. Topics include: business environment, opportunities for international investors, exporting to/from Australia, business taxation, taxation of individuals, labour, acquisition of property, accounting and auditing requirements.
(B. 57.929)

Hong Kong

BUSINESS PROFILE SERIES: HONG Kong
Hong Kong, The Hongkong and Shanghai Banking
Corporation Limited. 1993, pp. 56.
Ninth revised and updated edition of information booklet on the economic and investment climate in Hong Kong, including tax issues.
(B. 57.927)

Japan

TRADERS' MANUAL FOR ASIA AND the Pacific: Japan.
New York, UN United Nations. 1993, pp. 114.
(B. 57.920)

New Zealand

INTERNATIONAL TAX AND BUSINESS Guide: New Zealand.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 92.
Guide for foreign investors contemplating direct investments or passive investments in New Zealand. Basic information about the New Zealand business environment, including taxation.
(B. 57.902)

EUROPE

EUROPEAN REGIONAL INCENTIVES 1993-94. 13th Edition. Directory and review of regional grants and other aid available for industrial and business expansion and relocation in the Member States of the European Community and Sweden. Edited by D. Yuill, K. Allen, J. Bachtler, K. Clement and F. Wishlade.
London, Bowker-Saur, 60 Grosvenor Street, London W1X 9DA, England. 1993, pp. 484, £ 69.-.
Contains a review of changes to regional incentives policies of the EC countries and Sweden in 1991 and the first half of 1992. Apart from a detailed examination of changes to the incentive policies of each country,. there is a discussion of the European Commission's involvement in recent regional incentive developments. A survey of the ongoing debates regarding the future of regional policy at the Community level is also included. The bulk of the survey consists of a detailed directory of the main regional incentives available in the various countries covered. Comparative tables highlights the main recent changes to regional incentive policies and compare and contrast the various incentives available between countries.
(B. 113.212)

Austria

KODEX DES ÖSTERREICHISCHEN Rechts:
Arbeitsrecht, 11. Auflage, Stand 1.8.1993.
Bearbeitet von Wolfgang Mazal.
Vienna, Linde Verlag Wien AG. 1993, 295.- S.
Labour Law updated as per 1 August 1993.
(B. 113.194)

Belgium

KIRKPATRICK, John.
Le régime fiscal des sociétés en Belgique.
Brussels, Etablissements Emile Bruylant SA. 1992, pp. 324.
Handbook on the taxation of corporations and shareholders.
(B. 113.213)

FISCOLEX INKOMSTENBELASTINGEN 1993 – KB WIB/92.
Deurne, Kluwer rechtswetenschappen. 1993, pp. 188.
Text of the Royal Decree implementing the Income Tax Code, adapted to the consolidated version of the Income Tax Code.
(B. 113.201)

VOORLICHTINGSBROCHURE TEN behoeve van Belgische grensarbeiders in Nederland.
Brussels, Benelux Economische Unie. 1993, pp. 70.
Practical information on the tax- and social security regulations applicable to Belgian cross-border workers in the Netherlands.
(B. 113.178)

Benelux

VERGELIJKEND OVERZICHT VAN DE

© 1994 International Bureau of Fiscal Documentation

bepalingen van de Beneluxlanden betreffende de personenbelasting/inkomstenbelasting en de vennootschapsbelasting.
Brussels, Benelux Economische Unie, Regentschapsstraat 39, 1000 Brussel 1, Belgium.
1992, pp. 50.
Comparative description of taxation of individuals and companies in the Benelux countries.
(B. 113.179)

EEC

KIEHLING, Hartmut.
Finanzplatz Europa.
Munich, Verlag C.H. Beck; DTV Deutscher Taschenbuch Verlag. 1992, pp. 388, 19.80 DM.
Legal development with regard to finance transactions of the EEC, as well as in other European states.
(B. 112.465)

Finland

MYRSKY, Matti.
Kansainvälinen Henkilöverotus.
Helsinki, Lakimiesliiton Kustannus, Uudenmaankatu 4-6A, 00120 Helsinki. 1993, pp. 172.
International taxation of individuals. Textbook on basic problems regarding individual taxpayers in the field of international taxation. Topics covered include: principal concepts of international taxation; avoidance of double taxation; Finnish domestic international taxation; taxpayers with unlimited tax liability (residents), especially regarding employment income from abroad; taxpayers with limited tax liability (non-residents) and tax treaties concluded by Finland. Sample calculations are included and relevant tax return forms and regulations are reproduced. Also includes an index of court decisions and a topical index.
(B. 112.762)

Germany

OECHSLE, Klaus.
Die steuerlichen Grundrechte in der jüngeren deutschen Verfassungsgeschichte.
Berlin, Duncker & Humblot. 1993.
Tübinger Schriften zum Staats- und Verwaltungsrecht, Band 20, pp. 253, 78.- DM.
The basic tax laws under the recent history of German constitution. The limitation of legislative power with regard to taxation under constitutional rights.
(B. 113.216)

DURCHLAUB, Thomas.
Zur Steuerpflicht der Gewinne aus der Veräusserung von Privatvermogen.
Berlin, Dunker & Humblot. 1993.
Schriften zum Steuerrecht, Band 45, pp. 254, 76.- DM.
The taxation of profits from the alienation of private property. An introduction to the general aspects of taxation of capital gains from the alienation of private property in Germany and discussion of possible future changes. Taxation of capital gains in the present income tax law system. Justification of tax exemptions of private capital gains.
(B. 113.215)

ABGABENORDNUNG MIT
Finanzgerichtsordnung und Nebengesetzen.
17. Auflage, Stand 1, Januar 1993.
Munich, Verlag C.H. Beck; DTV Deutscher Taschenbuch Verlag. 1993.
Beck-Texte im dtv, pp. 420, 8.90 DM.
Texts of the Tax Code and the Code of Tax Procedure (up to date as per 1 January 1993). Introduction to these laws by Klaus Tipke.
(B. 113.155)

IMMOBILIEN IN DEN NEUEN
Bundesländern.
Fakten und Perspektiven. Herausgegeben von Erik Sonnemann.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 553, 138.- DM.
Immovable property in the new Länder. Complete guide to the land market, the boom town environment in Berlin, restitution, taxes and incentives with regard to the new Länder.
(B. 112.300)

SCHUHMANN, Helmut.
ABC der verdeckten Gewinnausschüttung.
3. Auflage.
Wiesbaden, Forkel Verlag. 1992.
Forkel Reihe Recht und Steuern, pp. 228, 36.- DM.
Glossary of important topics and terms with regard to hidden profit distributions and transfer pricing.
(B. 113.169)

POHLMANN, Hans-Richard.
Steuertips zum Jahresende 1993. Ausgabe September 1993.
Bonn, Stollfuss Verlag. 1993, pp. 260, 39.80 DM.
Tax hints for the end of 1993. Includes important tax saving and planning advice.
(B. 113.217)

FÖRSTER, Wolfgang.
Die Liquidationsbilanz. Eine handelsrechtliche, betriebswirtschaftliche und steuerrechtliche Darstellung mit Fallbeispiel.
3. Auflage. Cologne, Verlag Dr Otto Schmidt KG. 1992, pp. 362, 98.- DM.
The liquidation balance sheet. Comprehensive description how to establish a balance sheet for a company in liquidation. A case study is included. Also includes a discussion of commercial law, business administrative principles and individual and corporate tax law.
(B. 113.166)

SCHLEDER, Herbert.
Steuerrecht der Vereine. 2. Auflage.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 318, 58.- DM.
Tax law with regard to organizations. The taxation of clubs, societies, associations and other organizations.
(B. 113.170)

FRITZ, Michael.
Die Spaltung von Kapitalgesellschaften. Gesellschaftsrecht, Steuerrecht, Reformvorschläge.
Cologne, Verlag Dr Otto Schmidt KG. 1991.
Rechtsordnung und Steuerwesen, Band 15, pp. 195, 76.- DM.
The splitting of corporations. Includes a discussion of basic principles in corporate law, splitting as a problem in corporate and civil law, analysis of several splitting models and the decree of the Minister of Finance with regard to the tax treatment of corporation splittings of 9 January 1993.
(B. 113.164)

HERZIG, Norbert.
Besteuerung der Spaltung von Kapitalgesellschaften.
Cologne, Verlag Dr Otto Schmidt KG. 1992, pp. 140, 59.- DM.
Taxation of corporation splittings. Essays on topics such as: the decree of the German Minister of Finance with respect to the tax treatment of corporation splittings of 9 January 1993; income tax problems with regard of splittings in the new Länder; cross-border splittings, excise duties and future regulations.
(B. 113.165)

HARENBERG, Friedrich E.; IRMER, Gisbert.
Die Besteuerung privater Kapitaleinkünfte.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 342, 78.- DM.
The taxation of private capital income. Contains a description of the basic principles of the taxation of private capital income (e.g. dividends and interest) under the income tax law and the new anticipated capital gains tax.
(B. 113.168)

EINKOMMENSTEUERGESETZ.
12. Auflage Herausgegeben von Ludwig Schmidt.
Munich, C.H. Beck Verlagsbuchhandlung. 1993, pp. 2578, 154.- DM.
Twelfth revised and updated edition containing detailed practical commentary on the Individual Income Tax Law.
(B. 113.218)

DIE VERMÖGENSTEUER-
Hauptveranlagung 1993.
21. Auflage. Bearbeitet von H. Diedenhofen und W. Tess.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 665, 49.50 DM.
Annual updated guide containing the texts of the Valuation Law, Net Wealth Tax Law, Inheritance Tax Law and other relevant material for the 1993 assessment year.
(B. 113.189)

BRÖNNER, Herbert; RUX, Hans-Joachim; Wagner, Heidemarie.
Die GmbH & Co. KG in Recht und Praxis.
6. Auflage.

© 1994 International Bureau of Fiscal Documentation

Freiburg, Rudolf Haufe Verlag. 1992, pp. 383, 59.80 DM.
A description of the legal form and taxation of the limited commercial partnership in the form of the GmbH & Co. KG.
(B. 113.219)

JACOB, Friedhelm.
Handkommentar DBA–USA.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1992, pp. 372.
Commentary on the Germany–USA tax treaty of 29 August 1989.
(B. 111.717)

BOEKER, Christian.
Gewinnermittlung und Gewinnbesteuerung in Deutschland und Spanien.
Belastungsorientierter internationaler Rechtsvergleich.
Bielefeld, Erich Schmidt Verlag. 1992, pp. 180, 58.- DM.
Determination and taxation of profits in Germany and Spain. A tax orientated international comparison.
(B. 113.186)

NEUBERT, Achim O.
Ihre Waffen gegen die Finanzverwaltung.
Munich, Verlag C.H. Beck; DTV Deutscher Taschenbuch Verlag. 1992, pp. 188.
Glossary of options against the tax administration, such as right to inspect files, abuse of authority, adjustment of prepayments, examination, remedies and tax evasion.
(B. 112.161)

PEEMÖLLER, Volker H.; HÜTTCHE, Tobias.
Auswirkungen des D-Markbilanzgesetzes auf die Bilanzanalyse.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 193, 78.- DM.
Description of auditing problems with regard to the transformation of the former East German auditings to West German standards and using the DM as currency unit.
(B. 112.302)

ZIEGLER, Martin.
Ergebnisverwendung bei Kapitalgesellschaften aus der Sicht der Rechnungslegung und Publizität nach dem Bilanzrichtlinien-Gesetz.
Frankfurt, Verlag Peter Lang GmbH. 1991.
Europäische Hochschulschriften, Reihe V, Volks und Betriebswirtschaft, Vol. 1179, pp. 257.
Comprehensive description of guidelines on the use of profits within a company given by the Bilanzrichtliniengesetz.
(B. 112.231)

Italy

SANTORO, Enrico.
Manuale di pianificazione fiscale internazionale.
Rome, International Editing Publisher Srl – Roma, Via della Camilluccia 535, 00135 Rome. 1992, pp. 672.
International tax planning handbook. Contains a discussion of the most useful international tax planning structures with respect to both individuals and corporations. A review of the possibility of using a branch, subsidiary or other entity such as a trust. Also includes a study of the treaty network of various states, the anti-treaty shopping legislation and tax havens.
(B. 113.210)

Netherlands

HABERHAM, A.M.
Fiscale aspecten van vreemd vermogen verstrekt door aandeelhouders.
Deventer, Kluwer. 1993.
Fiscale Monografieën, No. 65, pp. 280, 88.50 Dfl.
Dissertation focusing on the tax aspects of loans and equity provided by shareholders to a legal entity under Dutch tax law with reference to case law. Similar tax aspects are also discussed under German and US tax law with reference to thin capitalization.
(B. 113.097)

INTERNATIONAL TAX AND BUSINESS Guide: Netherlands.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 129.
Guide for potential investors in the Netherlands. Includes information on establishing a business, foreign investment and exchange controls, foreign trade, accounting and auditing, tax system, corporate income tax, individual income tax, VAT, double taxation relief and other taxes.
(B. 112.972)

VOORLICHTINGSBROCHURE TEN behoeve van Belgische grensarbeiders in Nederland.
Brussels, Benelux Economische Unie. 1993, pp. 70.
Practical information on the tax- and social security regulations applicable to Belgian cross-border workers in the Netherlands.
(B. 113.178)

PROPOSED US–NETHERLANDS TAX treaty Amsterdam,
Arthur Andersen & Co., Zwaansvliet 20, 1081 AP Amsterdam, the Netherlands. 1993, pp. 110.
A general guide to the proposed Netherlands–USA tax treaty including computer programme of limitation on benefits.
(B. 113.177)

VETTER, J.J.; WATTEL, P.J.
Hoofdzaken invordering. 3rd Edition.
Deventer, Fed. 1993.
Fed Fiscale Studieserie No. 2, pp. 237, 62.50 Dfl.
Third updated edition of monograph describing the collection of tax arrears with reference to case law. Relevant statutes are appended.
(B. 113.204)

Poland

INVESTMENT IN POLAND. 2ND Edition.
Amsterdam, KPMG Klynveld. 1993, pp. 102.
Information of interest to those considering investing or doing business in Poland. Chapters covered: business environment, business and personal taxation, foreign investment and more related subjects.
(B. 113.133)

Spain

BOEKER, Christian.
Gewinnermittlung und Gewinnbesteuerung in Deutschland und Spanien.
Belastungsorientierter internationaler Rechtsvergleich.
Bielefeld, Erich Schmidt Verlag. 1992, pp. 180, 58.- DM.
Determination and taxation of profits in Germany and Spain. A tax orientated international comparison.
(B. 113.186)

Sweden

WIMAN, Bertil.
Koncernbeskattning. Med särskild inriktning pa omstruktureringar. 2nd Edition.
Uppsala, Iustus Förlag AB. 1992, pp. 212.
"Concern taxation (especially regarding corporate reorganizations)". University textbook on corporate taxation. Topics covered include: general principles of concerns, taxation of corporations, shifting of income between affiliated corporations and corporate reorganizations.
(B. 112.775)

INTERNATIONAL TAX AND Business Guide: Sweden.
New York, Deloitte Touche Tohmatsu International. 1993, pp. 110.
Guide including information on Swedish tax system, foreign investment, corporate income tax, individual income tax, VAT, accounting and auditing, capital gains tax and other taxes.
(B. 112.964)

FORSSEN, Björn.
Mervärdeskatt. En läro- och grundbok i moms.
Stockholm, C.E. Frizes AB, Box 6472, 11382 Stockholm. 1993, pp. 336.
Textbook on the Swedish value added tax. Topics covered include: taxable persons, taxable supply, tax mechanism, importation and exportation, reporting requirements and rates. A topical index is included.
(B. 112.760)

United Kingdom

PAY AND FILE: IT'S NEARER THAN you think.
London, Price Waterhouse. 1993, pp. 30.
A summary of the key features of the new corporation tax compliance regime.
(B. 113.109)

© 1994 International Bureau of Fiscal Documentation

OVERSEA COMPANIES. PLACE OF business and branch registrations.
Edinburgh, Companies House, 100-102 George Street, Edinburgh EH2 3DJ. 1993, pp. 24.
(B. 113.016)

SHOUP, Carl S.
Ricardo on taxation.
Aldershot, Gregg Revivals, Gower House, Croft Road, Aldershot, Hampshire GU11 3HR, England. 1992, pp. 285.
Reprint of a book initially published in 1960 describing the ideas of Ricardo on Taxation. He favoured an advantageous tax policy, dealing with various topics such as tax on agricultural land rent, proportional tax on agricultural output, tax on a fixed amount per acre, taxes on gold and on houses, taxes on profits and wages and taxable capacity of a nation. The author included an appraisal of Ricardian tax analysis based mainly on the publication of Ricardo "On the principles of political economy and taxation" (three editions published between 1817 and 1821).
(B. 112.441)

USSR

KOPITS, George.
Lessons in fiscal consolidation for the successor states of the Soviet Union.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/54, pp. 17.
(B. 113.122)

INTERNATIONAL

INTERNATIONAL TAX AND BUSINESS Guide:
Corporate and withholding tax rates between major trading nations.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 131.
Information on corporate income tax rates and non-treaty and treaty withholding tax rates on dividends as well as interest and royalties of major trading countries.
(B. 113.241)

SANTORO, Enrico.
Manuale di pianificazione fiscale internazionale.
Rome, International Editing Publisher Srl – Roma, Via della Camilluccia 535, 00135 Rome. 1992, pp. 672.
International tax planning handbook. Contains a discussion of the most useful international tax planning structures with respect to both individuals and corporations. A review of the possibility of using a branch, subsidiary or other entity such as a trust. Also includes a study of the treaty network of various states, the anti-treaty shopping legislation and tax havens.
(B. 113.210)

FRY, M.J.
The fiscal abuse of central banks.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/58, pp. 26.
Reviews of the fiscal activities which governments in 26 developing countries have obliged their central banks to undertake.
(B. 113.145)

TANZI, Vito.
Fiscal policy and the economic restructuring of economies in transition.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/22, pp. 33.
(B. 57.873)

TANZI, Vito; SHOME, Parthasarathi.
A primer on tax evasion.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/21, pp. 23.
(B. 57.874)

MOURMOURAS, A.; JIJERINA, J.A.
Collection lags and the optimal inflation tax. A reconsideration.
Washington, IMF International Monetary Fund. 1993.
IMF Working Paper WP/93/60, pp. 22.
(B. 113.228)

ANDRIESSEN, J.E.; ESCH, R.F. van.
Globalisering: een zekere trend.
The Hague, Ministry of Economic Affairs. 1993.
Discussienota No. 9301, pp. 15.
Discussion paper focusing on the globalization process and its effect on competition, employment, production of goods and the rendering of services in an unifying world economic market.
(B. 113.091)

Developing Countries

MORE TAXING THAN TAXES? THE taxlike effects of nontax policies in LDCs. Edited by Richard M. Bird. A Sequoia Seminar.
San Francisco, ICS Institute for Contemporary Studies. 1991, pp. 266.
Contributions of the fourth Sequoia Seminar on the tax effects of non-tax policies in less developed countries. "The hidden costs of public expenditure" by D. Usher; "More taxing than taxes?" by R.M. Bird; "Taxlike features of developing country trade regimes" by J. Whalley; "Financial institutions and their quasi taxes..." by W.R. Thirsk; "Tacit taxes and sub rosa subsidies through state-owned enterprises" by M. Gillis.
(B. 57.932)

LATIN AMERICA

Mexico

IMPLEMENTACION EN EL AMBITO estatal de una contribución especial para la preservación ecológica.
Guadalajara, Indetec. 1993, pp. 232.
Implementation at the individual state level of a special contribution for environmental preservation.
(B. 18.800)

NORTH AMERICA

Canada

INCOME TAX ACT AND REGULATIONS. Department of Finance. Technical Notes. 4th Edition, consolidated to 1992. Compiled, edited and annotated by David M. Sherman.
Scarborough, Carswell Thomson Professional Publishing. 1992, pp. 1585, $ 62.60.
A consolidation of technical notes and other income tax commentary from the Department of Finance. The book is intended to be a companion to the published Income Tax Act. It explains the provisions of the Act.
(B. 113.242)

USA

JACOB, Friedhelm.
Handkommentar DBA–USA.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1992, pp. 372.
Commentary on the Germany–USA tax treaty of 29 August 1989.
(B. 111.717)

PROPOSED US–NETHERLANDS TAX Treaty.
Amsterdam, Arthur Andersen & Co., Zwaansvliet 20, 1081 AP Amsterdam, the Netherlands. 1993, pp. 110.
A general guide to the proposed Netherlands–USA tax treaty including computer program of limitation on benefits.
(B. 113.177)

© 1994 International Bureau of Fiscal Documentation

Looseleaf Services

Received between 1 and 31 December 1993

AFRICA

FISCALITE AFRICAINE
releases 20 and 21
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
- Rulings and guidelines
  release 143
- Legislation
  release 70

Butterworths, North Ryde.

AUSTRALIAN STAMP DUTIES LAW
Tolhurst - Wallace - Zipfinger
release 126
Butterworths, North Ryde.

AUSTRIA

DIE EINKOMMENSTEUER 1972
Hofstätter-Reichel
release 38
Anton Orac Verlag, Vienna.

BELGIUM

FUNDAMENTELE BELGISCHE WETGEVING
release 56
Kluwer Rechtswetenschappen, Deurne.

IMPORT-EXPORT. GUNSTREGELINGEN EN PROCEDURES IN DE BTW EN DOUANEREGLEMENTERING
Brassine - Koedijk - Marckx
release 88bis
Kluwer Rechtswetenschappen, Deurne.

VENNOOTSCHAP EN BELASTINGEN
release 20
Kluwer Rechtswetenschappen, Deurne.

WETBOEK VAN DE INKOMSTENBELASTING
release 97
Ministry of Finance, Brussels.

CANADA

GLOBAL INVESTMENT IN CANADA
release 100
Prentice-Hall of Canada Ltd., Scarborough.

INCOME TAX REFERENCES/ REFERENCES A LA LOI DE L'IMPOT SUR LE REVENUE
release 52
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATTION IN CANADA – REPORT BULLETIN
releases 863, 864, 866 and 868
Prentice-Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Skattenyt – Kronologisk
  releases 25 and 26
- Skattebestemmelser – Systematisk
  releases 12 and 12A

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 337

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – IMPOTS INDIRECTS
release 3
Editions Francis Lefebvre, Paris.

JURIS CLASSEUR – CHIFFRE D'AFFAIRES – COMMENTAIRES
release 6159
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – CODE GENERAL DES IMPOTS
release 72
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – COMMENTAIRES – IMPOTS DIRECTS
release 1186
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – FISCALITE IMMOBILIERE
release 82
Editions Techniques, Paris.

GERMANY

ABC FÜHRER SOZIALVERSICHERUNG
release 46
Verlag Schäffer & Co., Stuttgart.

ABGABENORDNUNG – FINANZGERICHTSORDNUNG
Tipke - Kruze
release 71
Verlag Dr. Otto Schmidt KG., Cologne.

BONNER HANDBUCH RECHNUNGSLEGUNG – AUFSTELLUNG PRUFUNG UND OFFENLEGUNG DES JAHRESABSCHLUSSES
Hofbauer - Kupsch
releases 6 and 7
Stollfuss Verlag, Bonn.

DEUTSCHE STEUERPRAXIS – NACHSCHLAGWERK PRAKTISCHER STEUERFÄLLE
Felix
releases 153 and 154
Verlag Dr. Otto Schmidt KG., Cologne.

EINKOMMENSTEUERGESETZ. KOMMENTAR
Kirchhof - Sohn.
release 48
Peter Deubner Verlag, Cologne.

HANDBUCH DER GMBH
Eder - Heuser - Tillmann - Gaul
releases 62 and 63
Verlag Dr. Otto Schmidt KG., Cologne.

KOMMENTAR BEWERTUNGSGESETZ – VERMÖGENSTEUERGESETZ
release 72
Verlag Dr. Otto Schmidt KG., Cologne.

KOMMENTAR ZUM ERBSCHAFTSTEUERGESETZ UND SCHENKUNGSTEUERGESETZ
Kapp
release 31
Verlag Dr. Otto Schmidt KG., Cologne.

KOMMENTAR ZUM GEWERBESTEUERGESETZ
Lenski - Sternberg
release 70
Verlag Dr. Otto Schmidt KG., Cologne.

KOMMENTAR ZUM ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
Hübschmann - Hepp - SPitaler
release 139
Verlag Dr. Otto Schmidt KG., Cologne.

PRAKTISCHER FÜHRER DURCH DAS STEUERRECHT
Theis - Theis
release 81
Verlag Dr. Otto Schmidt KG., Cologne.

STEUERERLASSE IN KARTEIFORM
releases 385-387
Verlag Dr. Otto Schmidt KG., Cologne.

STEUERGESETZE
I, release 106
Verlag C.H. Beck, Munich.

STEUERRECHT DER BETRIEBLICHEN ALTERSVERSORGUNG
Ahrend - Förster - Rössler
release 10
Verlag Dr. Otto Schmidt KG., Cologne.

© 1994 International Bureau of Fiscal Documentation

STEUERRECHTSSPRECHUNG IN KARTEIFORM
releases 502 and 503
Verlag Dr. Otto Schmidt KG., Cologne.

INTERNATIONAL

INTERFISC TAX TREATY SERVICE
John Dewhurst
release 57
J.F. Chown, London.

NETHERLANDS

BELASTINGWETTEN (DE BELASTINGGGIDS)
release 161
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
releases 98 and 99
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
- Algemene wet inzake rijksbelastingen
- release 81
- Inkomstenbelasting 1964
- release 247
- Loonbelasting
- release 149

Noorduijn BV, Arnhem.

CURSUS BELASTINGRECHT
Mobach
releases 209 and 210
Gouda Quint/D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Gemeentelijke belastingen e.a.
  release 182

Kluwer, Deventer.

FISCAAL FUNDAMENT
release 2
Kluwer, Deventer.

FISCALE WETTEN
release 208
Fed, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Belastingheffing bij invoer
  releases 446 and 447
- Gecombineerde nomenclatuur
  release 82-84
- Tarief van invoerrechten
  release 105

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 365 and 366
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 142 and 143
Kluwer, Deventer.

LEIDRAAD BIJ DE BELASTINGGIDS
van Soest - Meering
release 124
Gouda Quint/D. Brouwer, Arnhem.

NEDERLANDSE REGELINGEN VAN INTERNATIONALE BELASTINGRECHT
releases 169 and 170
Kluwer, Deventer.

DE SOCIALE VERZEKERINGSWETTEN
- AKBW, release 46
- AOW/AWW, release 63

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
release 292
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  releases 227 and 228
- Inkomstenbelasting 1964
  releases 883-886
- Investeringsregelingen
  release 106
- Invorderingswet
  releases 51-53
- Loonbelasting
  releases 560-566 559
- Successiewet 1956
  releases 168-170
- Vennootschapsbelasting
  releases 312 and 313

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, release 11
Norsk Skattebetalerforening, Oslo.

SOUTH AFRICA

JUTA'S TAX SERVICE – LEGISLATION SECTION – SOUTH AFRICA
release 53
Juta & Co., Kenwyn.

SWITZERLAND

DIE PRAXIS DER BUNDESSTEUERN
Noher
Band II, release 47
Verlag für Recht und Gesellschaft AG., Basel.

UNITED KINGDOM

BRITISH TAX ENCYCLOPEDIA
Wheatcroft
release 141
Sweet & Maxwell Ltd., London.

SIMON'S TAX CASES
releases 35-37
Butterworth, London.

SIMON'S TAXES
release 194
Butterworth, London.

SIMON'S TAX INTELLIGENCE
releases 45-49
Butterworth, London.

VALUE ADDED TAX – DE VOIL
release 220
Butterworth, London.

USA

UNITED STATES TAX REPORTER
releases 47-51
RIA – Research Institute of America Inc., New York.

UNITED STATES INCOME TAX TREATIES VOGEL – SHANNON – DOERNBERG
release 5
Kluwer Law and Taxation Publishers, Deventer.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax. Untangling the undergrowth of company and shareholders tax rules 82

China (People's Rep.):
Jinyan Li:
New Individual Income Tax-unified taxation of citizens and foreigners ??

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Pierre-Jean Douvier:
Three percent tax on real estate in France 89

International:
Pierre-Jean Douvier:
Choosing the right location for pooled services of a group of companies 7

Seth E. Terkper:
Improving the accountancy context of tax reform in developing countries 21

Glenn P. Jenkins:
Modernization of tax administrations: Revenue boards as an instrument for change 75

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and recent developments – the path to sustainable growth 94

New Zealand:
Andrew M.C. Smith:
Taxation of non-resident equity investment in New Zealand: Unilateral extension of domestic imputation regime to non-residents portfolio investors 59

Qatar:
Finbarr Sexton:
Taxation regime for foreign entities following the fundamental reform of existing income tax regulations 14

United States:
Leonard W. Rothschild, Jr.:
California's new "water's edge" election enhances business opportunities for foreign investors: the US Supreme Court to rule in *Barclays* case 3

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41

IV. CONFERENCE DIARY 55

V. BIBLIOGRAPHY

– Books 45
– Looseleaf services 49
– List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 4 APRIL 1994

INTERNATIONAL:

THE STATE OF TAX POLICY IN THE CENTRAL ASIAN AND TRANSCAUCASIAN NEWLY INDEPENDENT STATES 159

Parthasarathi Shome and Julio Escolano

Two possible tax policy strategies for the NIS are: (1) an optimal non-distortionary tax structure as a one-shot action; and (2) a structure with identifiable and clearly understood distortionary elements as a temporary phenomenon to close the fiscal gap. An assessment of NIS tax structures reveals that they conform to neither. They are rapidly acquiring complex features comprising multiple rates, exemptions and other difficult-to-administer properties, with uncertain ramifications for efficiency, equity and the fiscal deficit. Steady – and perhaps prolonged – effort needs to be made if simple, broad-based and revenue-productive tax structures are to be achieved.

NEW ZEALAND:

TAX IMPLICATIONS OF THE NEW COMPANIES ACT 1993 167

Adrian J. Sawyer

The New Zealand Parliament recently enacted one of its most dynamic pieces of legislation impacting upon the activities of the commercial community of New Zealand: the Companies Act 1993. A discussion document was released in December 1993, which dealt with the tax implications of the company law reform. This article outlines the principal recommendations of the discussion document and analyses the implications of the recommendations on existing tax law in New Zealand.

AUSTRALIA:

CAPITAL GAINS TAX AMENDMENTS 176

Ann O'Connell

The Australian Government recently announced amendments to some of the capital gains tax provisions in order to deal with "emerging tax avoidance practices", redress certain unintended consequences of a number of provisions and reduce the compliance burden on taxpayers. Ms O'Connell takes a look at these important changes.

UNITED STATES:

HOW TO AVOID US TRANSFER PRICING PENALTIES 180

Marianne Burge and Cym Lowell

On 27 January 1994 the IRS issued temporary regulations giving guidance to US taxpayers on how to avoid transfer pricing penalties. These regulations give taxpayers important guidance as to how to comply with the current US view of transfer pricing, and therefore help them file tax returns which may avoid disputes in the future.

SWITZERLAND:

LOW TAX OPPORTUNITIES 183

William Bush

Swiss companies have traditionally had a place in the armoury of the international tax planner. However, with the advent of the single market in Europe and the appearance of constellations of tax havens and regions with special tax incentives across the globe is there still a place for the Swiss company in international tax planning? This article offers a few ideas.

PORTUGAL:

RECENT DEVELOPMENTS 185

William T. Cunningham

The 1994 budget and the supplementary 1993 budget constitute the most extensive revision of the Portuguese tax system since the 1986 introduction of VAT and the 1989 reform of direct taxation. The combined effect of the budgets has been to signal to taxpayers a change of attitude in relation to tax evasion – nevertheless the success of the new measures remains to be seen.

© 1994 International Bureau of Fiscal Documentation

FRANCE:

TRANSFER OF THE AVOIR FISCAL TO NON-RESIDENTS: NEW RULES, OPPORTUNITIES AND PRACTICAL CONSIDERATIONS 191

Philippe Juilhard

This article analyses the peculiar situation of non-resident taxpayers in light of recent changes regarding tax treaty benefits when the avoir fiscal is transferred.

INDIA:

1994/95 BUDGET 197

G.K. Kawatra

The 1994/95 Budget, which has been welcomed for its bold initiatives on tax reform, was presented to Parliament on 28 February. Mr Kawatra highlights the most important measures of the new Budget.

BIBLIOGRAPHY

– Books 201
– Looseleaf services 205

CONFERENCE DIARY 207

CUMULATIVE INDEX 208

IFA NEWS 200

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

INTERNATIONAL

THE STATE OF TAX POLICY IN THE CENTRAL ASIAN AND TRANSCAUCASIAN NEWLY INDEPENDENT STATES

Parthasarathi Shome and Julio Escolano

Parthasarathi Shome and Julio Escolano, Division Chief and Economist, Tax Policy Division IMF, respectively. Opinions expressed are those of the authors and not necessarily of the IMF. *The authors would like to thank Messrs. Dan Citrin, John Odling-Smee, Emil Sunley, Alan Tait and Howell Zee for many insightful comments that enabled the authors to reconsider selected issues and reflect some of their thinking. However, the overall view as well as remaining errors are the sole responsibility of the authors.*

I. INTRODUCTION

The objective of this paper is to assess whether a clear strategy over tax policy has developed in the Central Asian and Transcaucasian newly independent states ("NIS").[1] The paper begins by exploring the ideal form and components of such a strategy. It then describes the state of tax policy in the NIS, provides an assessment and points to the gap from ideal tax policy norms. It concludes that the NIS have implemented neither an immediate shift to an ideal system nor a gradual approach from the present system to the ideal, where the interim steps are chosen with a view to containing the fiscal deficit. Rather, the NIS tax systems are rapidly acquiring complex, distortionary features which hinder tax administration without necessarily enhancing revenue-generating capacity.

II. A TAX REFORM STRATEGY

Many articles have appeared in the literature proposing tax reform for economies in transition (Tanzi, 1993). They can be divided into two main groups: (1) those that recommend a one-shot transformation of a prevailing tax system with features found in a command economy to one that deals fully with the concerns of an optimal tax system in a market economy; and (2) those that recommend a step-wise approach that allows only broad approximations to an ideal tax structure to prevail during the transition to a market economy.[2] Advice related to technical assistance to the NIS also reflects these two views over tax reform.

The concerns of the two groups are relatively clearly discernible. The first stream of thought focuses on the need to get the tax structure quickly on the right track in terms of efficiency of resource allocation, while bearing in mind its implications for horizontal and vertical equity. The belief is that continued inefficiency of resource allocation as well as unequal treatment of comparable taxpayers caused by the tax system would be very costly in terms of loss in output. This group also believes that the ideal tax structure would be simple and therefore easy to implement.

The second line of thought reflects greater immediate concern for the macroeconomic implications of continued large fiscal deficits that could result from the first approach. The preferred alternative is to close or reduce the fiscal deficit as a first objective and then to think of tax reform in its purest form. This is based on a fundamental opinion that the trajectory to an ideal tax system would not be simple. Instead, it would be time consuming and could lead at least to transitory loss in revenue.

The important features of the respective tax structures can be spelled out as follows. The first would include:

(1) a broad-based and, preferably, a single-rate value added tax ("VAT") that would be the mainstay of the tax system in terms of its revenue generation capacity founded on a wide base with as few exemptions and as low a threshold as possible, with credit allowed for VAT paid on capital goods purchases, to minimize inefficiency in resource allocation; the VAT would be based on the invoice and accruals methods, and be designed according to the destination – as opposed to the origin – principle of taxation to minimize tax competition and to facilitate tax administration;

(2) a short list of traditional excises on alcoholic beverages, petroleum products, tobacco products and a maximum of two or three other products considered luxuries in a particular society;

(3) a corporate income tax with a single rate, equal to the top personal income tax rate, clear accounting rules for tax purposes as distinct from financial purposes, adequate provisions against arbitrary burdens on the taxpayer of inflation and equal treatment of domestic and foreign

1. They cover Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan. The scope of the paper is not to provide a description of individual tax systems, which are continually changing; rather, it is to identify their policy content in an attempt to point toward necessary improvements.

2. On related "big bang versus gradualism" issues for overall economic policy, refer to Borensztein (1993). See Shome (1993) for fiscal issues in particular.

© 1994 International Bureau of Fiscal Documentation

investors coupled with regulations to counter transfer pricing problems that are likely to arise with increased foreign investment;

(4) a personal income tax with a rate structure in the range of 10 to 30 percent, a high level of personal allowance in the range of two to four times per capita GDP and few or no additional deductions;

(5) a property tax to be instituted at the beginning in the urban areas as urban properties are privatized and to rural areas as agricultural land is privatized;

(6) customs duties rates within a low and narrow range of 10 to 30 percent – perhaps even a single rate – complemented with a minimum duty for purposes of revenue generation; and

(7) the abolition of all export duties because they inhibit international competitiveness as well as small nuisance taxes so that the tax administration can focus on the important taxes.[3]

In short, the first group espouses the ideal tax structure that many market economies strive toward. This is based on the belief that, since the NIS are starting afresh, it would be easier for them to aim directly at the ideal.[4]

The second group finds fault with the above argument on mainly two grounds. First, the NIS are not beginning from a non-existent tax structure. In fact, the NIS have operated a mechanism for government revenue generation, however inefficient, for decades. Second, dismantling that structure and replacing it with the ideal one would require, at least, a medium-term effort. In the interim, in many cases, the problem of an increasing ratio of fiscal deficit to GDP – revenues falling faster even as government spending is decreasing – needs to be addressed. Therefore, there have to be transitory tax packages that would definitely have a greater revenue-generating capacity in the short run. They might include, among others:

(1) wide use of tax withholding from wages, interest and dividends, even with an underlying global concept – if not strict adherence to the concept – of personal income taxation;

(2) extraordinary tax bases – for example, one that includes all or part of wages – for companies in the absence of rapid privatization while keeping the tax simple and widely based;

(3) a long list of excises or production taxes;

(4) a rudimentary production-type VAT up to the importer-manufacturer level;

(5) relatively high rates of import duties and a temporary continuation of export duties; and

(6) land taxes that would cover rural as well as urban land.

Our objective is not to select one approach over another. Rather, it is to identify whether the current tax structures of the NIS fit within these two alternatives. This is what we turn to next.

III. NIS TAX STRUCTURES[5]

This section has two objectives: (1) to present the prevailing tax systems and offer comments on their suitability; and (2) to assess whether they adhere to either of the two approaches described in the previous section.

A. Value added tax

A VAT was enacted in the NIS on 1 January 1992, replacing most turnover taxes. When the VAT was introduced, a high rate – 28 percent – was considered necessary at least in the short term to sustain revenues at a level comparable to the old turnover taxes.[6] The rate has been lowered recently in many republics, although it is still generally high. In Armenia, Tajikistan and Turkmenistan the rate is still 28 percent; Uzbekistan has reduced it to 25 percent; and Azerbaijan, Kazakhstan, Kyrgyzstan and Moldova to 20 percent. In part, the reductions have been obligated by initial moves by Russia. Most of the VATs are origin-based in the intra-NIS context (see below). It is not surprising, therefore, that a decrease in the VAT rate in one republic will prompt matching moves by trade partners.

The generally high rate of VAT has led to multiple pressures for exemptions and reduced rates. The pressures also stem from the inclination to use tax policy for the purpose of economic planning and income redistribution. As a result, the number of rates and exemptions have tended to increase across republics, with many variations in the combination of rates and exemptions.

In general, technical assistance advice goes in favour of VAT structures that allow credit for the VAT paid on capital goods purchases. When the existing VAT does not possess this feature, such recommendations generally allow a transition phase toward full implementation of credit for capital goods purchases, keeping in mind revenue considerations. However, the prevailing VATs do not allow such credit. Also, they do not have any phasing-in plan for such credit to be allowed.

The NIS have chosen the origin principle for trade among themselves. That is, exports are taxed and imports are not. The standard international convention of destination-based taxation, with zero-rating of exports and regular taxation of imports, makes the VAT neutral with respect to international trade, effectively isolating domestic markets from foreign VAT changes. Origin-based taxation, on the other hand, requires strong coordination of domestic tax policies. In this case, the tax content of virtually any commodity – tradeable or not – is determined by the taxes prevailing in its origin, embodied in its inputs (and inputs of its inputs, and so on). Thus, differences in rates and exemptions among republics would tend to spread distortions in relative prices across bor-

3. The area of international trade taxes needs much action as the NIS grapple with as yet open issues of intra-former Soviet Union trade, trade with the rest of the world, and so on. In sum, their tariff policies are yet to be developed. This area of taxation is not considered in the paper.

4. Some, for example, McLure (1991), have also used this argument to recommend new or untried taxes such as the cash-flow tax for economies in transition.

5. The tax structures reflect those in existence in the early part of 1993. Subsequent changes may have taken place. The intention here is to provide a flavour of the tax complexity and rapid changes that are taking place continuously in the tax structures.

6. Turnover taxes constituted a very important source of revenue – around 12% of GDP and 30% of total tax revenue – in the former Soviet Union. See Tanzi (1991).

© 1994 International Bureau of Fiscal Documentation

ders. In turn, the emergence of market-oriented economies should witness increasing attempts at export competition through exempting, zero-rating or under-taxing exportable goods. Corresponding matching moves in importing republics, under-taxing domestically produced goods, are likely to multiply, eroding the VAT base and complicating VAT administration.[7]

Armenia and Azerbaijan apply the invoice-based system for tax computation. Moldova, Turkmenistan and Uzbekistan use a method based on the accounts of the firm. Kyrgyzstan applies different accounts-based systems to manufacturers and retailers: manufacturers are allowed credit for the tax content of inputs effectively used in production while retailers compute tax liabilities as a percentage of mark-up. This requires the maintenance of detailed separate accounts and keeping track of which inputs are used in the production of individual outputs. Finally, Kazakhstan uses the invoice method for manufacturers and the accounts-based method for retailers.[8] The known disadvantages of accounts-based VATs are compounded by high inflation that demands frequent computation of tax returns to minimize a fall in the real value of revenue. None of the republics has developed specific accounting regulations to address inflation.

Most NIS countries apply a cash-based VAT – in contrast with common international practice, which is accruals-based. It is usually recommended to switch to an accruals-based VAT as soon as possible. The issue is further complicated by the existence of large volumes of inter-enterprise tax arrears. These may significantly erode the base of a cash-based VAT.[9]

The threshold and criteria for small businesses are also varied. Armenia, Azerbaijan and Turkmenistan apply a threshold based on sales volume although in Armenia and Azerbaijan it has not yet been legislated. Kazakhstan and Tajikistan have established a threshold based on income.[10] Moldova and Uzbekistan do not provide a small business exemption. Thresholds are generally restricted to individuals and do not apply to companies.

Conclusion: The VAT systems currently found in the NIS have already become complicated – perhaps too complicated – for the tax administrations. They generally operate beyond the manufacturer-importer stage; some have a multiple-rate structure; they allow exemptions of various sorts; they use cash rather than the accrual method, and mixes of the invoice- and accounts-based methods of tax computation; they use the origin principle for intra-former Soviet Union trade (and, increasingly, the destination principle for trade outside the former Soviet Union). This has led to tax rate competition within the NIS with the likelihood of further problems and revenue ramifications in the future.

In the authors' view, the VATs are a *fait accompli* since they are already advanced enough not to make it a realistic consideration to return to turnover taxes in any significant way. Indeed, the VATs have become distortionary and are in need of immediate reform. They, therefore, do not really conform to either of the two – optimal or interim – approaches.

B. Excises

Excise taxation, like the VAT, appears to be origin based. In particular, exempting imports from within the NIS from excise taxation is the common practice. Turkmenistan extends the exemption to all imports. With respect to other matters in the excise tax area, the list of excisable goods is being reduced with time and most excises are now set at *ad valorem* rates.

Conclusion: Excises are a commonly used form of taxation and are moving in the right direction. However, there remains the possibility of greater revenue productivity by imposing excises on the imports of excisable products. Also, excises should be imposed on the basis of the destination principle, since the same arguments apply here as in the case of the VAT.

C. Enterprise profits tax

The NIS could still be characterized by a high degree of state ownership of enterprises commensurate with difficulties in rapid privatization. This might throw some light on the rationale behind certain common provisions found in the enterprise profits tax laws that appear to be tailored to public enterprises and to heavily regulated markets. The development of market-oriented private sectors should eventually result in the revision of many segments of the present laws.

1. Tax rate

The central rate is comparable to international standards in Kazakhstan, Tajikistan and Turkmenistan with 35 percent, Moldova with 32 percent, Armenia with 30 percent and Azerbaijan with an average rate of 28 percent. Uzbekistan has a basic rate of 18 percent. Given the acknowledged need to generate revenue, moderately higher rates could be considered.

The rate structures usually comprise some form of progressivity. For instance, in Moldova extraordinary profits are taxed at 80 percent. A firm is considered to have extraordinary profits when the ratio of profits to costs is more than twice the average, which is administratively determined. In Tajikistan, extraordinary profits (above 50 percent of costs) are taxed at 90 percent. The average statutory tax rate can reach 70 percent in Azerbaijan and Kazakhstan, and 60 per-

7. Another disadvantage of origin-based taxation is that it will force a different treatment of trade among NIS countries as compared with the rest of the world. Most of the republics do not yet have significant international trade with non-former Soviet Union countries. Also, existing trade is handled by a handful of public enterprises applying ad hoc rules. This situation should change in the near future and a consistent tax treatment of imports and exports under the VAT will be needed.

8. In the present context, accounts-based VAT refers to the method used in some NIS countries, mainly at the retail level. According to this method, VAT liability is determined as a percentage of the mark-up on sales. It necessitates detailed accounting of inventories, sales of different products, and use of inputs.

9. For a detailed analysis of this and other characteristics of VAT implementation in NIS countries, see Silvani (1992).

10. Since it is not uncommon for firms with a high sales volume to report low profits or even losses, thresholds based on sales can be expected to be more revenue productive.

© 1994 International Bureau of Fiscal Documentation

cent in Uzbekistan and Turkmenistan. In general, special – higher – rates apply to banking, insurance and financial intermediation.

Despite particular motivations leading the NIS to introduce multiple enterprise profits tax rates, there are many arguments against progressivity. First, profits in some industries are intrinsically erratic, a year's high profits compensating another year's losses. This problem is further aggravated by a commonly found lack of loss carry-forward provisions. Second, the possibility of high profits could be a much needed incentive for increased investment specially in risky sectors. After the initial ground-breaker entrepreneurs have obtained significant profits, competition is likely to drive profits to normal levels. Third, the lack of financial intermediation and mature banking sectors is an important cause for minimizing discriminatory tax rates against the financial sector and profits obtained by it. Indeed, the financial system may need to be temporarily subjected to a preferential regime.

2. Tax base

During the last few years, due to uncertain economic prospects and weakened government control over public enterprises, there has been a tendency among upper-level employees to award themselves disproportionately high salaries. In an attempt to curb this trend, the authorities, with the exception of Armenia, Kazakhstan and Tajikistan, have included wages (Uzbekistan) or "excess" wages (Azerbaijan, Kyrgyzstan, Moldova and Turkmenistan) in the base of the enterprise profits tax. Excess wages are defined as that part of the wage bill that exceeds four times (or six in Kyrgyzstan) the minimum wage multiplied by the number of employees. This provision, intended to obviate a problem specific to the public sector, applies, nevertheless, to all enterprises.

Even among public enterprises, the effectiveness of the measure may be questioned. Since excess wages are calculated in comparison with the firm's average wage, the levy may encourage wasteful hiring of low paid employees.[11] In any event, the prospect of reduced after-tax profits is unlikely to dissuade managers, who do not own the firm, from awarding themselves higher wages. The issue should be considered beyond the purview of fiscal policy and will only be solved by strengthened, competent and independent control of public enterprises, advances in the privatization process and development of competitive labour markets.

For private enterprises, the tax on excess wages penalizes firms that employ a work force with higher training and productivity. In the case of Uzbekistan, where the entire wage bill is part of the tax base, the profits tax is equivalent to a standard corporate income tax plus a payroll tax. The unconventionality of the tax base, when it applies to foreign companies, also raises the issue of whether the tax can be credited against the corporate income taxes due in their home countries.

3. Depreciation

A point that remains to be resolved in much of the NIS relates to depreciation deduction rules. In Kyrgyzstan, depreciation is a deductible business expense only to the extent that funds are set aside in a separate sinking fund or are used to repay debt. In Tajikistan, the law allows immediate deduction for new investment expenditure for the amount in excess of the original value of the capital goods which are being replaced and, then, normal depreciation of the full value of the new capital goods is also allowed. Turkmenistan has some deductions that amount to a double depreciation deduction and ad hoc depreciation schedules are issued every year. Uzbekistan allows deductions for repayment of some loans used to buy capital assets, which again, amounts to double depreciation deductions. Moldova allows both accelerated depreciation of full value of the asset and tax credit for part of it.

The issue is further complicated by high inflation, obsolete equipment and the desire to give investment incentives. Some form of linear depreciation, to be applied within a shorter time frame (three to five years for capital assets and ten years for buildings) has often been recommended in technical assistance advice as a temporary measure.

4. Multiple objectives

A common characteristic of all enterprise profits taxes surveyed seems to be the spread of exemptions and special privileges depending on a variety of – and, on occasion conflicting – objectives. This feature tends to generate pressures to multiply further the number of different rates. There is a clear tendency to use profit taxation as an instrument of economic and social engineering. Sometimes the objectives themselves are outdated. For example, there is a general bias in favour of manufacture and against production of services ("unproductive labour"), especially financial services and entertainment (other than culture and sports) through the use of differentiated rates and exemptions. The efficiency of the market mechanism for allocation of resources requires neutrality of profits taxation. Furthermore, exemptions and multiple rates erode revenue, make tax administration difficult and facilitate tax avoidance and evasion.

Most of the special treatment provisions that beset all the profits tax laws are intended as domestic and foreign investment incentives. Azerbaijan, Kazakhstan, Moldova, Turkmenistan and Uzbekistan grant tax holidays (usually two years) for foreign or joint ventures. Some grant similar exemptions for investment in the production of consumer goods, non-traditional exports, etc. Temporary reduced tax rates for new firms or exemption of profits obtained by increased production are also common.

Agricultural enterprises receive favourable treatment. In Turkmenistan, collective and state farms are exempt from enterprise profits taxation and new firms producing agricultural products are given a tax holiday of two years. In Kazakhstan and Uzbekistan, farms and agricultural production are fully exempt from profits taxation. In Kyrgyzstan, they enjoy

11. Let W1 be the wage bill such that W1 = w x n, where w is the average wage and n is the number of employees. Let W2 be the threshold such that W2 = 4 x minimum wage. Then excess wages may be defined as:

W1 – W2 = (average wage – 4 times minimum wage) x n.

Thus, there would be a tendency to maintain an average wage near 4 times minimum wage in order to reduce the possibility of incurring "excess wages".

© 1994 International Bureau of Fiscal Documentation

a general temporary exemption and, thereafter, a reduced rate of 10 percent. In Moldova, the enterprise profits tax rate for farming is 1.5 percent (or 10 percent of income, including wages, if it is a cooperative).

5. Payment methods

Advance payments are required once or twice a month and returns are filed, at least, once quarterly, with the objective of reducing the erosion of real revenue in an inflationary environment. There is no perfect solution to avoiding the Tanzi effect – loss in the real value of revenue due to lags in tax collection – short of attacking its cause, that is, reducing inflation. Nevertheless, the revenue loss can be minimized by requiring frequent advance payments based on past returns and updated by some index of inflation, and restricting the return filing requirement to once or twice a year. This could be specially relevant for small businesses who do not usually practice sophisticated bookkeeping.

Conclusion: The enterprise profits tax conforms to neither the optimal nor the interim approach. In neither approach is a multiple-rate tax recommended as is the common practice currently. Neither approach favours the wide use of incentives, causing widespread erosion of the base, as is the case today in the NIS.[12] The systems suffer from multiple – and conflicting – objectives, making the tax very complicated and distortionary. Technical aspects of the tax, such as depreciation rules, and (the lack) of inflation adjustment, on the other hand, lend a rudimentary aspect to the tax. These need to be quickly corrected since the problems they generate are immediate. Finally, while the interim approach would accommodate inclusion of wages in the tax base of public enterprises, in practice the systems are quite complicated inasmuch as they are based on the excess over minimum wage, leading to widespread distortions. Its application to the private sector also adds to anomalous complications of the particular construction of the tax base. Much remains to be improved, as a result of all these problems, in the area of the enterprise profits tax.

D. Personal income tax

A common feature is the schedular character of the income tax (with the exception of Armenia). Generally, wages, dividends and interest, and entrepreneurial income are taxed differently without global assessment of overall earnings. Taxation of wages is collected at source through withholding and provides the bulk of the income tax revenues. This is adequate for it provides frequent and regular payments and simple administration.

The schedule for wage and entrepreneurial income is progressive with a minimum rate of 12 percent and a maximum of 60 percent in Azerbaijan, Tajikistan and Uzbekistan, 50 percent in Turkmenistan, and 30 percent in Armenia (global income), Kazakhstan and Moldova. In Armenia, Azerbaijan, Tajikistan, Turkmenistan and Uzbekistan, most taxpayers tend to fall within the 12 or 15 percent tax rate bracket. Therefore, the high marginal tax rates do not provide significant revenue while still having negative incentive effects. The threshold is generally equal to the minimum wage. A package of reform measures that could enhance revenues would include: (1) indexing brackets and the threshold with inflation, (2) reducing marginal tax rates, (3) increasing the minimum tax rate, and (4) reducing the size of the lower brackets, in such a way that the revenue gain of the last two measures should offset the revenue loss from the first two.

Taxation of entrepreneurial income and the income of self-employed individuals is, and will be, a delicate issue during the transition to a market economy, and difficult even after the transition. Since an important part of the thrust of the transition lies in entrepreneurial activities, tax policy has to avoid discouraging them without creating possibilities for tax avoidance. The problem is compounded by the usual difficulties in identifying taxpayers and assessing their incomes. The method of choice has been to establish licence fee payments in lieu of income taxes. Although licence fees may be adequate during the initial stages, with the development of a larger and diversified private sector, they will have to be complemented with a more versatile and sensitive approach to income assessment. A possible intermediate method which has been recommended in selected NIS is to complement licences with a presumptive tax based on clear and objective criteria (e.g. the size of the business premises, location and the number of employees). This could then constitute the forerunner of a self-assessment return filing scheme for entrepreneurs with income over a set threshold. However, an accounting-based estimate of income might have to be complemented with some form of presumptive taxation, such as the gross assets tax used by some Latin American countries.

As in enterprise profit taxation, the multiplication of exemptions, special rates and privileges has to be singled out as the main drawback of the personal income tax laws in the NIS. Certain sectors, typically incomes from agricultural activities, receive special treatment in different forms. For example, in Moldova, farmers and farm workers are currently exempt from personal income taxation for five years.

In general, exemptions and special treatment provisions are designed to protect low-income individuals, large families, the handicapped, etc. A minimum threshold and possible fixed allowances for dependents from the immediate family are a better and more efficient way of introducing these concerns into the personal income tax. Exemption of a given proportion of income benefits higher-income households, without affecting the most needy, who would be below the existing threshold in any case. Therefore, lump-sum allowances are to be preferred to exemptions of income. Programmes funded through the budget can better target and reach the sectors needing special attention. Under the present system, income tax privileges overlap with existing welfare programmes in ways which are difficult to detect. Further, special rates and exemptions complicate administration of the

12. Arguably, there could be an interim role for narrowly targeted tax and non-tax incentives for important, "engine-of-growth", sectors, as was the case for post-World War II Japan. See Shome (1993) on this issue. The nature of tax incentives in the NIS does not seem to be confined to very few economic activities; their objectives are more broadly defined.

© 1994 International Bureau of Fiscal Documentation

personal income tax. In Turkmenistan, exemptions and low-rating rules have led to the requirement that bookkeepers of enterprises be trained and certified by the tax service in order to implement the withholding of taxes of employees.

Conclusion: Existing personal income tax systems tend to fall in between the optimal and interim approaches. On the one hand, final withholding of wages is common while withholding of interest and dividends may still be impractical (while financial earnings are still low and the nascent financial sector cannot be discouraged). On the other hand, top marginal tax rates are very high; there is experimentation going on regarding the taxation of entrepreneurial income; and there is a generally widespread occurrence of privileges, that is, the tax structure is encumbered by multiple objectives. Again, as in the cases of the VAT and the enterprise profits tax, reform and simplification of the personal income tax is already called for, even before the full development of a widely based global tax.

E. Land and assets taxes

International experience reveals that taxation of agriculture, except in the case of formal enterprises, is a difficult issue. Land taxes may play a role in bringing agricultural income into the tax net, especially since land taxes could be conveniently introduced at the moment of privatization. A cadastre would exist immediately. Also, the sale of land need not recuperate immediately the present value of land. Instead, the latter could be divided into the sale value plus the present value of the stream of tax revenue from the piece of land. This would facilitate participation by poorer farmers – who do not have access to credit – in acquiring land through the privatization process while preserving government revenues. At present, land tax legislation is being drafted or has been enacted in most republics.

A tax on fixed or book assets of state enterprises has been proposed as a means to obtain a minimum return on past government investments. Such a tax exists in Armenia. Assets taxes covering public and private enterprises exist in Turkmenistan and Uzbekistan (1 percent rate).

Conclusion: If, in the interim approach, taxes such as the land tax are to be used, there is great need for them to be quickly developed and implemented. On the contrary, agricultural income seems to be favourably treated in much of the NIS; it does not seem, therefore, that much of a likelihood exists for the land tax to be utilized in a serious manner very soon. However, there is some evidence of the utilization of an assets tax to obtain a minimum return from past government investment. This tax could be transformed into a gross assets tax on all enterprises – public and private – with a credit for profits taxes paid. It would function, therefore, as a minimum profits tax. Such a form of presumptive taxation has been successfully used in Argentina and Mexico.

IV. CONCLUDING REMARKS

Even as modern tax policy is taking form in the NIS and, while recognizing that they may have come a long way from the system of transfers typical of a command economy, it would be pertinent to note that NIS tax systems are rapidly acquiring complex, distortionary features. Most of the taxes conform neither to an optimal tax structure design, nor to a simple – though distortionary – interim tax structure focused on closing the fiscal deficit. Needless to say, nascent tax administrations could hardly be expected to implement these tax structures efficiently. As a result, much remains to be improved in the tax systems.

While it is not the purpose of this paper to analyse the causes behind this situation, it may be worthwhile to list them if a correction is to be considered important. First, the NIS were operating their own complex tax/transfer mechanisms – reflecting social considerations as well as priority activities – before the period of change. Some of the current practices – even though modified – reflect old centralized operations in favour of intervention and differentiation. Effort has to be made in steadily reducing such methods. Second, many NIS are still in the phase of casting their tax policies in the model of (or as a reaction to) the Russian Federation. Third, the NIS are receiving technical assistance from diverse sources. Their tax policies reflect a mix of such advice. For example, European thinking on the VAT with the accommodation of multiple rates is different from that based on wider experience, inclusive of Latin America and Asia, which tends to indicate that multi-rated VATs are difficult to administer. Or, some experts may think that a modified cash-flow tax may be ideal in a fresh environment while others may think it to be quite complex as a starter (Tait, 1992). Therefore, the least to hope for is that NIS tax policy might reflect the best of diverse technical assistance, rather than the worst. Fourth, experience in both West and East Europe reveals that tax reform is a complex process and may be expected to be the same in the NIS. Long preparation is needed for major tax reform even in industrial countries, such as Germany and the Netherlands, to name just two, in terms of tax administrator and taxpayer education, as well as in terms of the fruition of the process – from tax policymaking, to giving it legal form, to putting it into action. In East Europe, such as in the Czech Republic, tax packages have had to be withdrawn after their announcement and publication, to be ratified later in a modified form, through a referendum.[13] Similarly, in the NIS, already, tax packages proposed by the executive branch of government – reflecting, for example, technical assistance recommendations of multilateral institutions – have not been accepted by the legislative branch. This simply implies that tax reform will be a slow process, as experienced in many countries in Latin America or East Asia where fundamental tax reform can be said to be taking hold after decades of experimentation.

To conclude, tax policy education in the NIS needs to be continuous, rather than in fits and starts, so that a smooth tax reform process may evolve. Complex tax policies should not be contemplated until the preparedness of the new authorities is readily apparent. However, external opinions can, at best, influence but not necessarily change overnight their existing and, often, firm convictions. A steady effort at such a modifi-

13. Also, see Gordon (1992) on Poland, and Kopits (1993) on Hungary.

© 1994 International Bureau of Fiscal Documentation

cation, which could be expected to be prolonged, needs to be kept up.

REFERENCES

Borensztein, Eduardo, "The Strategy of Reform in the Previously Centrally Planned Economies of Eastern Europe: Lessons and Challenges", IMF Paper on Policy Analysis and Assessment, PPAA/93/6 (Washington: International Monetary Fund, 1993).

Gordon, Roger H., "Fiscal Policy During the Transition in Eastern Europe", paper presented at the Conference on the Transition in Eastern Europe, National Bureau of Economic Research, 26-28 February 1992, unpublished.

Kopits, George, "Hungary: A Case of Gradual Fiscal Reform", in *Transition to Market: Studies in Fiscal Reform*, ed. Vito Tanzi (Washington: International Monetary Fund, 1993).

McLure, Charles, *A Consumption Based Direct Tax for Countries in Transition from Socialism*, The World Bank, Country Economics Department Working Paper Series No. 751 (Washington: The World Bank, 1991).

Shome, Parthasarathi, "Transition and Transformation: Fiscal Sector Issues in Kazakhstan", in *Transition to Market: Studies in Fiscal Reform*, ed. Vito Tanzi (Washington: International Monetary Fund, 1993).

Silvani, Carlos, "VAT Implementation in the CIS", Topical Seminar Series (Fiscal Affairs Department, International Monetary Fund, June 1992).

Tait, Alan A., "A Not-so-Simple Alternative to the Income Tax for Socialist Economies in Transition", *The World Bank Research Observer* (Washington) Vol. 7, No. 2 (July 1992), pp. 239-48.

Tanzi, Vito, "Tax Reform and the Move to a Market Economy: Overview of the Issues", in *The Role of Tax Reform in Central and Eastern European Economies* (Paris: OECD, 1991).

_____, ed., *Transition to Market: Studies in Fiscal Reform* (Washington: International Monetary Fund, 1993).

Tax Systems: Selected Features

COUNTRY	VALUE ADDED TAX	ENTERPRISE PROFITS TAX	PERSONAL INCOME TAX
Armenia	Rate: 20%. Invoice-based system. The base includes goods and services and virtually all agricultural products (there is a list of exemptions). Excises are part of the base. Exports outside the NIS are exempt (zero-rating of exports and regular taxation of imports from outside the NIS is under discussion). VAT paid on capital assets is not deductible. Although it is not stated in the law, a threshold for individuals based on sales volume is operative.	Progressive four-rate structure based on annual profits. Rates: 12-18-25-30%. Banking and insurance: flat rate of 45%. Partnerships and self-employed entrepreneurs are taxed under the personal income tax. Excess wages (part of the wage bill above five times the minimum wage times the number of employees) are taxed through a separate tax.	Tax rates have been aligned with the enterprise profits tax. Interest income is exempt. There are many other exemptions. Taxes on wages are withheld at source.
Azerbaijan	Rate: 20%. Invoice-based system. The base covers goods and services with a list of exemptions. Excises are part of the base. There is a threshold based on sales volume that applies to self-employed individuals.	Three progressive marginal rates: 25-30-35%. Banking and insurance: 45%. Multiple special rates from 6% to 70%. A modified cash basis method is employed. Foreign investors can get up to three years tax holiday under some circumstances. Deduction of "excess wages" (portion of the wage bill that exceeds four times the minimum wage multiplied by the number of employees) is not allowed.	Schedular, with three main types of income: Wages, royalties and entrepreneurial. Rates range from 12% to 60%. Most taxpayers fall within the 12% rate bracket. Entrepreneurial income is taxed through fees in lieu of income tax.
Kazakhstan	Rate: 20% (10% for some products). Exports outside the NIS, meat, butter and many goods and services are zero-rated. Excises are part of the base. The manufacturing sector applies an invoice-based method. Credit for VAT paid on capital assets is not allowed. There is a threshold based on income that applies to self-employed individuals.	Standard rate: 25%. Special rates range from 55% to 70%. Profits derived from agricultural production are exempt. Dividends and interest are subject to a withholding tax of 15%. Reserve formation (up to 50% of profits or 25% of statutory capital) and profits reinvested under some conditions are exempt. There is a two year tax holiday for investment in selected sectors.	Schedular. Rates range from 12% to 40%. Taxes on wages are withheld at source. The general deduction for employees and deductions for dependents are the minimum wage. Social insurance benefits are exempt. There are many exemptions and deductions. Special exemptions and deductions apply to foreigners. Non-labour income of non-residents is taxed at 20%.
Kyrgyzstan	Rate: 20%. VAT paid on capital assets is not deductible. In the manufacturing sector, credit is allowed for VAT paid on purchases effectively used in the production of sales. Retailers apply VAT on the mark-up.	Multiple rates centered around 35%. The base includes "excess wages" (portion of the wage bill that exceeds six times the minimum wage multiplied by the number of employees). Amortization is a deductible expense only to the extent that funds are set aside in a sinking fund or used for repayment of debt. There are many investment tax incentives. There is no loss carry-forward provision.	There are many exemptions of particular types of income. Tax on wages is withheld at source.

© 1994 International Bureau of Fiscal Documentation

COUNTRY	VALUE ADDED TAX	ENTERPRISE PROFITS TAX	PERSONAL INCOME TAX
Moldova	Rate: 20%. There is no zero-rating for exports. Computation of liabilities is based on the substraction method. There is no threshold for small business.	The main rate is 32%. Special rates apply to farming (1.5%), enterprises providing community services (25%) and cooperatives (from 10% to 50%). A special rate of 80% applies to "excess profits" (when the ratio of profits to costs exceeds some percentages established by the law). The base includes "excess wages" (portion of the wage bill that exceeds four times the minimum wage multiplied by the number of employees). There is a tax holiday of two years for new small enterprises producing consumer goods, enterprises with foreign participation and other. There are many investment tax incentives.	Schedular. Rates range from 12% to 50%. Taxes on wage income are fully computed and withheld by the employer. There are many exemptions.
Tajikistan	Rate: 20%. Exports outside the NIS are exempted but not zero-rated. VAT paid on capital assets is not deductible. There is a small business threshold based on income.	Progressive rate structure around a basic rate of 45%. Banking and insurance: 45%. Agricultural enterprises: 25%. If the ratio of profits to production costs is higher than 50%, a marginal rate of 90% may apply. Joint ventures: 30%. Joint ventures enjoy other tax advantages (loss carry-forward, deductibility of interest paid, etc.). There is no loss carry-forward nor deductibility of interest on long-term loans for domestic enterprises. There is immediate deduction for new investment expenditures for the amount in excess of the original value of capital goods replaced and depreciation based on their full value. Certain loan repayments are deductible. There are many investment incentives and tax holidays for newly created enterprises. Amortization rules are determined every year by the Gosplan for each sector and type of good.	Schedular. Rates range from 12% to 60%. There is no minimum income threshold except for wage earners. Tax on wages is fully withheld by employers. Social insurance benefits are exempt. Income from interest is exempt but not from dividends. Income used to buy state properties is exempt.
Turkmenistan	Rate: 20%. No credit is allowed for amortizable assets. Computation of liabilities is based on the substraction method. There is a small business threshold based on sales volume.	Rate: 25%. The base of the tax are profits after distribution of dividends and "excess wages" (portion of the wage bill that exceeds four times the minimum wage multiplied by the number of employees). Dividend and interest income is exempt and taxed apart (15%). Some sectors are taxed at 60%. There are tax holidays for new enterprises in agriculture and production of construction materials. Profits due to increased production in food and other sectors are exempt.	Schedular. Workers: exempt minimum. Rates rage from 12% to 30%. Entrepreneurs: no exempt minimum. Rates range from 12% to 50%. Royalties: rates range from 4% to 90%. Tax on wage income is fully computed and withheld by employers. Many exemptions and deductions; among them, collective farm workers, small farmers, social insurance benefits, unemployment benefits and severance payments.
Uzbekistan	Rate: 25%. VAT extends only through the manufacturing sector. VAT is applied on imports outside the NIS. Corresponding exports are exempt but not zero-rated. The base includes excises but not custom duties. Credit for VAT paid on capital assets is not allowed.	Tax on profits and wages. The basic rate is 18% but specific rates by sector range from 12% to 60%. Joint ventures with more than 30% foreign capital have a special rate of 10%. There are many exemptions and tax holidays affecting mainly foreign investment, new enterprises and the agricultural sector. Local councils may grant further privileges.	Schedular. Minimum exempt equal to minimum wage. Rates: from 12% to 60%. For royalties, rates may be higher. Tax on wage income is fully computed and withheld by main employer. Many exemptions and deductions; among them, collective farm workers, small farmers and social insurance benefits. Some types of interest income are exempt, dividends are not.

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND

TAX IMPLICATIONS OF THE NEW COMPANIES ACT 1993

Adrian J. Sawyer

*M. Com (Hons), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand, **Adrian Sawyer** is a lecturer in taxation and commercial law in the Department of Accounting, Finance and Information Systems at the University of Canterbury, Christchurch. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a consultant for the New Zealand Treasury on effective tax rate research and is a member of the New Zealand Society of Accountants and is on the Canterbury/Westland Branch of the Society's Tax Committee. Previously he was an investigating accountant with the New Zealand Inland Revenue Department.*

I. INTRODUCTION

Recently the New Zealand Parliament enacted one of its most dynamic pieces of legislation impacting upon the activities of the commercial community in New Zealand: the Companies Act 1993 ("the Act"). The previous legislative environment for companies was the Companies Act 1955, modelled on the 1948 UK Companies Act. Company law in New Zealand has attempted to catch up with the demands and practices of business in the 1980s and 1990s. The legislation has its foundations in a Ministerial directive made during September 1986 when the New Zealand Law Commission was requested to review the 1955 Act. In 1990 a Companies Bill was introduced to the New Zealand Parliament. Seven years after the initial directive was given to the Law Commission, a Law Commission Report, discussion document, public submissions to Parliamentary Select Committees and widespread concern from the business community over perceived draconic obligations imposed upon directors (leading to a significant number of resignations), the legislation finally emerged in September 1993. The package has been described as a *juggernaut* by the current Minister of Justice, Hon. Doug Graham.

However, in spite of the widespread coverage of the company law reform package and the measures to update related legislation, the taxation implications were not addressed in the September 1993 package. With the effective date of the companies legislation set for 1 July 1994, a nine month time frame has been provided to discuss the taxation implications of the company legislation and enact the necessary legislation (presuming the implementation date is 1 July 1994). Just before the Christmas break on 22 December 1993 (a typical period for the release of important proposed tax legislation changes in New Zealand, providing some vacation reading for practitioners and advisers), the Government released a discussion document entitled: "The Taxation Implications of Company Law Reform".

The purpose of this article is to outline the principal recommendations of this discussion document and analyse the implications of the recommendations on existing tax law in New Zealand. Essentially the document discusses the tax implications of four major areas of change in the Companies Act 1993; share repurchases, amalgamations, tax accounting issues and miscellaneous issues relating mainly to terminology changes. Each of these four areas is reviewed and several of the more controversial aspects highlighted. The document attempts to facilitate the development of the previous and current Governments' objectives of a "level playing field", where taxation should not influence the decision-making process in favour of one approach over another.

This article is structured as follows. In Part II, the underlying philosophy of the discussion document is explored. Part III reviews the core issues of the discussion document, with the proposals for the tax treatment of share repurchases presented first. The tax implications for company amalgamations are summarized and an overview of the tax accounting implications of the legislation are also set out. Several other minor issues are mentioned. Some overall conclusions are offered in Part IV.

II. THE UNDERLYING PHILOSOPHY: INTEGRATING AND BALANCING COMPANY LAW FLEXIBILITY WITH EFFECTIVE TAX LEGISLATION

The discussion document assesses the implications of the company law changes for income tax rules. At the commencement of the document, the purpose is clearly stated and should be foremost in assessing the approach and commercial desirability of the recommendations:[1]

> The purpose of this document is to put the Government's perspective on the issues before the taxpaying community as part of the process of undertaking widespread consultation on tax policy changes. The Government seeks to ensure that the reasons for tax policy changes are well understood and that, before they become law, tax policy changes are properly worked through with those in the private sector who will operate under them.

The sentiments of this statement are admirable; indeed New Zealanders' are frequently provided with the opportunity to make submissions on government policy recommendations,

1. New Zealand Government, "The Taxation Implications of Company Law Reform" (Wellington, December 1993), at 1.

© 1994 International Bureau of Fiscal Documentation

with varying levels of success. The history of recent tax reform in New Zealand reflects a consultative approach.[2] This discussion paper, while released by the Government rather than an appointed committee, nevertheless invites submissions from tax professionals and the private sector.[3] The document later emphasizes the balancing act between increased flexibility for companies and the need to protect the revenue base, highlighting the influence of the New Zealand Treasury in preparation of the document:[4]

> The Government desires to see taxation law integrate well with revised company law rules. While there is no desire to see taxation provisions inhibit the willingness of companies to take advantage of any increased flexibility that company law changes may confer, the need to maintain the integrity of the tax base must be given due weight. It is unrealistic to assume that because company law changes may increase the ability of companies to restructure or return funds to shareholders, tax imposts on such activities should be removed. Tax rules must be designed to achieve an appropriate balance between the competing considerations of maximising commercial activity and maintaining robust and fair tax rules. Furthermore, the Government seeks rules that provide certainty and that impose as few as possible compliance costs on taxpayers in their day to day operations.

Unfortunately, the balance in some areas is weighted too far in favour of the tax base at the expense of the improved flexibility sought by the new Companies Act, as will be seen later in this article. The document is set out in two parts. Part One contains the tax implications of the company law changes and the tax policy proposed to address the issues. The second part sets out the explanatory note and draft legislation, reflecting changes to the Income Tax Act 1976 ("ITA"), Goods and Services Tax Act 1985, Inland Revenue Department Act 1974, the Estate and Gift Duties Act 1968, and the Stamp and Cheque Duties Act 1971.

The four principal areas for discussion are each assigned a chapter in the first part of the discussion document. Dealing with each of the four areas in the order they appear in the discussion document.

A. Share repurchases

- determining the reserves from which tax-free distributions resulting from share repurchases can be funded;
- determining when distributions by way of repurchases can be attributed to tax-free reserves;
- the mechanism for taxing the dividend component of share repurchases.

The taxation 'dividend' definition is revised to encapsulate the share repurchase that will be treated to some extent as a dividend.

B. Amalgamations

Amalgamating companies, either utilizing the short form procedure under Section 222 of the new Companies Act or the traditional shareholder approved amalgamation procedure, would be permitted to utilize tax-free asset transfer rules based on the existing consolidation regime, allowing tax losses and imputation credits of the amalgamating companies to be retained (subject to shareholder continuity and commonality tests being satisfied). However, dispositions of shares through an amalgamation would remain assessable to revenue account shareholders.

C. Tax accounting issues

Issues considered include conversion of reserve accounts to satisfy the new environment of shares and share capital without the concepts of "par value", "nominal capital" or "share premium". Certain "qualifying share premium" will be permitted to be distributed tax free. Provision for the tax treatment of the rare situation of recovery of excess distributions paid to shareholders is included in this chapter of the discussion document.

D. Miscellaneous issues

The impact of terminology changes in the Companies Act 1993 upon tax legislation is addressed, particularly that of nominal and paid-up capital and removal of the often crucial public and private company distinction. In essence "housekeeping" matters are given due consideration.

III. THE TAX IMPLICATIONS OF COMPANY LAW REFORM

The discussion document is substantial in size, amounting to nearly 120 pages (including the draft legislation). While the tenor of the document is generally positive and provides a useful benchmark upon which to base submissions and refine the eventual legislation, nevertheless there are several proposals that cause real concern. Two substantial areas which, if enacted, will detract from the commendable neutral approach of the discussion document to the tax implications of company law reform, have been termed by two commentators as "unavoidable" double taxation,[5] and the taxation of unrealized capital gains where a company repurchases its shares for a price in excess of net asset backing (as well as the shortcomings in the proposed tax treatment of amalgamations). Each of the four major reform issues will now be outlined with associated comment on its expected implications for the business community.

A. Share repurchases and related issues

The freedom granted to companies to repurchase their own shares is a major change in the underlying commercial phi-

2. For example, the recent discussion documents and consultative committee reports of the 1990s addressing matters of tax simplification (Tax Simplification: Final Report of the Consultative Committee: (Waugh Committee), Auckland, September 1990) and reforms to the Income Tax Act 1976, in a series of discussion papers released by the Consultative Committee on the Taxation of Income from Capital (Valabh Committee) throughout the period November 1990 to early 1992.
3. The two-month period for submissions (from 22 December 1993), is effectively reduced by half for the Christmas period, and closed on 21 February.
4. *Supra* note 1, at 2.
5. S. Titter and C. De Freyne, "Taxpayers – speak now or forever hold your peace – Officials foresee 'unavoidable' double taxation in new regime", *The Independent* (28 January 1994), at 17.

© 1994 International Bureau of Fiscal Documentation

losophy in New Zealand, representing the move toward a North American approach to company law. The share repurchase facility offers greater scope for funds to be returned to shareholders other than by way of a dividend. Consequently there are some restrictive rules proposed in the document to prevent issued capital being returned tax free in lieu of taxable ordinary dividends. The rules are refined further through distinguishing between "on-market" and "off-market" repurchases. The principal recommendations included in the discussion document for the treatment of share repurchases are:

– The Valabh Committee's recommendation[6] that distributions by way of share cancellation or repurchase funded from realized capital profits be tax free is essentially adopted, so long as the distribution is not 'promoted' in substitution for a dividend.

– Where a company purchases its shares on-market, essentially the proposal is for the company to be liable for the tax on the dividend component of the purchase price, with a debit to the imputation credit account ("ICA"); the calculation on the same basis as resident withholding tax ("RWT") on a non-cash dividend. Insufficient imputation credits must be met by a further payment of company tax. The vendor would generally be exempt from tax on the dividend component, leaving the vendor in the same position as if the shares were sold to a third party. An on-market purchase arises when the shares are acquired on a recognized stock exchange through a broker and the seller is unaware of the buyer's identity (a concept which is not clarified in the discussion document).

– To determine the taxable component, a "slice" rule is applied, that is a portion of the repurchase price is deemed to come from any retained earnings and other taxable reserves of the company, and a portion from share capital and other non-taxable reserves. For example, if a company has subscribed capital of $ 100 and retained earnings of $ 100, a share repurchase for $ 100 would have a taxable component of $ 50.

– However, a major drawback of the proposal is the "double taxation" referred to by Titter and De Freyne.[7] Two categories of vendors will be unable to utilize the imputation credit. A corporate shareholder will not receive imputation credits to match the debit in the ICA of the repurchasing company, limiting the opportunity of the corporate shareholder to pass on imputation credits to its own shareholders. Secondly, if the vendor is a share trader, tax may be payable on any gain in value, without any relief for the tax already paid by the buyer on the dividend component. Titter and De Freyne suggest that the imputation credits, in limited circumstances, be permitted to pass on to the seller, but with restrictive uses to which these credits may be applied. The arguments of some other commentators to allow all on-market purchases to be non-taxable could be accommodated without substantial pressure being applied to the underlying philosophy of the discussion document, since general anti-avoidance rules are seen as being sufficiently robust to handle this situation.

– The off-market repurchase proposals are more intricate, complicated and somewhat contrary to the underlying premise that tax legislation should be directed at reducing complexity and minimizing compliance costs for taxpayers (in this situation, companies). Off-market repurchases are subject to "qualifying capital reductions", under which repurchases are able to be funded partly from tax-free funds. There are what is referred to as "brightline tests" that qualifying capital reductions must satisfy. These tests are "... designed to give a clear, objective determination of when a distribution is a qualifying capital reduction or a qualifying disproportionate reduction as opposed to a deemed dividend".[8] Essentially the tests involve two critical percentages:

- where a repurchase offer is made on a *pro rata* basis, the amount distributed must be at least 15 percent of the market value of the company's shares;
- where a repurchase offer is made on a selective basis, a shareholder's proportionate interest in the company after the repurchase must not exceed 85 percent of the shareholder's pre-repurchase interest.

If the appropriate test in the circumstances is not satisfied, then the repurchase price is a taxable dividend to the shareholder where the normal RWT and imputation credit provisions apply. If the appropriate test is met, then the "slice rule" applies. However, the "slice rule" is modified for the off-market repurchase where the Commissioner of Inland Revenue may determine that the repurchase price is less than the market value. In such event, the amounts of subscribed capital[9] and tax-free reserves returnable are reduced proportionately to reflect this "under value".[10] These "brightline tests" also apply to redemptions and cancellations of shares; hence there are substantial changes proposed to the dividend rules contained in the ITA.

Why have the "magic" figures of 15 percent and 85 percent been selected? One objective of the new Companies Act is to facilitate downsizing of companies, permitting one-off distributions to shareholders partly from tax-free reserves. In terms of the underlying objective to protect the revenue base, the 15 percent level for *pro rata* distributions has been determined to indicate a situation where the repurchase is clearly not in substitution for a dividend. New Zealand listed companies tend to have a dividend yield in the region of 4-7 percent, and the 15 percent level clearly indicates a return of capital. However, as Titter and De Freyne argue,[11] this 15 percent figure is excessively rigid and arbitrary. Should not a repurchase of 12 percent of the company which is a genuine capital reduction be permitted?

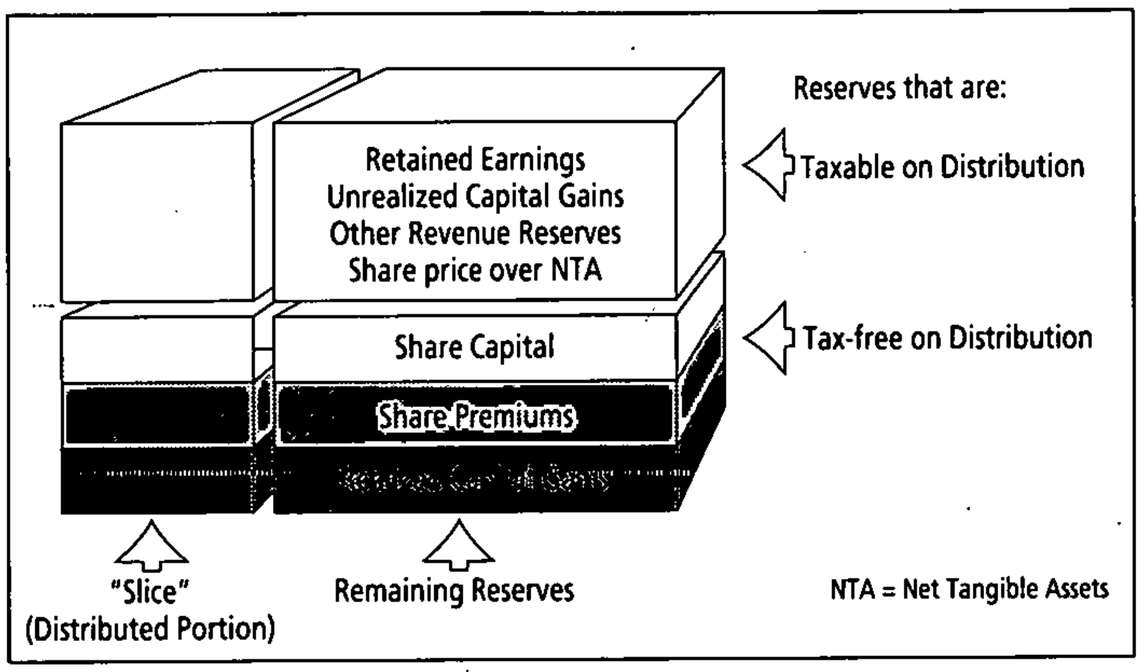
Titter and De Freyne advocate a discretion for the Commissioner to permit such repurchases to be classified as a qualifying capital reduction in spite of the brightline tests. This is

6. Valabh Committee, "The Taxation of Income from Companies (Wellington, July 1991).
7. *Supra* note 5, at 17.
8. Discussion document *supra* note 1, at 17.
9. Subscribed capital is (transitional capital amount [arising from the change between the old and new legislative regimes] + consideration received for all shares in the company of the same classes the shares being acquired – aggregate of subscribed capital amounts previously returned)/aggregate number of shares of the same class on issue immediately before the time of cancellation.
10. The reduced amount is: (Subscribed capital amount + Capital gain amount) x (Price paid/Market price).
11. *Supra* note 5, at 17.

© 1994 International Bureau of Fiscal Documentation

an argument worthy of inclusion in the eventual legislative changes. This approach is justified in light of the residual discretion vested in the Commissioner to deem repurchases that otherwise satisfy the "brightline tests" to be in lieu of a dividend and be fully taxable to the shareholder. The "brightline tests" are clearly one-sided. If a "return of capital" exceeds 15 percent, the taxpayer cannot be certain that the Commissioner will agree with this interpretation. On the other hand, if the return is less than 15 percent, the taxpayer may not argue that the distribution is not in lieu of a dividend (where if this could be argued a portion could be returned tax free). A case of the Commissioner being able to "have his cake and eat it too".

The "Slice Rule"



When a qualifying capital reduction is achieved, application of the slice rule requires the dividend component (the portion which is not the return of subscribed capital and tax-free reserves, such as capital gains) be taxable in the shareholders hands, to which imputation credits (or if insufficient, resident withholding tax be deducted) may be attached. An example may assist to illustrate the indirect taxing of unrealized capital gains. (see Share Repurchase Allocation Calculations).

The share repurchase proposals in the discussion document are yet another example of an indirect capital gains tax in New Zealand. While an explicit capital gains tax is not politically palatable at present, nevertheless New Zealand governments have been prepared to consider ad hoc and often partially disguised taxation of capital gains. This approach frustrates the ability of companies to undertake efficient share repurchases; tax policy yet again imposes unnecessary costs on the business community.

There are also proposals for the treatment of repurchases from non-resident shareholders, where non-resident withholding tax ("NRWT") will need to be deducted. A non-resident company repurchasing off-market would create a dividend for the New Zealand resident shareholder under the existing rules and the Government wishes to maintain this position. Conversely, there would be no tax implications where a non-resident company repurchases from a New Zealand resident on-market, since the jurisdictional and administrative difficulties would outweigh any potential revenue gains. A summary of the tax treatment of the dividend component appears in Appendix 1.

SHARE REPURCHASE ALLOCATION CALCULATIONS

A company has 10,000 shares, and net shareholders' funds of $50,000. Shareholders' funds are represented by:

Subscribed capital	$20,000
Realized capital profits	$15,000
Revaluation reserves	$ 5,000
Revenue reserves	$10,000
	$50,000
	that is $5.00 per share.

The market price is $7.50 per share. Suppose 40% (4,000) of the shares are to be repurchased at market value ($ 30,000, or $ 7.50 per share) equally from all shareholders. The relevant brightline test is met (15%), that is the amount returned exceeds 15%.

The slice rule, however, applies. That is the subscribed capital, realized capital gain and dividend components must be determined on a per share basis for the $ 30,000 repurchase. One cannot take $ 15,000 realized capital profits and $ 15,000 from subscribed capital, all tax-free.

In this situation, the repurchase is allocated according to the percentage of the components of shareholders funds (at market value). At market value, there is:

Subscribed capital	$20,000	(26.7%)
Realized capital profits	$15,000	(20.0%)
Revaluation reserves	$ 5,000	(6.7%)
Revenue reserves	$10,000	(13.3%)
Excess of share price over net tangible assets	$25,000	(33.3%)
	$75,000	100.0%

There will be deemed to be 26.7% ($ 8,000) from subscribed capital, and 20% ($ 6,000) from realized capital profits, 6.7% ($ 2,000) from revaluation reserves (unrealized capital gains), 13.3% ($ 4,000) from revenue reserves, and 33.3% ($ 10,000) from the excess of the share price over net tangible assets (an unrealized capital gain). Thus $ 16,000 ($ 4.00c per share) would represent a dividend to which imputation credits may be attached (or RWT deducted), and only $ 14,000 ($ 3.50 per share) is tax-free.

The dividend component (taxable portion) comprises:	$
Revaluation reserves	0.50
Revenue reserves	1.00
Excess of share price over net tangible assets	2.50
	4.00

The Valabh Committee considered how the Treasury Stock method of accounting for repurchased shares may be treated for tax purposes, but this is of academic interest only; the Companies Act 1993 has no provision for companies to resell their repurchased shares. Repurchased shares must be cancelled, with no provision for reissue. However, a company could increase its share capital and/or use share splits to increase the available share script.

B. Amalgamations

The Companies Act 1993 sought to reduce the regulatory impediments to amalgamations without creating any bias in favour of amalgamations – a structurally neutral approach.

© 1994 International Bureau of Fiscal Documentation

The discussion document mirrors this approach in the taxation context, in policy terms, with the proposed tax rules approximately the same as those affecting company and shareholder taxation. One provision of the Companies Act 1993 is to allow a "short form amalgamation" (Section 222) for companies within the same wholly-owned group. Therefore, unworkable company groups or companies which have outlived their usefulness may be amalgamated from 1 July 1994 without substantial cost and without the need to re-register each of the companies under the new Companies Act.

The tax treatment of amalgamations is concerned with three main issues: the position of revenue account shareholders, the transfer of assets and the situation regarding tax losses and imputation credits. Each issue is discussed in turn below.

1. Revenue account shareholders

These shareholders are either share traders or purchasers of shares with the intention of resale for a profit (such as financial institutions). In an amalgamating company, revenue account shareholders will realize assessable income or a deductible loss on the exchange of their shares in the amalgamating company for shares in the amalgamated company. This reflects the existing tax treatment, and with no special features in the Companies Act for amalgamations, no changes in tax treatment are proposed in order to minimize any further distortions to taxpayer decision-making.

Unfortunately, there is no "rollover" relief permitted for the cancellation of shares in the amalgamating (old) companies. The Government claims that any such relief would only alter the timing of income recognition, with delays in recognition of any income expected. Furthermore, it is argued that any delay would be extended if the amalgamated (new) company is more efficient, thereby increasing its share price (market value). Two other points are raised in a justification of the approach taken by the Government: any relief would require complex legislation and that with the absence of any capital gains tax regime (Australia, Canada and United Kingdom have such regimes and permit rollover relief), rollover relief should not be provided. Excessive complexity of the proposals follows precedent as complexity has rarely caused unease for New Zealand governments on previous occasions.[12]

2. Asset transfers

Asset transfers to an amalgamated company from the amalgamating company will be tax-free for qualifying amalgamations (if all companies are New Zealand resident and none are tax exempt), under rules similar to those applying to the consolidation regime. The two regimes are able to be used to achieve the same substantive effect and hence any influence on the path adopted by companies (and their shareholders and directors) should not be driven by tax provisions. Trading stock is afforded concessionary treatment where it may be transferred at opening book value where it was on hand at the beginning of the year and at cost where it was acquired during the year. Particular rules are also provided for transfers of financial instruments under the accrual rules, with stringent conditions requiring satisfaction if the transfer is to be tax-free.

For the non-qualifying amalgamation, some limitations to this broad principle are included to impose tax obligations when an asset moves from revenue to capital account consequent to an asset transfer, and where the transfer is made outside of New Zealand. Assets are treated as being transferred at market value with any gains or losses included in the amalgamated company's assessable income. In these situations, tax would be permanently avoided if no limitations were imposed. The "Qualifying Company Regime" philosophy is maintained with the approach taken in the discussion document.[13]

3. Tax losses and imputation credits

The general principle is that the amalgamated company should have access to the losses and imputation credits of the amalgamating companies, subject to ensuring that the shareholder continuity rules and the limitations on group losses are not circumvented.[14] That is, there should be no favourable treatment arising through an amalgamation, while at the same time no adverse consequences when compared to alternative comparable actions that may be implemented by companies. Unfortunately the proposed rules are extremely complex for shareholder continuity and loss carry-forward determination. The shareholder continuity rules require that 49 percent of the shares are held by the same persons throughout the continuity period (which translates to 49 percent of the shares in the amalgamating company and 49 percent of the shares in the amalgamated company remaining in the ownership of the same persons throughout the continuity period).

The prerequisite to carry forward losses in a group is that 66 percent of the shares are held by the same group of persons throughout the period in the amalgamated and amalgamating companies. Additionally, immediately prior to the amalgamation, the losses of the amalgamating company must have been able to have been grouped against income of all other amalgamating companies. Losses must be utilized on a first-in-first-out ("FIFO") basis; a requirement that will cause the forfeiture of losses where minimum shareholder continuity levels are not maintained for the periods covered by the losses and their subsequent (potential) utilization. If more than one amalgamating company has losses and these losses arose in the same year, the new amalgamated company should elect which are offset, or in default of an election they will be offset in a *pro rata* manner. Losses of the amalgamated company must continue to be identified separately for each of the predecessor companies they were inherited from where different shareholders existed for the period the losses were incurred.

12. See J. Doolan and M. Kogos, "Treasury again undermines government's best intentions on tax changes for company law", *The Independent* (4 February 1994) at 25.

13. See K. Holmes, "Taxation of Closely Held Companies: The New Zealand Model", 46 *Bulletin for International Fiscal Documentation* (October 1992), at 506, for a discussion on this regime; a regime where certain companies are in effect taxed as if they were a partnership.

14. There is no reference made in the discussion document to the situation where one of the amalgamating companies remains after the amalgamation. It is presumed that the surviving company must satisfy the existing requirements to be permitted to carry forward losses and imputation credits.

© 1994 International Bureau of Fiscal Documentation

With imputation credits, there must be shareholder continuity in accordance with the loss situation except that the threshold level is 66 percent (the group loss situation). However, with many amalgamations involving profitable companies with significant levels of imputation credits, they will fail to maintain a continuity of ownership of 66 percent and the imputation credits will be lost. This approach in the document fails to reflect the philosophy of the new amalgamated company being treated as a continuation of the former amalgamating companies. As Doolan and Kogos state, the New Zealand Government has the opportunity to avoid this level of complexity and introduce a business test for determining loss continuity similar to those existing in Australia and the United Kingdom.[15]

Shewan identifies two major issues with respect to amalgamations that are not dealt with in the discussion document.[16] The normal exemption from stamp duty on intercompany transfers under a tax consolidation is presumably an oversight. The second, and more fundamental issue, is whether the transfer of property between amalgamating and amalgamated companies is a "supply" within the provisions of Section 5 of the Goods and Services Tax Act 1985.

C. Tax accounting issues

This section of the discussion document covers the accounting questions associated with the transition between the existing and new companies regime, and company distributions other than by way of share repurchases. The document sets out a number of tax rules for companies registering under the new Companies Act:

- "Subscribed capital" will include for income tax purposes:

(a) existing paid-up capital reserves:
  (i) amounts subscribed by shareholders;
  (ii) where shares are "partly-paid" on subscription, the amount paid on subscription;
  (iii amounts that have arisen from taxable bonus issues;
  (iv) amounts represented by ten-year bonus issues that have reached their tenth anniversary;
  (v) amounts represented by both unexpired ten-year bonus issues and non-taxable bonus issues, that were sourced from either capital gain amounts or qualifying share premium.

(b) existing qualifying share premium reserves.

- In the situation where shares are issued by one company in exchange for shares in another (including amalgamations), several rules apply:

(i) the subscribed capital of the issued shares will be the lesser of the subscribed capital or market value of the shares received in exchange for the issued shares, subject to an anti-avoidance rule which is aimed at preventing any tax advantage arising from inflating the subscribed capital of the target company prior to acquisition. This would apply where some or all of the capital is returned to the subscribing shareholders in some form other than as shares in the amalgamated company;

(ii) subscribed capital represented by shares held by amalgamating companies in each other would not be credited to the subscribed capital of the amalgamated company.

An example of the application of the tax accounting rules to an amalgamation appears in Appendix 2.

- Subscriptions will be excluded from subscribed capital for tax purposes to the extent that they are attributable to dividends that were exempt from tax under Section 63 of the ITA (a list of exempt income items); and were not fully imputed (where an allocation rule applies to determine the non-imputed amount).

- Where distributions are recovered[17] from shareholders, for example where the distribution breaches the solvency test[18] contained in the Companies Act 1993:

(i) a credit to the value of the imputation credits attached to the recovered dividend would arise on the date of recovery in the ICA of the company that recovers the dividend;
(ii) the shareholder would be deemed not to have received that dividend, nor any imputation credits attached to it, and would be reassessed accordingly;
(iii) the Commissioner would be required to refund any RWT or NRWT that had previously been deducted from the recovered dividend; and
(iv) where the recipient of the dividend was a corporate, the repaying company would debit its ICA with an amount equal to the value of any RWT or imputation credits attached to the recovered dividend.

15. Doolan and Kogos state: "The business test recognizes companies are a separate legal entity and that, provided the same business is carried on by the companies under the new shareholders, there is no commercial reason for forfeiting the company's losses just because the company's shareholding has changed. If a loss company has not paid tax on its profits, the shareholders will when they receive the company dividends." See *supra* note 12, at 25.

16. J. Shewan, "Tax Implications of Company Law Reform", a paper presented at The Company Law Conference 1994 (Wellington, New Zealand, 17-18 February 1994), 52-93, at 75.

17. The discussion document presumes a full recovery of the distribution and fails to provide for a partial recovery from shareholders which is permitted under the new Companies Act 1993.

18. Sec. 4(1) of the Companies Act 1993 provides that "...a company satisfies the solvency test if –
(a) The company is able to pay its debts as they become due in the normal course of business; and
(b) The value of the company's assets is greater than the value of its liabilities including contingent liabilities.

Sec. 4(2) requires that consideration in determining whether Sec. 4(1)(b) is satisfied require that regard be given to the most recent financial statements of the company which comply with the Financial Reporting Act 1993, and all other circumstances that directors know or ought to know affect, or may affect the value of the items referred to in Sec. 4(1)(b). Also, the valuations used must be reasonable in the circumstances, and that the likelihood of contingencies occurring and any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability.

Directors may in certain circumstances be held liable for breaches of the solvency test. However, recovery from shareholders of any distribution (a distribution is any transfer of money or property (or incurring of a debt), other than the company's shares, for the benefit of the shareholder) is likely to be rare since there are three important exceptions to the company's right of recovery from shareholders:
(i) the shareholder received the dividend in good faith and without knowledge of the company's failure to satisfy the solvency test;
(ii) the shareholder has altered his position relying on the validity of the distribution; or
(iii) it would be unfair to require repayment.

© 1994 International Bureau of Fiscal Documentation

Companies must also consider the tax implications of deducting RWT from dividends where insufficient imputation credits are available, and assessments by the IRD which are disputed (requiring 50 percent of the tax dispute to be paid pending the final outcome).

D. Miscellaneous issues

This section of the discussion document sets out the taxation "house-keeping" issues arising from the new Companies Act. The proposed changes reflect, in essence, changes in terminology in the Companies Act and the removal of certain concepts and the creation of others.

The terms "nominal capital", "par value", "issued capital", "paid-up capital", where these terms are used to measure shareholders' interests in a company, will be replaced with the concepts of "voting interest" and "market value interest" for measuring company ownership. The concept of a single closely-held company (excluding the qualifying company regime) is used to replace the private company and proprietary company references in the ITA. The public company references will be replaced with a widely-held company definition. Amendments, as appropriate, will be made to the other Revenue Acts (Goods and Services Tax Act 1985, Inland Revenue Department Act 1974, the Estate and Gift Duties Act 1968, and the Stamp and Cheque Duties Act 1971). The document lists sections requiring amendment.

The Companies Act 1993 introduces the concept of the 'one shareholder' company – the incorporated person. It also removes the need for a separate Memorandum of Association and Articles of Association, replacing them with a single Constitution in statutory form (which may be amended to suit a particular company's requirements). Issues surrounding the winding up, dissolution and striking-off of a company have been replaced by the concepts of liquidation and removal from the register, and corresponding changes are proposed to the Revenue Acts to reflect this approach. The Commissioner will remain a preferred creditor under the new Companies Act.

The final part of the document contains the explanatory note which is proposed to be attached to the draft legislation to be introduced to the New Zealand Parliament for consideration and eventual addition to the statute books. This explanatory note and draft legislation are open to submission before they are introduced to the New Zealand Parliament, and will be open to further public submissions when they are referred to the Finance and Expenditure Select Committee after the first reading of the Bill. Consequently there is considerable scope for public input into the proposed legislative changes, be it within a short time frame. It would appear that the Bill, when drafted, needs to be operative law by 1 July 1994 to dovetail with the implementation of the Companies Act 1993.

Unfortunately, the document fails to address several issues, which in Shewan's opinion, require action either by statutory means or a policy statement from the Commissioner. Thorough consideration of these matters is imperative to enable the implementation of the new companies regime to be as smooth as possible. The areas noted by Shewan are:[19] interest deductibility and share repurchases; waiver of entitlement to dividend; deferred payment for shares; deferred repayment of shares; deductibility of adviser's fees; the definition of "director"; deductibility of director's indemnity insurance; and transfers of company registrations to and from overseas jurisdictions.

IV. CONCLUSIONS

New Zealand's company law reform will see the introduction of momentous changes in the structure of companies and the activities they may undertake. Transitional provisions nevertheless apply from 1 July 1994 for up to three years as the regime is "phased in". Tax issues form a significant component of the changes and are likely to influence accounting treatment, yet these have been left to the "last minute" for completion. The discussion document provides the Government's view on the necessary changes to taxation law to reflect these recent developments in company law. The mood of the document must be seen as generally favourable as far as companies are concerned, subject to several areas of major concern in the areas of share repurchases and amalgamations, highlighted earlier. The Government's stated philosophy is to see taxation law integrate well with revised company law rules. Taxation provisions should not inhibit the willingness of companies to take advantage of any increased flexibility that company law changes may confer.

The document is a positive step in ensuring that the improved flexibility of the new companies regime is reflected in taxation law, while at the same time providing some protection for the revenue. There are some aspects of "double taxation" for certain shareholders that should be eliminated, or at least reduced, following the hearing of submissions. The document covers the broad issues of share repurchases, amalgamations, tax accounting procedures and various miscellaneous issues relating mostly to general house-keeping. The implementation date of the new companies legislation is 1 July 1994. Before that date, legislation must be enacted to reflect the essential matters of issue in the discussion document; an extremely short time-frame to produce well considered and effective legislation.

The desire by Government to provide tax rules that provide certainty and that impose as few as possible compliance costs on taxpayers in their day-to-day operations will come under pressure with the recommendations contained in the discussion document. Nevertheless the document represents a valiant effort to ascertain tax rules which are designed to achieve a balance between the competing considerations of maximizing commercial activity and maintaining a robust and fair tax system. We await with interest the final legislative approach that the New Zealand Parliament will take, and the level of success that public submissions have achieved to alleviate the shortcomings of the discussion document, particularly with respect to share repurchases and amalgamations. There are shortcomings that need to be addressed (and

19. Shewan *supra*, note 16, at 87–89.

© 1994 International Bureau of Fiscal Documentation

indeed they should be if the Government's stated purpose underlying the discussion document is given full effect).[20] Further opportunities for submissions and considerations will provide the opportunity for the tax implications of the recent company law reform to be a major step forward, complementing the new more flexible company law environment.

The financial accounting issues raised by the share repurchase, amalgamation and tax accounting issues in the discussion document are numerous and fundamental. Further consideration of the financial accounting treatment of the proposals in the discussion document is imperative before any legislation emerges.

20. *Supra*, notes 1 and 4.

APPENDIX 1

MECHANISMS FOR TAXING THE DIVIDEND COMPONENT

Shareholder	REPURCHASING COMPANIES				
	Resident Non-Qualifying Company		Resident Qualifying Company	Non-Resident Company	
	On-Market selective only	Off-market pro rata or selective	Off-market pro rata or selective	On-market	Off-market
Resident Non-Corporate	Dividend exempt to recipient. Debit to ICA	Ordinary dividend treatment. ICA, RWT credits attached	Ordinary dividend treatment. ICA, RWT credits attached	No Tax	Ordinary dividend treatment
Resident Corporate	As above	As above	As above	No Tax	As above
Resident vendor taxable on share gain	As above plus tax on gain	As above plus tax on gain over and above dividend	As above plus tax on gain over and above dividend	No Tax	As above plus tax on gain over and above dividend
Resident Tax Exempt	Debit to ICA	Ordinary dividend treatment (exempt)	Ordinary dividend treatment (exempt)	No Tax	Ordinary dividend treatment
Non-Residents	No NRWT. Debit to ICA	Ordinary dividend NRWT deduction	Ordinary dividend NRWT deduction	No Tax	No Tax

Source: Discussion Document: Annex 2.2, p. 28.

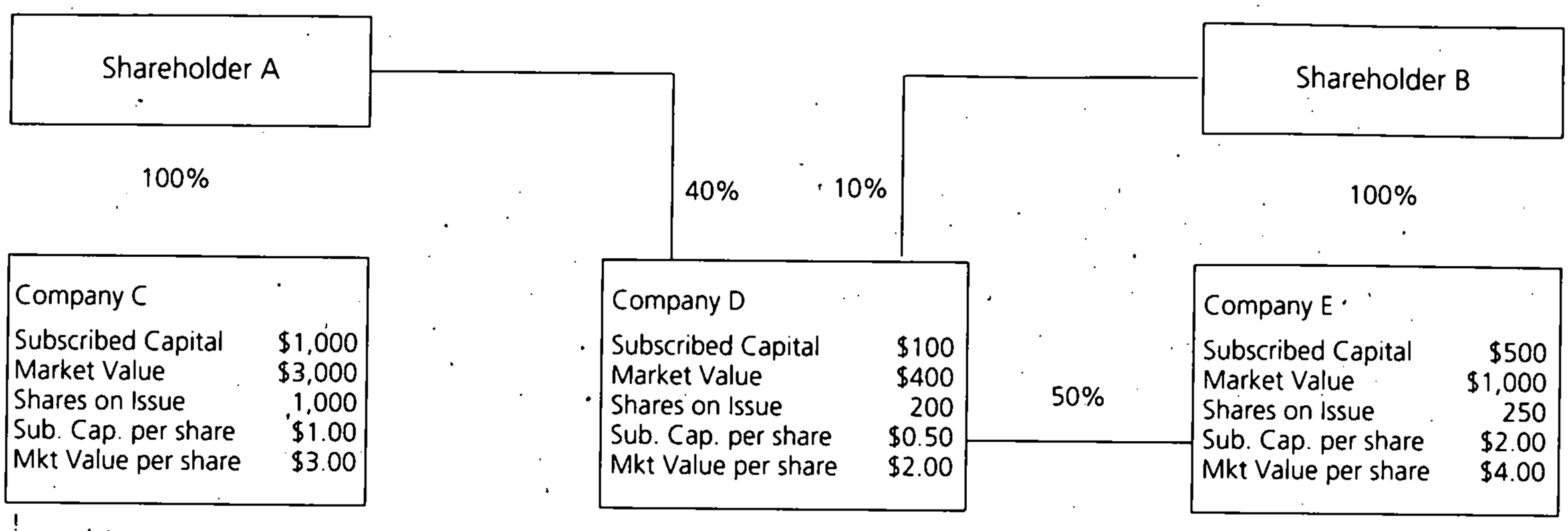
© 1994 International Bureau of Fiscal Documentation

APPENDIX 2

APPLICATION OF TAX ACCOUNTING RULES TO AN AMALGAMATION

Stage 1

Start position



Stage 2

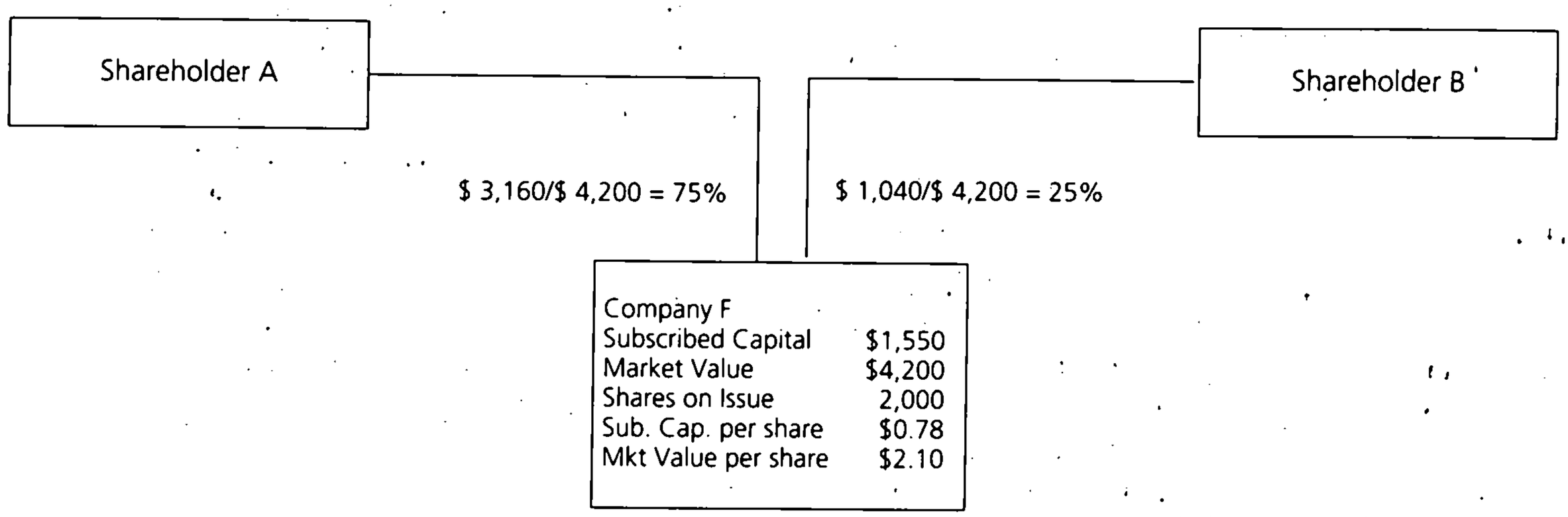
A and B agree to amalgamate C Co, D Co and E Co into a new company, F Co F Co issues 2,000 shares in total to A and B in proportion to the market value of their direct holdings (double counting results if indirect holdings are included, as the value of an indirect shareholding is counted once as the market value of the subsidiary company, and again as a share investment forming part of the value of the shareholding company).

In return for existing holdings in C Co and D Co, A is issued shares in F Co with a market value of:
C Co's market value x A's shareholding, plus D Co's market value x A's shareholding, = $3,000 x 100% + $400 x 40% = $3,160

In return for existing holdings in D Co and E Co, B is issued shares in F Co with a market value of:
D Co's market value x B's shareholding, plus E Co's market value x B's shareholding, = $400 x 10% + $1,000 x 100% = $1,040

The subscribed capital of F Co is the subscribed capital of C, D and E Co shares acquired by F Co in return for the F Co shares, excluding holdings by any of the amalgamating companies in each other =
Subscribed capital (C Co + D Co + E Co), less sub. cap. of D Co held by E Co = $1,000 + $100 + $500–($100 x 50%) = $1,550.

End position



Source: Discussion Document: Annex 4.1, p. 47.

© 1994 International Bureau of Fiscal Documentation

AUSTRALIA

CAPITAL GAINS TAX AMENDMENTS

Ann O'Connell

BA (Hons)/LL B (Hons), LL M (Melb), Senior Lecturer in Law, University of Melbourne.

The Australian Government has announced amendments to some of the capital gains tax provisions of the Income Tax Assessment Act 1936. The aim of the amendments is to deal with "emerging tax avoidance practices", redress certain unintended consequences of a number of provisions and reduce the compliance burden on taxpayers. Most of the amendments are effective from the date of the announcement by the Assistant Treasurer (12 January 1994), but draft legislation is not expected until later in the year.

I. COMBATING "EMERGING AVOIDANCE SCHEMES"

The most important proposals in the reform package are those aimed at emerging avoidance schemes. These fall into five groups:

A. Rebatable dividend schemes

Intercorporate dividends in Australia are included in the taxable income of the recipient company. To prevent cascading taxes as profits are distributed through a company chain, a rebate or tax credit is provided to incorporated shareholders to offset the tax otherwise payable on the taxable dividends. This is to ensure that there is only one tier of tax on profits derived at the corporate level. Thus, intercorporate dividends are effectively tax-free, notwithstanding the fact that they are nominally included in taxable income.

The Australian capital gains provisions were designed to augment the ordinary income tax system by catching gains that would otherwise escape taxation because of the narrow income concept adopted by the Australian courts. The capital gains provisions were drafted broadly to achieve this aim and in many cases they overlap with other inclusive provisions. Double taxation is prevented in these cases by Subsection 160ZA(4), which modifies the calculation of a capital gain where the disposal of property generates a profit that is also taxable under another provision in the Act. It operates by lowering the capital gain to the extent that the gain is also taxable under another provision of the Act.

Some company taxpayers have entered into schemes designed to extract from subsidiaries in a tax-free manner, retained profits that were not taxed at the subsidiary level as a result of concessions or tax preferences. The schemes involve the taxpayer liquidating a subsidiary or arranging for the subsidiary to redeem most of the taxpayer's shares in the subsidiary. In both these cases, the excess of distribution proceeds is treated as dividends under Australian law. However, as explained earlier, an incorporated shareholder is entitled to a rebate for taxes otherwise payable on intercorporate dividends. So, although the dividends are fully "taxable", no tax is actually paid on them. However, because the dividends are "taxable", they are subtracted from the consideration received for the disposal when calculating the capital gain derived by the taxpayer in respect of the disposal. The net result is to reduce the capital gain to zero while no tax is paid on the distribution because of the intercorporate dividend rebate. In this manner, the parent company can extract free of tax retained profits that were not taxed at the subsidiary level.

The Australian Taxation Office had expressed the view that the general anti-avoidance provisions of Part IVA of the Act could apply to schemes of this sort (Taxation Ruling, IT 2456). However, the anti-avoidance provisions can only be applied on a case-by-case basis and the provisions will only apply if it can be shown that the sole or dominant object of the arrangements was the avoidance of tax. Accordingly, the government has decided to adopt specific counter measures.

The proposed changes will modify Subsection 160ZA(4) so it does not reduce a capital gain where a company taxpayer receives a rebatable dividend as a result of the liquidation of a subsidiary or as a consequence of the cancellation or redemption of shares in a subsidiary.

The modifications to Subsection 160ZA(4) are subject to a safe harbour exception where distributions are paid out of taxed profits. In such a case, the arrangements described above will not give rise to tax avoidance since company tax will have already been paid on the distributed amounts prior to the distribution.

In addition, the anti-avoidance modifications will also not apply to a distribution in specie to a company in the same group where the transferor and transferee have elected to use the rollover provisions in respect of the transfer. The effect of the rollover provision is to transfer the future tax liability for the unrealized gain to the transferee, so tax will be paid on the unrealized gain when there is a disposal of the asset to a taxpayer outside the company group.

B. Value shifting schemes

When Australia included capital gains in the income tax base in 1985, it adopted a unique transition formula – gains on assets acquired before the commencement date of the new

© 1994 International Bureau of Fiscal Documentation

provisions were completely exempted from taxation. Taxpayers owning pre-capital gains tax shares and post-capital gains tax shares in the same company sought to avoid tax on the sale of shares by means of "value shifting" arrangements. These involved the alteration of rights attached to their post-capital gains tax shares in order to devalue those shares while causing a corresponding increase in the value of their pre-capital gains tax shares. Gains realized on a subsequent disposal of the pre and post shares could thus escape taxation completely. Value could also be shifted from shares owned by one person into shares owned by another which could achieve the *effect* of a disposal of the shares without actually disposing of them for capital gains tax purposes. Clearly, only shareholders who can exercise control of the company's shares are able to exploit value shifting schemes.

The amendments will apply where a transaction results in a material shift in value of shares held by a person who controls the company. A material shift in value will constitute a disposal of those shares for market value to the extent that the shares value has been transferred to pre-capital gains tax shares or to shares in the company held by another person(s); and the cost base of the shares will be reduced by the amount of value shifted to post-capital gains tax shares held by the controller.

The notion of when a shareholder has a "controlling interest" in the company will be defined but the question of what constitutes a "material shift" in value will "depend on the circumstances of the case".

C. Disposal of assets without change in beneficial ownership

Subsection 160M(1A) provides that a change in the legal ownership of an asset, without a change in beneficial ownership, will not be a disposal of the asset. Subsection 160M(1A) was necessary to ensure that a mere change of trustee of a trust, without any change to beneficial interests, would not trigger capital gains liability. One example given of potential avoidance under this provision is where a person transfers an asset to a unit trust in which he or she holds all the units, and then disposes of those units for an amount equal to their cost base (the market value of the asset). Another example concerns the transfer of assets between companies in the same corporate group. The amendments are designed to ensure that Subsection 160M(1A) is not used to avoid tax and will ensure that the subsection does not apply where assets are transferred to a unit trust or where an asset is transferred between companies.

D. Assignments of prospective shares of interests in partnerships

Where a person prospectively assigns a share of a partnership interest before becoming a partner, for instance, by agreeing to hold on trust part of the partnership share for the benefit of a number of discretionary beneficiaries (as in a family trust), the assignment might not attract capital gains tax because Subsection 160M(6), a key deeming provision which deals with the creation of incorporeal assets, only operates where those rights vest in another person on creation. In the above example, they vest in the creator in his or her capacity as a trustee. By contrast, where a person who is already a partner assigns a share of his or her interest in the partnership, capital gains tax will apply in relation to the market value of the assigned share because the rights vest in the assignee. The government proposes to amend the Act to deem the creator of an incorporeal asset and the person in whom the asset is vested to be two separate persons for capital gains tax purposes when the asset is vested in the creator as trustee. As a result, in a prospective partnership assignment, the partner would be subject to capital gains tax on the value of the share in the partnership interest which is effectively assigned.

E. Transfer of property to a trust of which the transferor is trustee

Currently, property transferred by a person to a trust of which another person is the trustee is generally treated as a disposal of the property for capital gains tax purposes. However, if a discretionary trust is created over property with the owner of the property as trustee, it is arguable that a disposal does not take place. In both cases the trust has similar effect.

It is proposed to treat the creation of a trust with the owner of the property as the trustee in the same way as the transfer of property to a trust of which a person other than the transferor is the trustee.

Each of the above amendments will have effect from 12 January 1994.

II. EXTENDING THE SCOPE OF CONCESSIONAL PROVISIONS

Several of the reform proposals are intended to extend the scope of the concessional measures in the capital gains tax "by redressing certain unintended consequences of a number of provisions and reducing the compliance burden on taxpayers".

A. In specie liquidation distributions to a parent company

One key proposal is to correct the unintended over-taxation that can arise through the interaction of the intercorporate rollover provisions and the liquidation provisions. The intercorporate rollover provisions enable a company to rollover an asset to another group company without recognizing capital gains on the transfer. The transferor company is not required to receive any consideration for the transfer. In the absence of any anti-avoidance provision, a parent company could therefore generate an artificial loss by effecting a tax-free transfer of assets from one subsidiary to another and then selling the shares in the worthless transferor company at a loss. To prevent this, anti-avoidance provisions (in Division 19A of Part III of the Act) lower a parent's cost base in its shares in a subsidiary by the value of assets that were trans-

© 1994 International Bureau of Fiscal Documentation

ferred out of the subsidiary in a tax-free rollover to another group company.

The cost reduction provisions in Division 19A also operate where assets are rolled over from a subsidiary to a parent company. It can cause problems, however, where the rollover is used in conjunction with a distribution in specie. In this case, the subsidiary will avoid recognition of gain on the transferred assets. However, the parent will be treated as having received consideration equal to the transferred assets in return for its disposal of the shares in the subsidiary. If the cost base of the shares in the subsidiary has been lowered by the operation of Division 19A, the parent may recognize a large capital gain even though it is receiving nothing more than a return of its original capital investment. To prevent this result, the proposed amendments will suspend the operation of Division 19A provided the liquidation proceedings are completed within two years of their commencement. The amendments will have a retrospective operation to 6 December 1990, the date of application of Division 19A.

B. Transfer of assets within company subgroups

It was explained in the previous section that a company need not receive consideration for the transfer of an asset to another group company in order to take advantage of the intergroup rollover provision. There is nothing preventing it from taking consideration for the transfer, however. Commonly, transferor companies accept shares in the transferee company as consideration for the transferred asset.

The rollover provisions deem the transferee company to have acquired the transferred asset for the same cost as the transferor. No similar deeming provisions apply to the transferor company, however, and the transferor can treat the market value of the transferred property as its cost base in any shares issued by the transferee as consideration for the transfer.

Soon after the capital gains tax was introduced, some companies devised schemes that exploited these provisions to avoid capital gains tax on the sale of assets. Rather than sell appreciated assets directly, the companies would establish a subsidiary and transfer the asset to the subsidiary in return for an issue of shares. They would then sell the subsidiary to the purchaser interested in the underlying asset. Because their cost base in the subsidiary's shares was equal to the value of the asset held by the subsidiary, no capital gains were recognized on the sale. Section 160ZZOA was enacted to prevent schemes of this sort. It requires a company to recapture an unrecognized capital gain when a company to which an asset has been rolled over is sold to a taxpayer outside the company group.

The anti-avoidance provision achieves the correct result where the transferee company is sold directly. However, it also operates where the transferee company leaves the company group because an intermediary company is sold. That is, where a taxpayer sells a subsidiary that owns a transferee subsidiary, Section 160ZZOA will trigger a recognition of gain by the taxpayer equal to the unrecognized gain on the transferred asset. If the transferor company and the transferee company belong to the same subgroup that is being transferred by the sale of an intermediary (in other words, the two companies are subsidiaries of the intermediary company), there is no opportunity for avoidance as a result of the sale since any gain in the value of the transferred asset will ultimately be reflected in the value of the taxpayer's shares in the intermediary company. Accordingly, the government has proposed to suspend the operation of Section 160ZZOA if the taxpayer sells a subgroup that contains both the transferor company and the transferee company that utilized the intercorporate rollover provision to effect a tax-free intercorporate asset transfer. The change will operate retrospectively from 16 December 1992, the date of original application of Section 160ZZOA.

C. Prerequisite for rollover relief for transfer of assets within company groups

A prerequisite for obtaining rollover relief for transfers of assets within a wholly-owned company group is that the transferor and transferee companies are group companies for the whole of the year of income in which the transfer takes place. The proposed amendment will remove this requirement so that "efficiency-motivated corporate restructures are not unnecessarily impeded". The amendment will apply to disposals of assets in the 1993-4 income year and later income years.

D. Group company capital loss transfers

The current provision dealing with transfer of capital losses between members of a company group provide for a reduction of the cost base of the shares in the company that transfers the loss without providing for the appropriate increase in the cost base of the shares in the company to which the loss is transferred. They also do not take account of payments made by the transferee company to the transferor company as consideration for the loss. The proposed amendment, which will apply to agreements to transfer losses entered into during the 1993-4 or later income year (even if the loss is incurred in an earlier year), will ensure that these adjustments are made.

E. Capital gains tax application to Rural Incentives Program and other government incentive schemes

Australia is a highly urbanized country and from time to time government incentive schemes aim to encourage businesses and professionals to relocate to rural areas. Currently, general medical practitioners participating in the General Practice Rural Incentives Program are reimbursed, up to certain limits, for relocation expenses. However, the amount of the reimbursement would be liable to capital gains tax. This may also be the case with other Commonwealth, State and Territory incentive schemes. The proposed amendment, which will apply to all payments made under the prescribed schemes, will exempt from capital gains tax amounts paid under the Rural Incentives Program and other schemes that are approved by the Treasurer on a case-by-case basis and prescribed by Regulation.

© 1994 International Bureau of Fiscal Documentation

F. Amendment of assessments

Section 170 of the Act generally prevents the amendment of an assessment after four years have passed from when the tax became due and payable under the assessment. Three situations identified in which the time limits imposed by Section 170 can cause capital gains tax problems are the sale of land, the compulsory acquisition of an asset and the voiding of a contract from the beginning. This is because Section 160U, the general timing provision, departs significantly from property law principles as to when assets are acquired and disposed of. The proposed amendment, effective from 12 January 1994, will ensure that nothing in Section 170 prevents the amendment of an assessment in these situations.

G. Assets used by non-residents in Australian permanent establishments

Currently, capital gains tax is payable on disposals of assets used by non-residents in permanent establishments in Australia. The tax liability is calculated by reference to the total period of the non-resident's ownership of the asset but does not seek to limit it to the period of use in the permanent establishment. The proposed amendment will ensure that capital gains tax will be paid by reference only to the gains that accrued during the period of use of the asset in the permanent establishment in Australia. This amendment, effective 12 January 1994, will apply only where the asset does not qualify as a taxable Australian asset under any of the other categories of taxable Australian assets.

The Press Release does not provide full details of the amendments as the government has indicated that the precise form of the amendments will be formulated in consultation with taxpayer representatives and the tax profession. Legislation to implement the proposed amendments will be introduced during 1994 as soon as possible after the consultation process is completed.

TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

- **Looseleaf in 10 volumes**
- **Updated 12 times a year**
- **38 countries covered**
- **Includes treaties**

Forms of doing business
Exchange control
Investment laws
Taxation of companies including special entities and businesses
Property and wealth taxes
Registration and licence (stamp) duties
Taxes on goods and services
Payroll taxes
Anti-avoidance provisions
Tax rates
Establishment and expansion of business, liquidation, amalgamation and mergers
Investment income
Group taxation
Tax-related incentives for investment
Tax treaties (full texts in English)
Bibliography

NLG 2,800, including basic volumes, binders, updates for 1994, postage by air and packing.
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD PUBLICATIONS BV
P.O. Box 20237 • 1000 HE AMSTERDAM • THE NETHERLANDS
Tel. +31 (0)20 626 7726 • Fax +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

How to Avoid US Transfer Pricing Penalties

Marianne Burge and Cym Lowell

Marianne Burge, Price Waterhouse, New York, and Cym H Lowell, Gardere & Wynne, Dallas. They are co-authors of an upcoming two-volume treatise on international transfer pricing to be published by Warren Gorham & Lamont (New York and Boston), scheduled to appear in the autumn.

I. INTRODUCTION

On 27 January 1994, the US Internal Revenue Service ("IRS") issued temporary regulations, giving guidance to US taxpayers on how to avoid transfer pricing penalties. Although these regulations are issued under the penalty provisions of the Internal Revenue Code ("IRC"), they in fact give taxpayers important guidance as to how to comply with the current US view of transfer pricing and so help them file tax returns which may keep them out of trouble in the future.

The IRS has in recent years undertaken extensive efforts to determine whether multinational corporations, both US and offshore based, have adopted appropriate transfer pricing methodologies. The essential focus of these efforts has been to defend the tax base of the United States. Similar initiatives have been undertaken by the tax authorities of other OECD countries.

One of the essential elements of this effort by the IRS, as well as the US Congress, has been to require the maintenance and disclosure of extensive information with respect to US and foreign corporations doing business in the United States. This focus has, in part, resulted from the experience of the IRS that many multinational taxpayers do not attempt to document their transfer pricing policies and methodologies used for tax reporting purposes until after an examination has begun. This means that both the taxpayer and the IRS are undertaking to determine the appropriate pricing approaches after the fact, perhaps many years later.

The so-called transfer pricing penalty (in Section 6662(e) of the IRC of 1986) encourages taxpayers to maintain contemporaneous documentation relating to their transfer pricing matters (prepared by the time of filing the pertinent tax return), and imposes a Draconian (and perhaps career-ending for a tax executive) penalty on adjustments to such transfer pricing methodology.

The regulations under Section 6662(e) and (h) were issued as "temporary". This means that they expire within three years after the date of issuance, by which time they could have been replaced by final regulations, either in their temporary form, or amended. However, while they are temporary, they are in effect and in this way differ from "proposed regulations". The Section 6662 regulations apply to taxable years beginning after 31 December 1993, and are thus already in effect for calendar year companies.

It may be helpful to give the chronology of events as regards these regulations. Section 6662 contains the provisions of the "accuracy-related penalty". Penalties for the underpayment of tax are imposed in certain circumstances, such as "negligence or disregard of rules or regulations", "substantial understatement of income tax" and "substantial valuation misstatement..." and other types of understatements.

In the Revenue Reconciliation Act of 1990, specific penalties with respect to underpayments of tax as a result of transfer pricing adjustments were added to Section 6662(e) and (h). Proposed regulations were issued on these changes on 13 January 1993. Of particular interest were the exceptions to these penalties, which included such tests as whether the taxpayer had acted in good faith, etc.

Then in the Omnibus Budget Reconciliation Act of 1993 ("OBRA") Section 6662 was again amended, and the exceptions to the penalties, which had previously been part of the proposed regulations, were codified and became part of Section 6662. The penalty circumstances themselves were made more stringent. The current 1994 temporary regulations replace the 1993 proposed regulations, which were thereby withdrawn, although the proposed regulations may be used for taxable years ending after 5 November 1990 and beginning before 1 January 1994.

The penalties themselves are important, because they are extremely high and could easily apply in many cases now that the IRS is stepping up its examinations of transfer pricing, in both inbound and outbound situations. The penalties could be imposed in the following situations:

Substantial valuation misstatement: This exists if the net Section 482 transfer price adjustment[1] in the case of intercompany sales, etc. of goods or services, including licence fees, claimed on a return exceeds the lesser of $ 5 million or 10 percent of the taxpayer's gross receipts. This is known as the net adjustment penalty. All Section 482 adjustments must be aggregated to determine whether the threshold has been met.

Alternatively, a substantial valuation misstatement exists if the Section 482 adjustment is 200 percent or more or 50 percent or less than the price in question. This is known as the transactional penalty. Thus, the penalty could apply not only

1. IRC Sec. 482 authorizes the IRS to make adjustments to the taxable income of related parties, where necessary to prevent tax evasion or to reflect the income of each of the parties.

© 1994 International Bureau of Fiscal Documentation

to a large adjustment ($ 5 million), but also to a smaller adjustment where the pricing was out by 200 percent, etc. The penalty is 20 percent of the tax on the adjustment under the Section 482.

Gross valuation misstatements: These exist if the adjustment level is $ 20 million and is part of the net adjustment penalty. In the case of transactions, the percentage levels are 400 percent and 25 percent. In this case the penalty is 40 percent of the tax on the adjustments. This is also part of the transactional penalty.

With potential penalties at these levels, it can readily be understood that the tax departments of US multinationals are under notice to make sure that they will never be imposed. So, as noted above, the important question is: what are the exceptions to the penalty in the event that a taxpayer is assessed adjustments under Section 482, which would otherwise fall within the penalty thresholds.

II. HOW TO AVOID THE PENALTY

Before the OBRA amendments, Section 6662(e) provided that the understatement (i.e. the adjustment, the tax on which was the subject of the penalty) could be reduced if there was "substantial authority" for the tax treatment claimed by the taxpayer, or if the relevant facts were disclosed in the tax return or an attached statement. In addition, no penalty is imposed if the taxpayer can show that there was a "reasonable cause" for the tax position taken and the taxpayer acted in "good faith". The reasonable cause and good faith exceptions are contained in Section 6664, which provides certain definitions, applicable in general and not specifically to transfer pricing deficiencies.

The 1993 proposed regulations dealt with these exceptions and provided guidance, which have now, for the most part, been codified by the 1993 tax law, and are now the subject of the recent temporary regulations. Amended Section 6662(e) now provides that in determining the threshold amounts in cases of the net Section 482 transfer price adjustment, adjustments are to be excluded with respect to any increase in net taxable income as a result of a price redetermination if:

(1) the price was determined in accordance with a specific pricing method prescribed in the Section 482 regulations[2] and the use of the method was reasonable; and
(2) the taxpayer has documentation in existence at the time of filing the return, which sets forth the determination of the prices in accordance with the method and which shows that the use of the method was reasonable; and
(3) the taxpayer provides the documentation within 30 days of a request by the IRS.

If the price was not determined in accordance with a specified Section 482 pricing method, the understatement can still be reduced if:

- the taxpayer shows that none of the specified pricing methods was likely to result in a price that clearly reflects income, and the other method used was likely to so reflect; and
- the taxpayer has documentation as required in (2) above; and
- the taxpayer provides the documentation within 30 days as in (3) above.

A third exception applies to transactions solely between foreign corporations, unless the treatment of the transaction affects US-source income or income effectively connected with a US trade or business.

These requirements must also be met if the taxpayer tries to claim the "reasonable cause" exception under Section 6664, mentioned above. Thus, reasonable cause in the case of transfer pricing is now defined in Section 6662(e).

III. WHAT THE NEW REGULATIONS SAY

It should be remembered that the accuracy-related penalty applies only if the IRS has made a redermination of the taxpayer's pricing, has assessed a deficiency amount and is now considering whether to impose a 20 or 40 percent penalty on top of the tax. However, although the stated purpose of these regulations is to explain how these penalties may be reduced, the steps to be taken by a taxpayer with regard to pricing looks very similar to what is required in Section 482 compliance in general.

The regulations provide for a two-part exception, depending on whether the taxpayer used a specified pricing method or an unspecified method, as noted above. Regardless of the method, contemporaneous documentation is required, articulating the required analysis at the time the return was filed. The taxpayer is encouraged to "prepare a factual and economic analysis based on reasonably available related party and third party market data that substantiates the price chosen, and to maintain appropriate documentation of that analysis".

The regulations note that the experience of the IRS has been that the majority of taxpayers do not provide an explanation of the pricing practices and often do not rely on comparables. The regulations are one more effort by the IRS to encourage compliance with the arm's length standard.

The regulations provide that specified methods for tangible property include the comparable uncontrolled method or CUP, resale price and cost plus methods, and the comparable profits method or CPM.[3] For intangible property transfers the methods currently include the comparable uncontrolled transactions method and the CPM. A cost sharing arrangement under the 1968 Section 482 regulations is considered a specified method.

Unspecified methods are those which are not specified. The profit split method and the new cost sharing arrangements under the proposed regulations will become specified if and when those regulations are finalized.

2. Regulations under Sec. 482 were issued on 13 January 1993, in both temporary and proposed form, at the same time as the proposed regulations under Sec. 6662.

3. The comparable profits method or CPM is a creation of recent Sec. 482 regulations and now embodied in the 1993 temporary regulations. The method looks at comparable companies and selects certain profit indicators from those comparable companies, with a view to comparing the results of the taxpayer with those of the other companies. It is essentially results driven, rather than transaction driven.

© 1994 International Bureau of Fiscal Documentation

IV. AVOIDING THE NET ADJUSTMENT PENALTY

The regulations provide guidance with respect to the two requirements: the specified method requirement and the documentation requirement. The unspecified method requirement is a third part in the regulations.

A. The unspecified method requirement

The taxpayer must establish that the specified method was selected in a reasonable manner. Although he need not show that it was more accurate and arm's length than any unspecified method, he must show that it was the best method in the circumstances. The reasonableness of his conclusion will be judged on the following factors:

(1) the experience and knowledge of the taxpayer, including all members of the related party group;
(2) the extent to which accurate data was available and analysed in a reasonable manner. The taxpayer must engage in a reasonably thorough search for data, and must use the most current data or make appropriate adjustments. The cost of collecting the data in relation to the dollar amount of the transactions in question will be taken into consideration;
(3) the extent to which the taxpayer following the methods required by the Section 482 regulations will be considered;
(4) the extent to which the taxpayer reasonably relied on analyses or studies conducted by qualified professionals, including an attorney, accountant or economist, will be taken into consideration. The professional need not be an outside advisor, but could be an employee, as long as the study is "objective, thorough and well reasoned".

The preamble also suggests that an Advanced Pricing Agreement ("APA") from a prior year can be reasonably relied on in the current year, if the facts have not changed or the methodology has been adjusted, but one would have hoped that an APA would have precluded an adjustment in the first place.

B. The documentation requirement

The regulations hammer home the need to have supporting documentation at the time of filing the return. The documentation is divided into two categories: principal and background documents. The principal documents must accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. They include:

- an overview of the taxpayer's business, including the economic and legal factors that affect the pricing of its property or services;
- an organizational chart, covering all related parties engaged in transactions potentially relevant under Section 482;
- documents specifically required under Section 482 regulations;
- description of the specified method selected and why it was selected;
- a description of the unspecified methods that were considered and why they were not selected;
- a description of the controlled transactions and any internal data used to analyse them;
- a description of comparables that were used, how evaluated and what if any adjustments;
- an explanation of the economic analysis and projections relied on in developing the method;
- a general index of the documents and a description of the recordkeeping system for accessing them.

And in case these are not sufficient, background documents supporting these principal documents must also be maintained and supplied on request. Documents of this kind may include the items listed Regulation Section 1,6038A-3(c). These are the notorious "safe harbour" documents which are to be maintained by foreign-owned US companies. It is interesting to see that these have now expanded their scope to US as well as foreign-owned companies!

C. Unspecified method requirement

If an unspecified pricing method has been used, the taxpayer must show why the unspecified method was used. The taxpayer must establish that none of the specified methods was likely to achieve an arm's length result, and that the unspecified method used achieved the most accurate measure of an arm's length result. If the transaction is of a kind for which a specified method was available, he must show why the unspecified method was selected and if no specified method was available, he must show why the method selected was reasonable. The same factors and documentation requirements must be satisfied as for the specified method requirement discussed above.

V. AVOIDING THE TRANSACTIONAL PENALTY

The transactional penalty can be avoided under the "reasonable cause and good faith" exception of Section 6664, mentioned above. A taxpayer who meets the requirements under the net adjustment penalty rules outlined above, will meet the reasonable cause and good faith requirements of Section 6664, and will therefore also be able to avoid the penalty. Thus, the requirements for all the Section 482 penalties are essentially the same.

VI. CONCLUSION

These regulations demonstrate once more the determination of the IRS to increase taxpayer compliance in the area of transfer pricing. The penalties are Draconian and apply both to inbound and outbound companies. The emphasis on transfer pricing compliance has already had its effect on the way US multinational companies approach this subject. Most companies have embarked on studies, either internally or with a mixture of internal and external expertise, in order to avoid costly and after-the-fact tax adjustments. That is bad enough. But the imposition of a penalty on top of an adjustment would be what is euphemistically described as a "career limiting" event for the tax department! Let us hope that the penalty will be a very rare occurrence.

© 1994 International Bureau of Fiscal Documentation

SWITZERLAND

LOW TAX OPPORTUNITIES

William Bush

William Bush worked as Tax Inspector with the UK Inland Revenue before he joined Coopers & Lybrand in 1987. He is now based at Coopers & Lybrand, Reading in the United Kingdom. However, he spends much of his time working on international projects in the Geneva office.

The views expressed in this article are those of the author and are not necessarily those of Coopers & Lybrand.

Swiss companies have always had a place in the armoury of the international tax planner. There is still a certain mystique which surrounds a Swiss company especially when it is owned by a non-Swiss shareholder or group. Tax authorities throughout the world are often put on their guard when a Swiss company appears in the affairs of one of their taxpayers. However, now, with the advent of the single market in Europe, and the appearance of constellations of tax havens and regions with special tax incentives across the globe, is there still a place for the Swiss company in international tax planning?

THE OLD . . . AND THE NEW . . .

The international tax planning landscape has changed dramatically over recent years and the Swiss company is now compared, frequently unfavourably, with other entities which are able to benefit from tax advantages. However, as well as the mystique and the undoubted tax advantages available to certain Swiss companies, there is also a certain respectability about a Swiss company when it is compared to some of its newer rivals.

Traditionally, Swiss companies were used as intermediate holding companies or as companies able to benefit from low direct tax rates in certain cantons in Switzerland. Sometimes, these companies had little substance and, indeed, in the case of domiciliary companies in some cantons, it was a condition of their favoured tax status that they had no establishment in Switzerland.

At the other extreme, in the last ten years, tax incentives have been made available in certain cantons, notably Neuchatel, and latterly, Geneva for foreign companies creating real substance, and particulary jobs, in Switzerland.

Between these extremes, certain cantons, such as Fribourg, now allow a domiciliary company to have employees and even an office in the canton whilst still benefiting from the favoured tax status.

So what are these various tax advantages?

DOMICILIARY AND AUXILIARY COMPANIES

A domiciliary company was traditionally, in the majority of cantons, a "letter box" company with no substance in Switzerland. The concept behind the true domiciliary company was that it had its address of convenience in Switzerland but it had no activities there and therefore there was no economic basis for it to be subject to direct taxes, least at cantonal level. In a majority of cantons, therefore, a true domiciliary company was only subject to tax at the federal level at a rate between 3.6 and 9.8 percent.

Direct taxation at this rate is still very competitive internationally, and when compared to the rates prevailing in OECD countries, ten years ago, interesting indeed!

The auxiliary company is only recognized in some cantons and is really a domiciliary company which has some substance and some Swiss-source income. Consequently, its results have to be apportioned between normally taxed income and income subject to domiciliary rules. It is problematic as to whether such "mixed" companies will continue to exist once the cantons fully implement the harmonization provisions contained in the federal tax reform due to come into force before the end of the century.

What then were these companies used for?

USE OF DOMICILIARY COMPANIES

Domiciliary companies were (and sometimes still are) used to receive royalty income from outside Switzerland or in some cases, foreign-source interest income. Companies used for this purpose are increasingly rare because of the famous (perhaps better infamous) 14 December 1962 decree. Currently, domiciliary companies are more often set up for rebilling activities or sales activities where sales are actually concluded outside Switzerland. Such activities are not normally caught by the regulations brought in by the 1962 decree, but there can be other problems referred to later.

PROBLEMS WITH DOMICILIARY COMPANIES

The use of rebilling companies or foreign sales companies in Switzerland subject to low tax rates is not discouraged by the 1962 decree law but it is increasingly marginalized to the proliferating international anti-avoidance tax laws implemented by many states, notably, the United States and states

© 1994 International Bureau of Fiscal Documentation

of the European Union. In broad terms, the trend in these tax jurisdictions is to examine economic substance rather than legal form in arriving at the result, and consequently domiciliary companies are frequent casualties of these tax changes.

The "functional analysis approach" to transfer pricing whose most vigorous exponent is the United States, but other European jurisdictions are following, determines the allocation of tax profits between members of an international group on the basis of the efforts they deploy and the risks they take in the cross-border business. A pure domiciliary company involved in rebilling, which by its very nature cannot have much substance in Switzerland, is unlikely to justify more than a very small margin on the transactions which it undertakes with other group members.

The "controlled foreign company laws" enacted now by the United States, the United Kingdom, Australia, Canada, Germany and France, among others, also deems lightly taxed foreign profits, typically earned outside the jurisdiction of incorporation of the company concerned, subject to the domestic taxes of the parent company's state.

THE DAYS OF DOMICILIARY COMPANIES ARE NUMBERED

It is clear therefore that groups operating out of developed countries with increasingly aggressive tax authorities are unlikely to be able to benefit greatly in practice from the use of a domiciliary company in Switzerland. They will need to increasingly turn to the alternatives offered by the "new" tax favoured companies which may be incorporated in certain cantons in Switzerland.

THE NEW PUSHES OUT THE OLD

Following the damage inflicted on the watch industry in the canton of Neuchatel by Far East competition over recent decades, Neuchatel canton adopted laws which provided that manufacturing companies set up in Neuchatel could benefit from a ten-year tax holiday at cantonal level. In some cases, it has even been possible to extend the holiday to the federal direct tax. In other cases not involving manufacturing investments, a small cantonal tax liability remains which results in an effective tax rate of approximately 10 percent once the federal direct tax is added.

The requirements for such incentives generally include the opening of offices and the employment of local staff in Neuchatel. Provided these conditions can be fulfilled, the canton of Neuchatel is prepared to ease the establishment of a foreign company, assisting with work permits, premises and recruitment of employees.

This policy has been extremely successful over recent years and many European and US companies have set up in this canton. Other cantons have followed in its footsteps. The most notable in recent months has been that of Geneva where a publicity campaign is being conducted by the economic affairs department of the canton to attract foreign investment. The campaign points out that Geneva's costs are no longer so high by international standards and offers ten-year tax holidays, at cantonal level only, for companies creating the appropriate economic activity in Geneva.

International tax planners in multinational groups should therefore keep Switzerland on their list of possible locations for siting group companies to benefit from attractive direct tax rates. There is an important shift away from the old domiciliary companies to the new companies favoured by tax incentives in cantons like Neuchatel and Geneva.

It is perhaps fortuitous that the tax incentives provided to such companies are conditional upon the creation of real economic substance in the canton concerned. This trend coincides with the increasing requirements of tax authorities that a company must contribute significantly at the economic level to the international business in order to be allowed to retain significant profits for tax purposes.

It therefore appears that the future is likely to belong to the companies favoured by tax incentives at cantonal level rather than the old fashioned domiciliary companies. Already this process is under way with significant moves by multinationals into the canton of Geneva following the success of Neuchatel. Other cantons, such as Vaud and Valais, have adopted similar measures, and so it appears that the Swiss company is back on the tax planners map, perhaps just as tax efficient as ever, and a great deal more respectable!

© 1994 International Bureau of Fiscal Documentation

PORTUGAL

RECENT DEVELOPMENTS

William T. Cunningham

Mr Cunningham is a partner of Arthur Andersen & Co. He has been in charge of the firm's Portuguese tax practice since 1983. Previously he spent nine years in the Dublin office of Arthur Andersen & Co., working on Irish, US and international tax matters. He is a fellow of the Institute of Chartered Accountants in Ireland, a member of the Institute of Taxation, the Portuguese Fiscal Association and IFA. Mr Cunningham holds a degree in Commerce from the National University of Ireland. He has lectured extensively on taxation matters for both Irish institutes and has co-authored several Arthur Andersen & Co. publications.

I. INTRODUCTION

The 1994 Portuguese State Budget[1] and the supplementary 1993 Budget[2] constitute the most extensive revision of the Portuguese tax system since the 1986 introduction of value added tax and the 1989 reform of direct taxation[3] and related incentives.[4] Their combined effect has been to signal to taxpayers a change of attitude in relation to incentives and the renewed seriousness of the Government in relation to tax evasion. However, the novelty of the concept of anti-avoidance in Portugal means that the Government's measures are directed with equal force at traditional evasion practices and at the emerging legitimate tax planning undertaken by both corporate and individual taxpayers. The result has been an increased distrust between taxpayers currently within the tax net and those entrusted by the electorate with its operation and maintenance. The retroactive nature of some of the provisions of the 1993 supplementary Budget has angered taxpayers and undermined the confidence with which these undertake the rational planning of their tax liabilities. The success of the measures in combating tax evasion remains to be seen.

II. CORPORATE TAXATION

A. Capital gains

From 1 January 1989, Portugal has had an unusually generous system of relief from taxation of capital gains. Article 44 of the Corporate Tax Code provided that capital gains on the disposal of fixed assets would not be taxable where the sales proceeds were fully reinvested in other fixed assets before the end of the second tax year following the year of disposal. No conditions were imposed on the retention of the replacement assets. No reduction of the tax-deductible or depreciable cost of the new assets was involved. In effect, the relief constituted an exemption, with no recapture provisions if the replacement assets were subsequently disposed of.

On 1 July 1989, the Tax Incentives Statute was exacted, retroactive to 1 January 1989. Article 18 of this law extended the reinvestment relief to broaden the range of assets eligible for the relief on disposal and qualifying as assets for reinvestment purposes. Disposals of and reinvestment in shares and securities were also made eligible for the relief. Full flexibility existed to switch from fixed to financial assets and vice versa. A minimum retention period of two years in respect of reinvestment in shares of Portuguese resident companies or Portuguese government securities was introduced.

During the expansionist years from 1989 to 1992 many companies availed themselves of these provisions to make tax-free disposals and restructure their holdings of fixed and financial assets. As a result, corporate tax revenues did not rise in line with corporate profits, which, particularly in 1992 were boosted by capital gains realized to offset declines in profits from trading and industrial activity.

Article 7 of Law No. 71/93 puts an end to this liberal state of affairs in three ways:

(i) the acquisition cost of replacement assets is to be reduced by the amount of untaxed capital gain on the original disposal;[5]

(ii) the depreciation of the replacement assets for corporate tax purposes is to be computed on their cost as reduced in (i) above; and

(iii) Article 18 of the Tax Incentives Statute is abolished. This means that capital gains on the disposal of assets other than tangible fixed assets – i.e. disposals of shares or securities – are no longer entitled to relief, and are fully taxable regardless of whether the related proceeds are reinvested. It also means that newly-limited relief in (i) above applies only where reinvestment is in tangible fixed assets.

Under Article 7(4), the abolition of Article 18 of the Tax Incentives Statute is "without prejudice to the continuation of its applicability to capital gains and losses realized up to the end of 1992, and to capital gains and losses realized and rein-

1. Law No. 75/93 of 20 December.
2. Law No. 71/93 of 26 November.
3. See William T. Cunningham, "Portuguese Tax Reform: A Closer Look at Portuguese Taxation", 43 *Bulletin for International Fiscal Documentation* (March 1989), at 123.
4. See M.A. García Caballero, "The New Tax Incentives Statute", 29 *European Taxation* (September 1989), at 299.
5. Art. 44(6) of the Corporate Tax Code, as amended.

© 1994 International Bureau of Fiscal Documentation

vested between 1 January 1993 and the date of entry into force of the new law". This results in the following transitional situation:

Table 1

Capital gains realized in	*Fully exempt if sales proceeds reinvested before*
1991	31 December 1993
1992	31 December 1994
1993 (pre-9 December)	9 December 1993
1993 (9 to 31 December)	No exemption–new provisions apply

The law entered into force five days after its promulgation. Some controversy surrounds the definition of the date on which it was effectively promulgated, but 9 December 1993 is the date most widely accepted as the date on which it entered into force. The situation is further confused by careless drafting. For 1993 disposals before 1 December the exemption applies if the "capital gain or capital loss is reinvested", not the entire sales proceeds. It is likely that this lack of precision will be dealt with by administrative circular rather than by new legislation to impose a requirement that an amount equal to the entire sales proceeds, rather than the gain, be reinvested for full relief to apply, and to grant only proportional relief if only part of the proceeds are reinvested.

B. Tax consolidation

In Portugal, companies within a 90 percent ownership group may "pool" profits and losses. Since the introduction of this concept in 1988,[6] access to this facility has been jealously guarded. Initially, the tax authorities interpreted the requirement for consolidation – *domínio total* – or total control by the group parent, as requiring 100 percent ownership. Even with the acceptance of a 90 percent ownership relationship, access to consolidated tax reporting was on a "case-by-case" basis, with applications being "vetted" by the Directorate General of Taxes in a highly restrictive manner. For example, subgroups within a larger qualifying group that chose not to request maximum tax consolidation were frequently refused authorization to file consolidated tax returns. The existence of one ineligible member within a group – for example, a company enjoying a tax holiday or having a branch in Madeira – was interpreted as justification for the denial of tax consolidation of all the other companies of the group.

The limited number of companies that succeeded in overcoming these obstacles face new restrictions under the 1993 supplementary Budget. Article 5 of Law No. 71/93 amends the provisions of the Corporate Tax Code dealing with tax consolidation to limit the offset of losses and profits of members of a qualifying tax consolidated group. It adds Article 59-A which provides that, where the taxable profit computed on a consolidated basis is less than 65 percent of the sum of the taxable profits of the individual members of the group computed without applying tax consolidation rules, and where this reduction results from the offset of losses of any of them, a minimum tax liability of 65 percent of that hypothetical liability is to apply, with any unutilized losses being carried forward for offset against consolidated profits of subsequent years.

Recapture of group relief is also introduced. Where authorization for tax consolidation lapses,[7] the taxable profits of the last year in which the consolidated tax return included that company are to be increased by one and one-half times the difference between the losses that were utilized against group profits and those that would have been considered for tax purposes if its individual members had been taxed on a stand-alone basis. This multiple is reduced to one where the break-up of the tax consolidated group is attributable to the expiration of the period for which tax consolidation was authorized.

To enable companies to renounce tax consolidation if they find that the new rules (retroactive to 1 January 1993) adversely affect them, Article 5(4) of Law No. 71/93 permits the group parent to request cancellation of the privilege of tax consolidation within 90 days of the entry into force of the legislation, i.e. 9 March 1994.

C. Taxation of collective investment undertakings

Portugal has not yet implemented the UCITS Directive.[8] Despite this, mutual funds have flourished since the 1989 tax reform. They are currently regulated by Decree Law No. 229 C/89 of 4 July, which is due to be superseded shortly by a new Decree Law implementing the Directive. Meanwhile, this law and the related tax legislation – the Tax Incentives Statute – distinguish between various types of funds. For tax purposes the relevant distinctions are between:

(i) Real Estate Investment Funds ("Fundos do Investimento Imobiliário – "FIIs");
(ii) Portfolio Investment Funds ("Fundos de Investimento Mobiliário – ("FIMs");
(iii) Venture Capital Investment Funds ("Fundos de Capital de Risco – ("FCRs").

The first type, FIIs, were exempt from tax on their income (usually from rentals or cash applications). Distributions by FIIs to holders of participation units were liable to a 20 percent withholding tax. For individuals and non-resident investors, this constituted full settlement of their Portuguese tax liability. For resident companies and permanent establishments of non-residents, it constituted a payment on account. Article 34 of Law No. 75/93 amends Article 19 of the Tax Incentives Statute to invert this tax treatment. From 1 January 1994, the net rental income of FIIs is liable to tax at a rate of 20 percent. Capital gains on the disposal of properties are taxable at 25 percent, but only 50 percent of the gain is to be taxable.

6. Decree Law No. 414/87 of 31 December.
7. Eligibility for tax consolidation may lapse if
- the effective ownership of any group member by the parent company falls below 10%;
- any of the group members falls outside the general tax regime (e.g. by establishing a branch in the Madera Free Zone);
- any of the group members becomes non-resident in Portugal;
- any one of a wide range of administratively imposed conditions is not met by any group member.
8. Council Directive No. 85/611/EEC of 20 December 1985.

© 1994 International Bureau of Fiscal Documentation

Other income and gains of FIIs are to be taxed as follows:

(a) Portuguese-source income is to be taxed in the same way as income of resident individuals, by deduction at source where applicable. The withholding will constitute full settlement of tax liability;

(b) non-Portuguese-source income is to be liable to tax at a 25 percent rate. The management company that administers the fund is liable for the payment of this tax to the authorities by the 20th day of the month following receipt of the income;[9]

(c) capital gains are taxable at 10 percent. The relevant management company is liable to pay the tax to the State by the end of April of the year following that to which it relates.

The income and gains of FIMs and FCRs is taxable in the manner outlined in (a) above in relation to FIIs. Individual unit-holders are exempt from further taxation on distributions received from FIMs and FCRs unless they elect to include them in their reported taxable income, in which case the withholding tax suffered by the fund is creditable on a *pro rata* basis against their tax liability. If they hold the units as business investments, reporting is compulsory, as it is for companies. Non-residents are exempt from tax on such distributions.

D. Anti-abuse provisions

Article 28 of Law No. 75/93 contains two legislative authorizations designed to enable the Government to introduce specific anti-evasion legislation for purposes of individual and corporate tax.

The first of these is to deny a tax deduction for amounts paid or payable to non-resident individuals or companies that are subject to a tax regime that is clearly more favourable than that of Portugal, unless the taxpayer can prove that the expense relates to transactions effectively entered into, and that the expense is not of an "abnormal character or exaggerated amount".

The second, when legislated, will attribute to Portuguese resident shareholders of companies resident outside Portugal and subject there to a tax regime that is clearly more favourable than that of Portugal, a proportional part of the profits of those companies, where the taxpayer holds directly or indirectly 25 percent or more of the non-resident company.

E. Banks' pension liabilities

The period for banks to constitute tax-deductible provisions for pension liabilities in respect of personnel employed by them on 31 December 1990 has been extended from five to seven years.

F. Tax-deductible provisions

There is a minor modification to the wording of Article 33(1)(d) to provide for the tax deductibility of provisions set up not only by financial institutions subject to Bank of Portugal supervision but also to Portuguese branches of EC-based banks and financial institutions, which, since 1 January 1993, passed to the supervision of the monetary authorities in their home country.

G. Regime applicable to Macau

The exemption from corporate tax and individual income tax in respect of profits of a Macau permanent establishment of a Portuguese resident is removed in relation to profits from Portuguese sources, except where the taxpayer proves that such profits relate to assets allocated to a permanent establishment for valid economic reasons and not for tax reasons.

H. Withholding tax

1. Interest on Portuguese government securities

The Government is authorized by Article 27 of Law No. 75/93 to legislate to exempt non-residents from taxation[10] of interest on public debt. The exemption is to operate by refund. However, Portugal will have to make radical changes to its present slow pace of refunding excess withholding taxes. At present, many non-resident companies experience delays of up to five years in obtaining refunds of excess withholding taxes on interest and royalties. The right to a refund will be conditional on the interest being subject to a tax regime outside Portugal that is not more favourable than the Portuguese regime. The authorities will be empowered to suspend or cancel refunds where they suspect the exemption is being availed of in connection with tax evasion or fraud.

2. Gambling winnings

The flat rate of 25 percent applicable to winnings from lotteries, betting and sweepstakes is increased to 35 percent.

3. Artistes and athletes

The withholding of 25 percent is extended to payments of fees to non-resident companies in respect of performances in Portugal by artistes or sportsmen, unless it can be demonstrated that such persons do not directly or indirectly control the company in question.

9. Art. 91 (4) of the tax code.

10. Text of the relevant article:
"The Government is authorised to adopt such legislative measures as are necessary to grant exemption from individual or corporate taxation in respect of interest on negotiable Government debt held by individuals or entities not resident in Portuguese territory and not operating here through a permanent establishment. The exemption is to operate by refund of tax paid or withheld. The right to exemption is conditional on the taxation regime to which the interest is subject outside Portugal not being demonstrably more favourable than it would have been in Portugal [in the absence of the exemption – author]. The Portuguese administration may suspend or cancel refunds where it is presumed that the exemption is being used is connected with evasion-related or fraudulent activities."

© 1994 International Bureau of Fiscal Documentation

I. Unilateral credit for foreign taxes

The deduction previously available for foreign tax suffered by Portuguese resident companies is replaced by a credit,[11] regardless of the existence of a tax treaty.

III. INDIVIDUAL TAXATION

A. Individual tax rates

The 1994 tax rate schedules are as follows:

(All figures in thousands of Escudos)	*Rate*
Up to 930[12]	15%
Between 930 and 2,170	25%
Between 2,170 and 5,570	35%
Over 5,570	40%

B. Rental income

In computing the amount of taxable income from the letting of Portuguese immovable property, the 35 percent standard deduction which was available in the absence of documented expenses of a greater amount is to be abolished. From 1994, only documented expenses are deductible against rental income.

C. Pensions

The first PTE (Portuguese Escudos) 1,200,000 of pension income is to be excluded from taxable income. However, pensions that exceed the current salary of the Prime Minister are to have the excluded amount reduced up to the amount of that excess.

D. Deductible expenses

Deductible expenses have been increased by between 3 and 4 percent, as follows:
(Figures are in PTE, and relate to taxpayers who are married filing jointly. The figures in brackets are for single, divorced, widowed or other taxpayers.)

Table 2

	1993	1994
Deductions:		
Earned income deduction	400,000	416,000
Overall limit on deductions	280,000	291,000
	(140,000)	(145,000)
Overall limit where insurance premiums, social security contributions and university-level educational expenses are involved	320,000	333,000
	(160,000)	(166,500)
Overall limit where expenditure on renewable energy equipment is involved	370,000	385,000
	(230,000)	(239,000)
Maximum limit on home mortgage interest or rental payments under new (post-15 October 1991) rental regime	260,000	270,500
Personal tax credits:		
Single, divorced or widowed taxpayer	29,000	30,100
Married filing jointly	44,000	45,600
Each child	16,000	16,500

The minimum standard deduction (PTE 140,000 for married, PTE 70,000 for single, taxpayers in 1993) is abolished for 1994 and future years. There is also a minor change to Article 55 of the tax code, to deny a tax deduction for the subsidized part, if any, of rentals paid under rental agreements entered into in accordance with Decree Law No. 321-B/91 of 15 October.

E. Tax incentives

The exemption from tax on interest on deposits in home purchase savings accounts is abolished for 1994 and later years.

The exemption for interest on emigrants' deposit accounts is also abolished, with a special rate of 12.5 percent applying with effect from 1 January.

The tax deduction for contributions to individual retirement savings accounts is halved to the lesser of PTE 250,000 per taxpayer or 20 percent of reported gross income.

F. Tax return filing dates

In place of the existing filing deadlines, a range of dates for filing tax returns is to be introduced as follows:
- for individuals having income only from employment or pensions: between 1 February and 15 March;
- for individuals having other sources of income: 16 March to 30 April.

G. Stamp tax

The amendments confirm that stamp tax at 0.5 percent applies to the amount of guarantees granted on behalf of Portuguese resident entities, even where the guarantor is a non-Portuguese credit institution or an overseas branch of a Portuguese credit institution. The person obliged to present the guarantee is liable for payment of the tax.

Stamp tax is also imposed at a rate of 0.5 percent on commissions payable by Portuguese resident entities in connection with the above guarantees.

H. Special tax on the enhancement of property values as a result of EXPO '98 in Lisbon

The Government is authorized to legislate for a special tax or betterment levy on properties that enjoy appreciation in value

11. The anomaly remains whereby Portuguese resident individuals are not entitled to a deduction or a credit for taxes suffered in a country that does not have a tax treaty with Portugal.
12. In the initial Budget proposals the PTE 930,000 figure was only PTE 920,000.

© 1994 International Bureau of Fiscal Documentation

as a result of EXPO '98. The proceeds of this tax may be passed to the company Sociedade Parque Expo '98, which is responsible for staging the International Exhibition of Lisbon in 1998. The Government is also authorized to grant exemptions to that company in respect of municipal property tax, stamp tax, notary and registration charges, municipal property transfer tax and gift and inheritance tax.

I. Value added tax

All of the proposed VAT changes will require specific legislation. Law No. 75/93 merely authorizes the Government to enact the necessary decree laws.

An exemption is to be introduced for the provision of international services in connection with movable property, carried out mainly in Portugal for a customer who is a VAT-registered taxpayer in another EC member state, who in any case could recover that VAT by way of refund. This exemption is also to be extended to transportation services in Portugal directly connected with intracommunity transport, including the provision of accessory services. This measure is intended to avoid the administrative effort of collecting tax and then refunding it under the provisions of the Eighth EC VAT Directive.

The limit that must be reached before a refund of VAT may be claimed is to be increased from PTE 500,000 to PTE 1,500,000.

The registration threshold of PTE 1,200,000 in turnover per annum is increased to PTE 1,500,000. The PTE 1,700,000 threshold currently applicable to small retailers is to be increased to PTE 2,000,000.

The facility available until now of effecting penalty-free corrections of tax in favour of the State in the VAT period (usually the month) following that to which they relate is to be eliminated.

J. Excise taxes

- The alcohol tax of PTE 150 per litre of alcohol is increased to PTE 1,348 per litre.[13]
- The tax on consumption of alcohol-based products is extended by broadening the definition of beverages covered and by raising the rate schedules on average by 6 percent.
- The tax on new motor vehicles is increased by around 10 percent.
- The annual municipal tax on motor vehicles is increased by 6 percent.
- The special tax on tobacco is increased by 15 percent, and stronger anti-evasion measures are taken to combat the influx of contraband cigarettes.
- The tax on petroleum-based products is to be revised, with the government being authorized to introduce a fixed-rate tax.

In addition, the omission in the 1989 tax reform of any provisions relating to the taxation of petroleum extraction (of which there is currently none in Portugal) is to be remedied, with the Government being authorized to introduce a progressive tax of up to 10 percent on the value of production. Natural gas production and deep-water drilling platforms are excluded from the scope of this tax.

K. Gift and inheritance tax

The tax rate schedules have been adjusted, approximately in line with inflation since their last revision in 1989.

L. Municipal property transfer tax ("Sisa")

The values in each of the bands liable to this tax on transfers of residential property are increased.

M. Large investment projects

The PTE 5,000 million ceiling for investment projects to qualify for corporate tax, property transfer tax, municipal property tax and stamp tax by means of a contract with the Portuguese State has been extended to projects aimed at the internationalization of Portuguese companies. Previously, this reduced ceiling applied only to projects aimed at the restructuring of national industrial enterprises, and projects aimed at the internationalization of Portuguese companies had to equal or exceed PTE 10,000 million to qualify. The PTE 5,000 million ceiling may also be lowered for eligible projects on a case-by-case basis.

N. Mergers and concentrations of enterprises

The Government is authorized to extend to 31 December 1995 the provisions already in force, but due to expire at the end of 1993, under which exemption from Sisa transfer tax may be requested of the Minister for Finance.[14] The scope of the exemption is to be extended to all acts and transactions associated with such corporate reorganizations. The definition of "acts of concentration" for purposes of the exemption is to be redrafted, to include the following:

- mergers of companies, nationalized corporations or cooperatives;
- the incorporation of companies by means of the absorption of all or part of the assets of an enterprise, whether operating in individual or corporate form, which from a technical viewpoint could be regarded as an autonomous business, provided that activity is discontinued by the shareholders and passes to the new company;
- the absorption, by a company already incorporated or to be incorporated, of all or part of the assets of other com-

13. Rectification No. 2/94 published in *Diário da República* of 1 February 1994 "corrected" this figure to PTE 159 per litre of 100% alcohol at 20ºC.

14. As of the date of writing this article the Government has not yet issued the legislation to extend the mergers incentives to 31 December 1995. However, in anticipation of a delay in this regard, Art. 36(2) of Law No. 75/93 extends the term of validity of the original incentives law, Decree Law No. 404/91 of 21 December, until the date of entry into force of the authorized new legislation.

© 1994 International Bureau of Fiscal Documentation

panies or individually-run businesses, provided the absorption includes all the assets of the activity or constitutes from a technical viewpoint a separate business and the companies or businesses absorbed cease to exist after the absorption;
- demergers of companies, provided such operations result in a concentration in one of the above forms.

IV. CONCLUSION

Most of the above changes entered into force on 1 January 1994. More controversially, those outlined above under II.A. and B. are retroactive to 1993. Other provisions will require the enactment of specific legislation. This usually takes several months, and frequently legislative authorization lapses before the drafting process is complete. Therefore, the anti-abuse measures and the exemption of non-residents from tax on Portuguese Government debt will be the subject of detailed future legislation that, when available, will merit close attention from businesses and investors. The VAT measures are easier to implement and should be implemented during February or March 1994.

NEW - NOW WITH OVER 30 COUNTRIES

Fast access to details of European tax law in one convenient volume

- Extensive, up-to-date summaries of the taxation of corporations and individuals
- Corporate taxation summaries include income taxes, group treatment, social security contributions, turnover taxes and net-worth taxes
- Individual taxation summaries include income taxes *(including local taxes)*, inheritance and gift taxes, social security contributions and net wealth taxes
- Particular attention is given to non-residents and relief from double taxation

1994 edition extended to cover over 30 European countries, plus a chapter on EC tax measures

Price (single copy of the 1994 edition): NLG 350
1994 subscription price: NLG 280

Now also available on subscription! Receive the new edition automatically every year for a lower price

IBFD PUBLICATIONS BV
P.O. Box 20237 · 1000 HE AMSTERDAM · THE NETHERLANDS
Tel: +31 (0)20 626 77 26 · Fax: +31 (0)20 622 86 58

© 1994 International Bureau of Fiscal Documentation

FRANCE

TRANSFER OF THE AVOIR FISCAL TO NON-RESIDENTS: NEW RULES, OPPORTUNITIES AND PRACTICAL CONSIDERATIONS

Philippe Juilhard

Mr Juilhard is Avocat at Bureau Francis Lefebvre, London and also a member of the New York bar.

It is a well-known fact that the taxation of business profits, where two different persons are taxable by reason of the same income, is the simplest example of "economic" double taxation of income. Business profits are first taxed at the level of the company, and again in the hands of the dividend recipient. To mitigate this double taxation, many countries have introduced specific provisions in their domestic legislation. In France, an imputation credit, i.e. the "avoir fiscal", is granted to resident individual or corporate shareholders receiving a dividend paid by a French company.[1]

This article analyses the peculiar situation of non-resident taxpayers in light of recent changes regarding tax treaty benefits when the avoir fiscal is transferred, the situation concerning US pension funds and the *Règlement mensuel* market. It also appears that a new policy may be in the making whereby the tax authorities will extend the benefit of a partial transfer of the avoir fiscal to foreign parent companies, as is the case under the France–Italy treaty.[2] If continued, this new trend may have an impact on the organizational chart of European groups with a French affiliate.

Before addressing these specifics, however, it might be of interest to overview the avoir fiscal and its counterpart, the "précompte", from both a domestic and an international point of view.

I. BACKGROUND OF THE AVOIR FISCAL

A. General principle

Profits realized in France and distributed by a company subject to corporate tax are taxed twice – once at the company level as corporate tax (at the rate of 33.33 percent), and at the shareholder level as distributed income tax (either personal tax or corporate tax, depending on the nature of the shareholder). As a general rule only French residents are entitled to the avoir fiscal, unless a tax treaty extends the benefit to non-residents.

The avoir fiscal mechanism was introduced to take into account the fact that the dividends distributed, and taxable as such in the hands of the shareholders, were originally subject to tax at the company level when the profits were realized. The mechanism implemented to mitigate the impact of double taxation of corporate income was to grant the shareholder an imputation credit which is deducted from his final tax bill.

The avoir fiscal attaches only to regular dividend distributions made by French companies, as opposed to other types of distributions, and it represents 50 percent of the dividend distributed. Initially the avoir fiscal only accounted for 50 percent of the underlying corporate tax, so that its effect was to minimize the overall tax burden. With the gradual reduction of corporate tax from 50 percent to the current 33.33 percent, the avoir fiscal represents a full refund of the upstream corporate tax and thus completely eliminates the double taxation of dividends for both individuals and corporations.

The taxable dividend is grossed up by the amount of the avoir fiscal credit, and the avoir fiscal is then deducted from the income tax computed on the grossed-up dividend. If the avoir fiscal exceeds an individual's income tax liability, the individual shareholder may request a refund of the excess.[3] Corporate shareholders, however, are not entitled to a refund, so they may lose their right to the avoir fiscal. Example 1 shows, in somewhat simplified form, the general mechanism of the avoir fiscal for both corporations and individuals.

Example 1

	Corporate shareholder	Individual shareholder
Profit before tax	100	100
Corporate tax (33.33%)	(33.3)	(33.3)
Dividend	66.7	66.7
Avoir fiscal (50%)	33.3	33.3
Taxable income (66.7 + 33.33)	100	100
Corporate tax (33.33%)	33.3	–
Income tax (56.8%)(1)	–	56.8
Avoir fiscal	(33.3)	(33.3)
Corporate/personal income tax due	0	23.5
Net after-tax income	66.7	43.20

(1) Maximum marginal income tax rate.

1. French Tax Code (hereinafter "CGI"), Art. 158. Although Art. 158 provides that only resident shareholders are entitled to the benefit of the avoir fiscal, some tax treaties extend the benefit to non-residents (see text below).
2. This treaty entered into force on 1 May 1992, and is currently the only treaty concluded by France under which France grants the avoir fiscal at one-half of its amount to a foreign parent company holding 10% or more of the capital of the French subsidiary.
3. CGI Art. 158 bis.

© 1994 International Bureau of Fiscal Documentation

Certain conditions must be met in order to qualify for the avoir fiscal:

- the distributing company must be treated as a corporation for tax purposes (i.e. it must be subject to French corporate tax) and not be exempt as are, for example, certain investment companies;
- the distribution must be a "true" distribution (a regular distribution in cash or in kind, and not a deemed distribution as, for instance, under transfer pricing adjustments);
- the distribution must benefit all shareholders *pro rata* based on their participation in the French company;
- the distribution must result from a resolution reached by a meeting of the shareholders;
- the dividends, grossed up by the avoir fiscal, must be included in the shareholder's taxable income in France.

The Technical Amendment Law for 1993 has introduced another condition for the avoir fiscal in the case of split ownership of shares between a bare owner and a usufruct owner. This new provision, which aims to close a loophole in the French tax legislation, will be addressed below.

B. International aspects of the avoir fiscal

At the international level, tax regimes applicable to shareholders vary widely since French domestic provisions may be limited by treaty law, in which case a non-resident shareholder's situation depends on the provisions of the applicable treaty.

Under French domestic law, dividends paid by a French corporation to a non-resident individual or corporate shareholder are subject to a 25 percent withholding tax unless reduced or eliminated by a treaty or under the parent-subsidiary directive.[4] CGI Article 242 quater, however, provides that the avoir fiscal may be granted to non-resident shareholders if a treaty so provides.

France's tax treaties generally reduce the 25 percent French withholding tax on dividends and, under certain circumstances, extend the benefit of the avoir fiscal to non-residents. Under France's most important treaties, the avoir fiscal is extended to individuals resident in the treaty country, in which case the French withholding tax is generally levied at the rate of 15 percent (i.e. the treaty rate) on the aggregate amount of the dividend and the attached avoir fiscal.

The situation is more complex for non-resident corporate shareholders, as the reduced withholding tax rate may depend on whether or not the dividend is paid to a parent company. The requisite shareholding to qualify as a parent varies from treaty to treaty but is generally set at 10 percent.

In general, corporate shareholders holding a substantial participation in the French company, i.e. more than 10 percent, may not claim the benefit of the avoir fiscal but rather benefit from a super-reduced rate of withholding tax (5 or 10 percent). However, a recipient company which is not entitled to the avoir fiscal may be entitled to a refund of any précompte paid by the distributing company less withholding tax at the treaty rate (see below).

Foreign corporate shareholders who do not hold a substantial participation in the French company may, depending on the wording of the tax treaty, claim the benefit of the avoir fiscal; withholding tax is levied at the treaty rate (generally 15 percent) on the aggregate amount of the dividend and the attached avoir fiscal.

The availability of the avoir fiscal in the international context varies substantially from one country to another. A number of France's treaties limit the entitlement to the credit. Some treaties do not provide for the benefit at all, either to individual or corporate shareholders.[5] Some treaties only grant the avoir fiscal to individual shareholders but not to corporate shareholders (regardless of their participation in the French distributing company).[6] However, there may be a new trend in French treaties to grant a partial credit to corporate shareholders holding a substantial participation in the capital of the French company. This situation will be examined in II.D below.

Under current rules, a specific procedure must be followed in order to benefit from the avoir fiscal. The avoir fiscal is generally not payable before January of the year following payment of the dividend, i.e. for a dividend decided in July 1993 and paid in September, the avoir fiscal will only be paid as from 15 January 1994 (generally May or June). Until recently, where a foreign shareholder was entitled to the avoir fiscal, the reduced treaty withholding tax rate would be granted by the French tax authorities in two steps: the full 25 percent rate would be collected upon payment of the dividend, and when the French payor received the required documentation evidencing the recipient's eligibility for the avoir fiscal, the excess withholding tax levied on the dividend was reimbursed.

Example

Step 1	
Dividend	100
Withholding tax (25%)	(25)
Dividend paid	75
Step 2	
Avoir fiscal	50
Withholding tax on the AF (15% x 50)	(7.5)
Excess withholding tax on the dividend	10
	52.5
Total payment (75 + 50 - 7.50 + 10)	127.5
Total withholding tax (= 15% X (100 + 50)	22.5

4. CGI Art. 119 bis-2. No such withholding tax is due on dividends distributed to resident shareholders. If the dividend recipient is located in a non-treaty country, the benefit of the avoir fiscal is not extended.
5. This is notably the case in the treaties with Algeria, Bangladesh, Bulgaria, Canada, China, Cyprus, Congo, Czechoslovakia, Denmark, Egypt, Equador, Hungary, Indonesia, Iran, Ireland, Israel, Jordan, Kuwait, Lebanon, Madagascar, Morocco, Monaco, Nigeria, Oman, Pakistan, Philippines, Poland, Portugal, Romania, Saudi Arabia and the United Arab Emirates.
6. This is notably the case of the tax treaties with Australia, Belgium, New Caledonia and St. Pierre et Miquelon.

© 1994 International Bureau of Fiscal Documentation

C. Précompte

A special tax, known as the equalization tax (précompte) is the counterpart to the avoir fiscal. The précompte, which is always equal to the avoir fiscal attached to a dividend, is due on all distributions of income which have not borne full corporate income tax in France,[7] and on income realized more than five years before the date of distribution (regardless of whether the income was subject to corporate income tax).[8] In the first instance, the rationale for the précompte is to compensate the French Treasury for granting the shareholder the avoir fiscal in respect of dividends distributed from exempt income or income subject to a reduced rate of tax, and in the second instance, the précompte appears to be a penalty for non-distribution of income.

Where a non-resident corporate shareholder is not entitled to the avoir fiscal (e.g. because it is a parent company), it may claim reimbursement of any précompte paid if it is located in a treaty country, even if the treaty does not specifically provide for such reimbursement.[9] The rationale for this favourable position is that the précompte on tax-exempt profits is the corollary of the avoir fiscal, and it would be unfair not to reimburse précompte paid by the distributing company when the distributee may not be entitled to the avoir fiscal.

According to the tax authorities, a refund of précompte may only be granted to a non-resident shareholder where an effective cash payment has been made by the distributing company to the French Treasury. As a rule of practice, the tax authorities will agree to refund the précompte when such charge has been paid by the French subsidiary of the distributing company.

Notwithstanding this rule of practice, the compatibility of the tax authorities' position with treaty law may be questionable if the authorities refuse to refund the précompte if such charge has been paid with the avoir fiscal. Accordingly, certain tax treaties provide that, unless a non-resident shareholder benefits from the avoir fiscal, the shareholder may claim reimbursement of the précompte relating to dividends which were paid by the distributing company.[10]

It is interesting to note that new tax treaties appear to restrict the refund of précompte to that which has been "effectively paid" (i.e. actually paid), rather than "merely" paid (i.e. offset against avoir fiscal or tax credit). However, using the avoir fiscal to satisfy payment of précompte may be sufficient for claiming the refund regardless of whether the treaty provides for a refund of précompte merely paid, or whether it provides for a refund of précompte effectively paid. Such a position, however, is contentious and the chance of success varies considerably depending on the actual wording of the treaty.

II. TAX OPPORTUNITIES AND RECENT DEVELOPMENTS RELATING TO THE AVOIR FISCAL

A. Avoir fiscal and treaty benefits

In a communiqué dated 17 September 1993, the Minister in charge stated that, for dividends paid as from January 1994, the benefit of the reduced treaty rate (generally 15 percent) will be granted immediately to non-resident shareholders entitled to the avoir fiscal under a treaty.

As from 1994, for a French-source dividend paid to a non-resident shareholder entitled to the avoir fiscal under a tax treaty, the shareholder will receive 85 immediately on a dividend payment of 100 (100 – 15, assuming a 15 percent withholding tax) instead of 75 under the "old" administrative procedure (100 – 25, see I.B. above). Upon payment of the avoir fiscal in the year following the year of distribution, the foreign shareholder will then receive an additional cash payment of 42.5 (50 – 7.5) instead of 52.5. This communiqué puts an end to the above-mentioned administrative practice which, to a certain extent, was financially prejudicial to the non-resident shareholder.

Unfortunately, the non-resident shareholder will still have to wait for the transfer of the avoir fiscal until the year following the year of the dividend payment. In the meantime, the exact procedures and certification requirements remain unclear. What is clear is that, for a dividend of 100 paid in July 1994, the net received should be 85 at payment date, and a supplementary payment of 42.50 should be received at the earliest on 15 January 1995.

B. US pension funds

1. General

The situation of collective investment entities (pension funds) as regards treaty benefits, and particularly the transfer of the avoir fiscal, is rather vague. Pension funds generally enjoy a special tax regime for their investment income and it is therefore questionable whether they can be considered as "resident" under a tax treaty. As a general rule, the French tax authorities do not allow pension funds to benefit from the avoir fiscal. However, for certain institutional investors established in the EC, the French tax authorities have agreed, subject to their prior authorization, to grant the benefit of the avoir fiscal credit.[11]

Until 1991, it appeared that as a practical matter the transfer of the French avoir fiscal tax credit to US pension funds did not create any particular problems. In 1991, however, the French tax authorities suddenly refused to apply the reduced treaty rate or to grant the avoir fiscal to US pension funds on the grounds that such funds were not subject to US tax on French dividend income so they could not benefit from the reduced rate of withholding tax or the avoir fiscal. This marked a dramatic change in the situation of US pension funds. For example, a pension fund which received a gross

7. For example, long-term capital gains and foreign branch income.
8. Précompte is due regardless of whether the shareholder is resident of France.
9. However, the reimbursement is subject to French withholding tax.
10. Some tax experts are of the opinion that, under such a provision, refund of précompte should not depend on any actual disbursement by the distributing company and should be allowed even if the précompte is offset against the underlying avoir fiscal.
11. This position mainly concerns pension funds in the Netherlands and Germany.

© 1994 International Bureau of Fiscal Documentation

dividend of 100, only received a net income of 75 (100 – 25) rather than 127.5 (150 – 22.5) when the reduced treaty withholding tax rate and avoir fiscal applied.

2. The revenue authorities compromise

In an administrative communiqué of 17 September 1993 the French tax authorities agreed to a compromise solution of the US pension fund issue pending renegotiation of the France–US treaty. According to the compromise dividends paid as from 1 January 1991 to US pension funds will be subject to the reduced treaty withholding tax of 15 percent, as well as a partial transfer of the avoir fiscal equal to the tax withheld.

Therefore, for a gross dividend of 100 which gives rise to a net payment of 85 after a withholding tax of 15, the US pension fund would receive a complementary payment of 15, as a partial refund of the avoir fiscal. As it appears that the partial avoir fiscal itself is not subject to withholding tax at the normal withholding tax rate, the result is no withholding tax on dividends. These benefits apply retroactively, so US pension funds which have received dividends since January 1991 are entitled to claim a refund of the avoir fiscal. The tax authorities have thereby clearly compromised but the result is not entirely satisfactory.

At law, a person either falls within the scope of a treaty or falls outside it, which leads first to the question of whether US pension funds are covered by the France–US treaty, and second whether they are entitled to the avoir fiscal. As regards the first issue, Article 3(2) of the treaty defines the term "resident of the US" as a US corporation or a person which is resident in the United States for purposes of US tax. Therefore, assuming that US pension funds are corporations or "other persons" for US tax purposes, even though they are exempt from tax they should benefit from the treaty provisions since they should be considered as US residents for tax purposes (depending on the precise characteristics of the fund).

As regards the second issue, i.e. the transfer of the avoir fiscal, Article 9 of the treaty does not make the avoir fiscal conditional on the US recipient being taxable on the grossed-up amount of the dividends and the avoir fiscal, unlike the solution adopted in other treaties. In particular, Article 9(6)(D), which provides that the competent authorities may prescribe regulations to implement the provisions relating to the transfer of the avoir fiscal and further define and determine the terms and conditions under which such transfer may be made, does not appear to allow France to limit the transfer of the avoir fiscal to a partial payment.

C. Monthly settlement market

As a starting point it should be noted that the French Civil Code provides that a sale is realized between parties and ownership is transferred from a seller to a buyer at the time an agreement is reached on the object and on the price, even though the object has not been delivered or the price has not been paid. However, the tax authorities have been reluctant to draw general tax consequences from this purely legal principle. As from 1 July 1994, a transfer of ownership of securities traded on a regulated market (as is the case with the Monthly Settlement Market ("RM Market")) will operate at settlement date and not at trade date.[12]

The settlement date for the RM Market is only once a month, generally around the 20th, so that between trade date and settlement date, a dividend coupon may be paid. Under these circumstances, the issue arises as to whether the dividend belongs to the seller or the buyer. The uncertainties surrounding this situation were exacerbated by the fact that a seller pays to the buyer an indemnity equal to the net amount of the coupon.

This situation has led to discrepancies between the tax treatment of dividends on RM market transactions. Practices varied from one financial institution to the other. Some institutions would consider that the buyer, because of the indemnity, was the ultimate beneficiary of the dividend, which resulted in an exemption for the seller. Other institutions would consider that the seller was the actual beneficiary of the dividend, which resulted in an exemption for the buyer. Finally, some institutions did not consider either the seller or the buyer to be taxable, since the seller only compensated the buyer.

The French tax authorities recently issued a note on the peculiar situation that exists on the RM Market. They made it clear that the seller's indemnity to the buyer corresponds to a correction of the price paid by the buyer in order to compensate for the fact that the share is delivered ex coupon, and that the indemnity as such may not be seen as a refund of the dividend coupon from the seller to the buyer. This derives from the principles set forth in the general regulations of the Stock Exchange Council which provide, *inter alia*, that deliveries of shares on the RM Market are made ex coupon. The purchaser of a share cum coupon is credited with an indemnity equal to the net coupon, and correlatively the seller is debited from the same amount.

The tax authorities therefore conclude that the seller receives the dividend at the time the coupon is paid, so he is taxable on such dividend, increased (as the case may be) by the avoir fiscal. Thus if a share is sold on the RM Market at trade date for 105 and a coupon of 5 is paid in the interim period between trade date and settlement date (a payment at record date), the buyer pays 105 but receives an indemnification of 5 for the loss of the coupon at the time of delivery of the share, and the purchase price for him is 105 – 5 = 100. For the seller who receives 105, the sale price is reduced by the indemnity of 5 (the sale price is 105 – 5 = 100), and in addition the seller receives a dividend of 5, increased by the avoid fiscal, as the case may be.

This tax treatment solves the problem of the intrinsic value of the share since the sale price is equal to the purchase price, while the other method necessarily leads to a discrepancy.

12. Law of 31 December 1993.

© 1994 International Bureau of Fiscal Documentation

D. Possible new trend in tax treaty policy: the France–Italy tax treaty

The France–Italy tax treaty of 5 October 1989 (in force as from 1 May 1992) provides for a specific mechanism to transfer part of the avoir fiscal to Italian corporate shareholders holding more than 10 percent of the capital of the French distributing company.

Under Article 10(3) of this treaty, an Italian resident receiving a dividend which, if received by a resident of France, would entitle such resident to the avoir fiscal, is entitled to:

- a cash payment from the French Treasury subject to a 15 percent withholding tax when the Italian resident is either (i) an individual who includes the grossed-up dividend in his gross income for income tax purposes, or (ii) a company which includes the grossed-up dividend received for corporate income tax purposes;
- a cash payment of 50 percent of the avoir fiscal subject to a 5 percent withholding tax when the Italian beneficiary is a corporation which owns 10 percent or more of the share capital of the French distributing company.

This treaty shows a possible new tendency of the French tax authorities not to limit the benefit of the avoir fiscal to individual shareholders or corporate shareholders that are not parent companies, but rather to extend it to non-resident companies having a substantial holding in the French subsidiary. This new policy is probably conditional upon reciprocity.

However, it raises a difficulty with respect to the compatibility of the 5 percent withholding tax with EC law. Dividends paid to qualifying EC parent companies (in particular the threshold of 25 percent) are exempt from any withholding tax in France. CGI Article 199 ter, however, reserves the right to withhold tax where the qualifying EC parent company is "*entitled to a payment from the French Treasury equal to the avoir fiscal* or to part of it in excess of the withholding tax provided for by the relevant tax treaty". The rationale for this provision is that the non-resident shareholder will in any case receive in the aggregate more than is required under the 1990 EC Directive. Accordingly, when a treaty provides for a transfer of part of the avoir fiscal subject to a 5 percent withholding tax, the withholding tax exemption may not apply since the payment received by the non-resident shareholder will exceed the withholding tax under the treaty provision.

The compatibility of this domestic provision with the directive is questionable, as the dividend distributed is still subject to a withholding tax, even though all of the conditions of the Directive are fulfilled. A strict reading of the Directive, combined with such a treaty provision should, in theory, lead to a levy of withholding tax only on the avoir fiscal transferred.

Under existing tax treaties with EC Member States, a refund of avoir fiscal is generally not granted to a qualifying parent company, except under the new France–Italy tax treaty. However, this issue goes beyond the scope of the Italian treaty since it could perhaps be used as a model for new treaties or for the renegotiation of existing ones.

The following example may illustrate the issue:

Administrative views		Strict reading of the Treaty and the Directive
Dividend	100	100
1/2 avoir fiscal	25	25
Grossed up dividend	125	125
Withholding tax (5%)	6.25	5% WT on ½ AF(1.25)
Net dividend	118.75	123.75

E. Investment vehicles

Specific rules for the transfer of the avoir fiscal apply where the non-resident shareholder does not hold his investment in the French distributing company directly but rather through an investment vehicle. For purposes of this article, we will limit our review to two types of investment vehicles: the "Fonds Commun de Placement" (("FCP") (investment fund) and the "Société d'Investissement à Capital variable" (("SICAV") (investment company).

1. FCPs

FCPs do not have legal personality and are not subject to corporate tax. They are generally not treated as "persons" or as "residents" under treaty law. Accordingly, even if FCPs may be treated as persons under those tax treaties which provide that a body without legal personality qualifies as a person, they could not qualify as French residents under said treaties because they are not liable for tax in France by reason of their residence, place of management or other criterion of a similar nature.

Given this pure flow-through characteristic of FCPs, income received and redistributed by an FCP keeps its original nature as to source (French or foreign) and its qualification (interest or dividends).

Therefore, foreign-source income may not be subject to withholding tax in France and the FCP may not transfer to its holders the tax credits since it is not entitled to benefit from them. The benefit of the tax credits should therefore be claimed directly by the FCP holder.

For foreign investors with non-French assets, the interposition of the FCP is neutral. The question whether unitholders will be able to take advantage of the tax treaties between their countries of residence and the country of source of the income will depend upon the legislation of each of such countries.

For foreign investors with French assets, as the FCP is transparent, non-resident unitholders will be in the same situation as if they owned the assets directly. Consequently, French-source dividends and interest will be subject to the normal withholding taxes provided for under domestic law, but unitholders resident in treaty countries will be able to benefit from the relevant tax treaty and the corresponding limitations of withholding taxes and transfer of tax credits, including the avoir fiscal.

The foreign unitholder may only claim the benefit of the treaty pro rata to his holding in the FCP. In order to obtain such treaty benefit, the foreign investor must file with the

© 1994 International Bureau of Fiscal Documentation

manager of the fund all necessary documentation to prove that he is a resident of a treaty country.

It should be noted that where an FCP's units are held by a large number of unitholders and where the assets are internationally diversified, it is in practice very difficult to apply the multiple tax treaties that may be concerned.

2. SICAVs

Distributions made by a SICAV are subject to specific rules, the purpose of which is to place the beneficiary shareholders in the same position as if they held the portfolio directly.

A SICAV is not a tax transparent entity but is tax-exempt if it distributes dividends (and interest) which it receives. Dividend distributions by SICAVs do not entitle the shareholders to the avoir fiscal and other tax credits attached to the investment income the SICAV has itself received. Since a SICAV is a legal entity and not a flow-through entity, SICAV shareholders are in principle unable to take advantage of a treaty on an individual basis (unlike the case of FCP unitholders). Whether or not a SICAV falls within the scope of a tax treaty must be examined on a case-by-case basis. If a treaty is applicable, foreign-source income will benefit from reduced withholding tax rates and the related tax credits will be transferable by the SICAV to the shareholders.

Subject to double taxation agreements, dividends paid to non-resident shareholders are liable to a 25 percent withholding tax under deduction of available foreign-source tax credits or tax credits related to certain French bonds.[13]

When the non-resident beneficiary is resident in a treaty country, the reduced withholding tax rate will be applicable, still under deduction of the above-mentioned tax credits.

Certain tax treaties specifically provide for the transfer of the excess tax credits and avoir fiscal attached to French-source dividends collected and redistributed by the SICAV.

F. Avoir fiscal and usufruct holders

The Technical Amendment Law for 1993 (Article 45) introduced an additional condition for granting the avoir fiscal to non- residents where the ownership of the shares has been split between two entities into bare ownership and usufruct.

Under this amendment, where the bare owner is a non-resident the avoir fiscal may only be granted to the usufruct holder (i.e. the entity entitled to the dividend) if the effect of splitting the ownership between the two entitites was not to obtain the benefit of an avoir fiscal credit which would not have been available without the splitting of ownership. This provision applies as from 24 November 1993, and applies not only to bare ownership/usufruct splits, but also to all kinds of arrangements with the same effect.

The tax authorities have explained that the goal of Article 45 is to put an end to certain legal structures which had developed during the last few years, one purpose of which was to grant the avoir fiscal to non-resident shareholders who in principle were not entitled to the credit (because they were located in a non- treaty country or located in a treaty country but held a 10 percent or more stock ownership in the French company).

The structure was based on the fact that certain administrative regulations and certain treaty provisions expressly allowed the avoir fiscal to be reimbursed to foreign usufruct holders. Therefore the owner of shares could establish a temporary usufruct on such shares (allowing it to obtain immediate cash for its own investment) for the benefit of a third party (i.e. the usufruct holder) interested in obtaining a good return on investment in the form of potentially high dividends, with the attached avoir fiscal, although with some degree of uncertainty since dividends are never assured. Apparently, rather than challenge these structures before the courts (which would be extremely difficult in case of a "true" usufruct), the French tax authorities preferred to propose an amendment to the law and attack all existing structures immediately.

Since the amendment only applies where the bare owner is a non-resident, certain commentators see it as discriminatory. It is clear, however, that the usufruct holder itself is not subject to discrimination since, whether French or foreign, it is not entitled to the avoir fiscal if the original shareholder (the bare owner) was not entitled to the avoir fiscal in the first place. Foreign usufruct holders would have no claim under treaty law since all of France's treaties which provide for the transfer of the avoir fiscal limit this possibility to cases where a French recipient would have been entitled to the avoir fiscal.

The only indirect discrimination, if any, may be that non-resident shareholders are placed in a more difficult position than French shareholders as regards the splitting of ownership of the shares of their French subsidiary. However, this is a remote argument whose chances of success are limited, unless one considers that the entire avoir fiscal regime is discriminatory *vis-à-vis* non- residents. Actually, while French shareholders of a French company benefit from the avoir fiscal, non-resident shareholders as general rule do not unless a treaty provides otherwise, which, in practice, imposes strict conditions on the granting of the credit.

In any case Article 45 of the 1993 Technical Amendment Law will certainly operate as a strong deterrent against usufruct structures. The scope of the provision, however, is limited and the restrictions only apply to a splitting of ownership and similar transactions. This hopefully leaves some scope for other tax opportunities and tax planning.

13. Distributions made by a SICAV fully invested in bonds are treated as interest for treaty purposes.

© 1994 International Bureau of Fiscal Documentation

INDIA

1994/95 BUDGET

G.K. Kawatra

LL M International Tax Program (Harvard); Additional Secretary, Federation of Indian Chambers of Commerce and Industry; former Honorary Secretary, Indian Branch of IFA.

I. INTRODUCTION

The 1994/95 Budget was presented to the Indian Parliament on 28 February 1994. The Budget, which has been welcomed for its bold initiatives on tax reforms, seeks to continue with the process of economic reconstruction which commenced three years ago. The Minister of Finance has gambled on fiscal deficit, and accordingly designed a Budget to stimulate industrial growth in the economy. The Budget measures also conform to the general proposals of the Chelliah Committee, a tax reform committee.

The Budget proposals are generally effective from 1 April 1994. This article highlights the most important measures.

II. INCOME TAX

A. Corporate tax rates

In India, different tax rates applied to widely-held and closely-held companies, i.e. widely held companies were taxed at a rate of 45 percent, while other domestic companies attracted 50 percent. A 15 percent surcharge on income tax made the effective rates for domestic companies 51.75 percent and 57.5 percent, respectively.

The Budget abolishes the distinction between widely-held and closely-held Indian companies (for purposes of tax rates), and imposes a single rate of 40 percent for both types of companies. The 15 percent surcharge, however, is retained. Accordingly, the effective tax rate for domestic companies will now be 46 percent.

The tax on foreign companies has been reduced from 65 percent to 55 percent.[1]

B. Personal income tax rates

The income tax exemption limit for individuals has been increased from Rs. 30,000 to Rs. 35,000. In addition, the surcharge of 12 percent on non-corporate income has been abolished, reducing the maximum marginal rate from 44.8 percent to 40 percent.

C. Capital gains tax

The tax rate for long-term capital gains of domestic companies has been reduced from 40 percent to 30 percent in order to assist companies in restructuring and improving their competitive position in the market. Further, the rate for long-term capital gains of foreign companies and non-resident non-corporate taxpayers has been reduced from 40 percent to 20 percent.

No change is proposed in the case of non-resident individuals who will continue to be taxed at the rate of 20 percent on long-term capital gains. There is also no change in the tax rate applicable to foreign institutional investors, i.e. they will continue to be taxed at 10 percent on such gains.

III. INDIRECT TAXES

A. Excise tax

The Budget proposes a major reform of the excise tax structure as part of the modernization of the tax system. The principal features of this restructuring are:

- the MODVAT scheme has been extended to capital goods and petroleum products;
- the bulk of excise taxes has been shifted from specific to *ad valorem* rates, which will ensure greater built-in buoyancy of revenue;
- the total number of *ad valorem* tax rates have been reduced to about half the existing number, which represents a major step towards simplicity and transparency;
- uniform rates apply to similar commodities in order to reduce classification problems and scope for misuse;
- the number of special exemption notifications has been reduced by about half.

A fiscal innovation that may have received less notice than warranted is the 5 percent service tax levied on the value of certain taxable services. The tax is to be levied on services of telephones, stock brokers and general insurance.

B. Customs duties

Customs duties have been reduced in order to make key imported raw materials and capital goods available to Indian industry at reasonable costs and to reduce unduly high levels of protection to industry. At the same time, the scale of duty reduction has been calibrated to ensure that it does not place unreasonable pressure on domestic production of similar products. In this framework, the key features of the customs tariff reform are as follows:

1. No surcharge is levied on the income of foreign companies.

© 1994 International Bureau of Fiscal Documentation

- the maximum import duty has been reduced from 85 percent to 65 percent (with certain exceptions);
- the duties on key raw materials, such as steel and chemicals, have been substantially reduced;
- customs duties on project imports and general capital goods have been reduced (to 25 percent) to boost investment, combined with other incentives which will help the domestic capital goods industry;
- anomalies caused by import duties on raw materials and components being higher than on finished products have been reduced or abolished;
- a systematic effort has been made to unify rates on similar products to serve both economic rationality and reduce the scope for classification disputes; and
- notifications including end-use exemptions, have been reduced to about half their present number, thus limiting discretionary power and possibilities for disputes.

C. Expenditure tax

With a view to meet the ambitious programme of attracting tourists, the rate of expenditure tax on hotels is reduced from 20 percent to 10 percent.

IV. TAX INCENTIVES FOR FOREIGNERS

A. Extension of benefit of weighted deduction

Under ITA Section 35 (2AA), any sum paid by an assessee carrying on a business or profession to a National Laboratory[2] for carrying out approved scientific research programmes is eligible for a weighted deduction of one and one-fourth times the amount paid. To encourage science and technology, the definition of National Laboratory has been broadened to include scientific laboratories functioning at the national level under the aegis of the Department of Electronics, the Defence Research and Development Organization, the Department of Biotechnology and the Department of Automatic Energy.

B. Investment in "backward" states

As a stimulus to new investment in "backward" states, the five-year tax holiday has been extended to industrial undertakings located in such areas. The five-year tax holiday is available to undertakings which begin production after 1 October 1994 but before 31 March 1999. Initially a 100 percent deduction will be allowed for the first five years; for subsequent assessment years the deduction is allowed at the normal rate of 30 percent in the case of companies and 25 percent in the case of non-corporate assessees.[3]

C. Export of computer software

The exemption from tax of profits from the export of computer software has been extended for an additional year, i.e. up to and including assessment year 1995-96.

V. PROCEDURAL AMENDMENTS

A. Presumptive taxation

The Budget contains two new schemes for estimating the income of taxpayers engaged in the business of civil construction and plying, leasing and hiring of trucks owned by them. The new estimated scheme applies to contractors engaged in the business of civil construction with a turnover of up to Rs. 4 million and to truck owners who own up to ten trucks. In the case of civil construction, the net profit will be estimated at 8 percent of gross receipts. In case of truck owners, the income from each truck, being a heavy goods vehicle, will be estimated at Rs. 2,500 for every month or part thereof, and Rs. 2,000 for another goods vehicle. No further deduction on account of depreciation, interest or other expenditure will be allowed in either case, and in both cases the scheme is optional.[4]

B. Withholding tax on rental income[5]

In order to broaden the tax base and the scope of deduction of income tax at source a new ITA Section 194-I has been introduced providing for a withholding tax on the payment of rent. Under this provision any person other than an individual and a Hindu Undivided Family must deduct tax at source at the rate of 20 percent on the payment of rent exceeding Rs. 120,000 in a financial year.

C. Non-resident Indians

Non-resident Indians will retain their non-residency status during a stay in India of up to 181 days – this has been increased from 149 days.

VI. GIFT TAX

The exemption limit under the Gift Tax Act on the marriage of a dependent relative has been increased to Rs. 100,000 from Rs. 30,000.

2. A National Laboratory is defined as a scientific laboratory functioning at the national level under the aegis of the Indian Council of Agricultural Research, the Indian Council of Medical Research or the Council of Scientific and Industrial Research and which is approved by the prescribed authority for this purpose.
3. The incentive already available to industrial units set up in States or Union Territories specified in the Eighth Schedule will continue.
4. However, under this system a person can claim that his income in respect of a specified business, i.e. civil construction or plying, leasing or hiring of trucks, is lower than the specified estimate of income. In such a case the taxpayer must produce evidence to prove that his case is eligible for regular assessment.
5. The expression 'rent' is defined to include any payment under a lease, sublease, tenancy or other agreement or arrangement for the use of land or a building, including factory buildings, together with furniture, fittings and the land appurtenant thereto, whether or not such building is owned by the payee.

© 1994 International Bureau of Fiscal Documentation

VII. CONCLUSION

The overall impact of the Budget on the economy is likely to be favourable. India is expected to achieve a growth rate of about 5 to 6 percent and industrial growth of about 6 to 7 percent while keeping inflation in the range of 8 to 9 percent during 1994-95. The Budget has finally thrown the gauntlet to the private sector which will have to rise to expectations in performance.

INTERNATIONAL AIR TRANSPORT ASSOCIATION LIST OF TICKET AND AIRPORT TAXES AND FEES

AN INVALUABLE AID

✔ A comprehensive list and quick reference tool with respect to the requirements for collection, filing, ticketing, remitting, etc. of various airline ticket and airport taxes, charges and fees.

✔ More than 900 information records for over 580 different airline ticket and airport taxes, charges and fees imposed in some 233 countries.

✔ The list is in loose-leaf format and comes in two volumes.

AVAILABLE NOW

✔ Available in English at the annual subscription rate of CHF 800 (USD 535) including revisions and mailings. Renewal rate will be CHF 400 (USD 270).

❒ Yes, I would like to receive ____ copy(ies) of the *IATA List of Ticket and Airport Taxes and Fees.*

Payment ❒ Cheque enclosed ❒ CHF ____ ❒ USD ____

❒ Please invoice me (publication will only be sent upon receipt of payment).

NAME _____

TITLE/DEPARTMENT _____

COMPANY/ORGANISATION _____

ADDRESS _____

_____

TEL _____ FAX _____

Mail or fax to: Charlotte Furusten,
Officer, Taxation
Industry Monetary Affairs Division,
INTERNATIONAL AIR TRANSPORT ASSOCIATION
Route de l'Aéroport 33, P.O. Box 672, CH-1215 Geneva 15 Airport, Switzerland
Tel: +41-22-799-2736 / Fax: +41-22-799-2683

© 1994 International Bureau of Fiscal Documentation

IFA NEWS

BRITISH BRANCH

Maarten Ellis from Loyens & Volkmaars and Ian McDade of Price Waterhouse spoke at the March monthly meeting on the US/NL double tax treaty.

NETHERLANDS BRANCH

The Dutch and US branches are planning a "pre-IFA Congress" meeting, to be held 26-27 August 1994 in Niagara-on-the-Lake. Topics to be covered include: the US/NL tax treaty, Dutch-based headquarters companies, portfolio and real estate investment, with a special focus on pension fund investments and current and anticipated issues in US/Dutch taxation. Onno Ruding, former Minister of Finance for the Netherlands, will be among the list of distinguished speakers.

US BRANCH

The US branch held its annual meeting on 3-4 March at the Ritz-Carlton Hotel in Atlanta. The meeting was launched with an impressive video montage of Atlanta, host to the 1996 summer Olympic games. Approximately 200 members attended the meeting to listen to more than 35 speakers and panellists, which included acknowledged experts among practitioners, academics and government officials.

Peter V.Z. Cobb, Deputy Chief of Staff of The Joint Committee on Taxation and Cynthia G. Beerbower, International Tax Counsel, Department of the Treasury spoke during the luncheon sessions. Mr Cobb made some general observations about the "tax weather forecast", acknowledging that the budget would not be a vehicle for tax legislation. Although a number of tax initiatives are included in the budget they are not principally tax legislation, i.e. initiatives relating to health care reform, GATT, the environmental super fund regime and welfare reform. In the pure tax arena Mr Cobb intimated there may be a simplification and corrections bill, a "nanny tax" reform and some "extenders". VAT is also being studied as an additional source of revenue, and as a replacement to the current system.

Ms Beerbower spoke candidly about the ITC's role in order to give the audience a sense of its extensive responsibilities. In addition to its role in negotiating tax treaties and drafting regulations, the ITC is becoming more involved in "trade" issues because of the increasing "tax/trade overlap"; assistance is requested on what are historically trade agreements, such as airline/shipping agreements, and exchange of information agreements. As a result of its expanding role – and personnel constraints – the ITC must of necessity prioritize its tasks. Ms Beerbower specifically referred to the need to prioritize treaty requests, and to end customized drafting of treaties – the US needs a model treaty (or several variations thereof) and needs to adopt consistent positions in its treaty negotiations so that treaties can be negotiated more quickly and with fewer personnel.

With respect to the drafting of regulations Ms Beerbower remarked that the Section 7701 regulations were difficult, and that the Section 482 regulations were moving along but probably would not be released until next quarter. She emphasized that the ITC would be taking a close look at what it was doing, and why. In conclusion she encouraged the participants to provide whatever assistance they could in the way of relevant feedback.

The topics covered during the two days were:

- Recent legislative, administrative and judicial developments;
- Recent treaty developments;
- US Report on demergers;
- Use of holding companies for operations in the EC and Eastern Europe;
- Use of special purpose entities in the Far East and Latin America;
- Joint venture planning and issues;
- Hybrid entity planning and issues;
- Intercompany transactions;
- Section 482 rules on services; and
- Alternative dispute resolution of Section 482 issues.

A number of the papers presented during the meeting will be published in an upcoming issue of the *Bulletin*.

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

ASIA & THE PACIFIC

Australia

1993 AUSTRALIAN MASTER TAX Guide. From the CCH Tax Editors.
North Ryde, CCH Australia Limited. 1993, pp. 1748.
Annual guide explaining the rules affecting everyday business and personal income tax questions in a practical way. Designed to help taxpayers prepare their returns for the 1992/93 income year and to provide information on the tax consequences flowing from decisions and transactions that taxpayers may face in the 1993/94 income year. Highlights the main legislative, judicial and administrative changes in tax law and practice which occurred during 1992. Special features include a depreciation table, personal tax calculator, provisional tax ready reckoner, 1993 tax calendar and checklists of deductible and non-deductible items and taxable and non-taxable items.
(B. 57.948)

Philippines

PRIMER ON INVESTMENT POLICIES IN the Philippines.
Manila, Depart. of Trade and Industry Board of Investments, 385 Sen. Gil Puyat Avenue, 1200 Makati, Metro Manila, Philippines. 1993, pp. 20.
Designed to answer basic questions on the current investment policies under Executive Order 226, which is also known as the Omnibus Investments Code of 1987.
(B. 57.865)

Singapore

THE GOODS AND SERVICES TAX.
Singapore, Ministry of Trade and Industry & Ministry of Finance. 1993, pp. 39.
(B. 57.921)

EUROPE

MANUALE DELLA TASSAZIONE IN Europa. 2nd Edition. Traduzione a cura di Claudio Sacchetto.
Milan, IPSOA Editore Srl.; Amsterdam, International Bureau of Fiscal Documentation. 1993, pp. 491. 170.000 Lrs.
Up-to-date summaries of the taxation of corporations and individuals in European countries.
(B. 113.309)

Austria

LANG, Michael.
Die Abfertigung im Steuerrecht.
Vienna, Wirtschaftsverlag Dr. Anton Orac. 1993, pp. 50.
Tax treatment of golden handshakes and similar remunerations under Austrian law.
(B. 113.233)

MÜLLER, Eduard.
Die Lohnsteuer in Beispielen. Richtlinien, Kommentar, Beispiele.
Vienna, Linde Verlag Wien AG. 1992, pp. 347. 390.- S.
Commentary on the new wage tax guidelines 1992 and explanation of the most important wage tax questions by means of examples.
(B. 112.017)

WESTERMAYER, Hans.
ABC der Lohnverrechnung. 22. Auflage.
Vienna, Linde Verlag Wien AG. 1992, pp. 101. 267.- S.
New developments with regard to computerized wages calculation and wage slips.
(B. 112.016)

BEDNAR, Kurt.
Die Betriebspension. Der Leitfaden für diePraxis.
Vienna, Linde Verlag Wien AG. 1993, pp. 486. 980.- S.
The company pension. A comprehensive guide to Austrian company pension schemes.
(B. 113.041)

GLUBIGERSCHUTZ, BETRIEBS-wirtschaftslehre und Recht. Festgabe für Otmar Koren zum 75 Geburtstag.
Herausgegeben von Gerhard Seicht. Vienna, Linde Verlag Wien AG. 1993, pp. 467. 760.- S.
Creditor's protection, business administration and law. Festschrift for Otmar Koren.
(B. 113.258)

MANAGEMENT PERSPEKTIVEN,
Band 1: Neue Ansätze in der Personalarbeit.
Kraus/Scheff/Gutschelhofer (Hrsg.).
Vienna, Linde Verlag Wien AG. 1993, pp. 288. 485.- S.
New approach to personnel planning. An explanation of the new perspectives with regard to the resource personnel.
(B. 113.040)

KÖHLE, Veronika; DEMETER, Georg.
Die Gesellschaft m.b.H. in Ungarn.
Gesellschaftsrecht, Gesetzestext, Kommentar.
Vienna, Linde Verlag Wien AG. 1992, pp. 245. 450.- S.
Description of the Hungarian type of limited liability company and a commentary to the text of the law. A comparison is made with German and Austrian limited liability companies. Taxation of Austrian corporations operating in Hungary is also covered.
(B. 111.680)

ENTWICKLUNGEN IM MANAGEMENT.
Gedankenskizzen für innovationsbewusste Manager. Festschrift für Herbert Kraus.
Vienna, Linde Verlag Wien AG. 1993, pp. 650. 650.- S.
Festschrift (commemorative publication) for Herbert Kraus on the topic "Development in Management".
(B. 113.257)

Belgium

CODE DES IMPOTS SUR LES revenus 1992.
(Edition 1993.2)
Diegem, CED Samsom. 1993, pp. 700.
Consolidated text of the Income Tax Code updated as of 31 September 1993.
(B. 113.312)

ROUSSEAUX, J.; De WOLF, E.J.; TIBERGHIEN, A.; DILLEN, J.
Fiscaal zakboekje 1993/2.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 313. 1034.- Bfrs.
Update of the description of Belgian taxes as of 31 August 1993.
(B. 113.206)

Channel Islands

BOULDING, John.
Tolley's Taxation in the Channel Islands and Isle of Man 1993/94.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 260. £ 23.95.
A guide to tax legislation in Guernsey, Jersey and the Isle of Man, revised to include the Channel Islands' law for 1993 and the Manx law for 1993-94.
(B. 113.324)

© 1994 International Bureau of Fiscal Documentation

Czech Republic

DAS TSCHECHOSLOVAKISCHE RECHT
für ausländische Unternehmer.
Vienna, Linde Verlag Wien AG. 1992,
pp. 314. 695.- S.
Guide (in German) on the Czechoslovakian law for foreign investors as of 1 January 1992.
(B. 111.971)

Denmark

AFGIFTER & GEBYRER.
Copenhagen, A/S Skattekartoteket. 1993.
Loose-leaf publication containing the texts and regulations of all special duties and levies imposed in Denmark, such as taxes on energy and on waste, stamp duties and the duty on hydrocarbons.
(B. 113.267)

Eastern Europe

EXCHANGE CONTROL POLICY.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 90.
(B. 113.229)

EEC

SASS, Gert.
Der Einfluss der EG-Steuerrichtlinien auf die grenzberschreitende Zusammenarbeit von Wirtschaftsunternehmen.
Saarbrücken, Europa Institut der Universität des Saarlandes. 1991.
Vorträge Reden und Berichte aus dem Europa Institut, No. 243. pp. 16.
Text of speech given on 17 May 1991 on the influence of EC Directives on cross-border joint ventures of commercial enterprises.
(B. 112.240)

Finland

KORKEIMMAN HALLINTO-OIKEUDEN vuosikirja 1992. B Verotus.
Helsinki, Painatuskeskus Oy. 1993, pp. 238.
Annual of the Supreme Administrative Court 1992, Part B – Taxation. Compilation of tax appeal cases decided by the Supreme Administrative Court during 1992. Issues include national and municipal income taxes, their assessment procedure, advance payment of tax, social security premiums, inheritance and gift tax, turnover tax and stamp tax. Texts of cases are in Finnish. Topical indexes in Finnish and Swedish are appended.
(B. 113.282)

France

CODE GENERAL DES IMPOTS.
Tome 1:
Législation; Tome 2: Annexes-Tables. Livre des procédures fiscales.
Paris, Imprimerie Nationale. 1993, pp. 1265.
French General Tax Code in 3 volumes. Contains the consolidated text of the direct and indirect taxes effective as of 18 August 1993.
(B. 113.283/284)

Germany

KIESSLING, Heinz; PELIKAN, Horst.
Körperschaftsteuer. 13. Auflage
Achim, Erich Fleischer Verlag. 1992
Grüne Reihe, Band 6, pp. 550. 68.50 DM.
Comprehensive textbook on the corporate income tax.
(B. 113.268)

JASPER, Lothar TH.; SCHWARZKOPFF, Christine.
Die neue Zinssteuer.
Bonn, Stollfuss Verlag. 1993, pp. 159.
42.80 DM.
Description of German taxation of interest.
(B. 112.598)

STAPPERFEND, Thomas.
Die steuer- und bilanzrechtliche Behandlung von Software.
Cologne, Verlag Dr. Otto Schmidt KG. 1991.
Der Rechts- und Steuerdienst, Kölner Schriftenreihe, Heft 71. pp. 191. 56.- DM.
The treatment of software for tax and balance sheet purposes.
(B. 112.019)

BULLINGER, M.; RADKE, J.; DRASCHIL, R.
Handkommentar zum Zinsabschlag.
Düsseldorf, IDW Verlag GmbH. 1994,
pp. 400. 88.- DM.
Explanation of the new regulation on the taxation of interest income of 9 November 1992.
(B. 113.297)

LINDBERG, Klaus.
Das Zinsabschlaggesetz. Die Besteuerung des Kapitalertrags ab 1.1.1993.
Munich, Verlag C.H. Beck. 1992.
DStR Schriftenreihe. pp. 158. 58.- DM.
The law on withholdings from interest income. A guide to the law of 9 November 1992 on taxation of interest and capital income as of 1 January 1993.
(B. 112.306)

BROSIG, Manfred.
Zur steuerlichen Behandlung von Basisgesellschaften. Unzulänglichkeiten im deutschen Aussensteuerrecht.
Frankfurt am Main, Peter Lang AG. 1993.
Eur. Hochschulschriften, Reihe II, Rechtswissenschaft, Vol. 1423, pp. 478.
The treatment of base companies for tax purposes. The author describes the taxation of base companies in Germany, as well as the legal treatment of base companies and legal and illegal possibilities under German tax law to use base companies for reducing the tax burden in an international environment.
(B. 113.318)

DEBATIN, H.; ENDRES, D.; MÖLLER, M.; MILES, A.
Unternehmensbesteuerung in Deutschland. Anmerkungen für Auslandsinvestoren.
Corporate taxation in Germany. Synoptic translation of statutory instruments with notes for foreign investors. Herausgegeben von Price Waterhouse GmbH., Frankfurt am Main.
Düsseldorf, IDW Verlag GmbH. 1994,
pp. 480. 68.- DM.
Part 1 of the book explains the basic principles of German tax law which are important for foreign investors. Part 2 describes the Standortsicherungsgesetz (Business Location Improvement Act of 13 September 1993), giving specific attention to those points which would seem to require planning attention. Part 3, the bulk of the book, contains the texts and brief explanations of the relevant provisions of the Corporation Tax Act and other statutes important to foreigners investing in Germany.
(B. 113.295)

EILERS, Stephan.
Rückstellungen für Altlasten und Umweltschutzverpflichtungen.
Munich, Verlag C.H. Beck. 1993.
DStR Schriftenreihe, pp. 136. 48.- DM.
Answers and solutions to the question of how to consider environmental rehabilitation measures, environmental protection schemes and other environmental-related obligations in the balance sheet. Also contains practical case studies.
(B. 113.269)

HÖTZEL, Oliver.
Steuerorientierte Gestaltung des Unternehmenskaufs.
Düsseldorf, IDW Verlag GmbH. 1993,
pp. 329. 88.- DM.
Tax-oriented planning of enterprise acquisitions. Theoretical analysis of enterprise acquisitions. Includes an examination of the basic principles of mergers and acquisitions and shows a typical time schedule.
(B. 112.355)

LIMMER, Peter.
Die Haftungsverfassung des faktischen GmbH-Konzerns. Haftungsrechtliche Konsequenzen und Konzernleitung und – organisation.
Cologne, Verlag Dr. Otto Schmidt KG. 1992.
Rechtsfragen der Handelsgesellschaften, Heft 70, pp. 403.
The statutes for the liability of a factual group of limited liability companies. Consequences of group management and group organization with respect to liability of groups of limited liability companies.
(B. 112.018)

BÖTTGES-PAPENDORF, D.; DANKMEYER, U.; TILLMANN, J.
ABC der Überschussrechnung. 2nd Edition.
Bonn, Stollfuss Verlag. 1993, pp. 242.
44.- DM.
The ABCs of the surplus calculation. A guide to the income determination method (in alphabetical order according to the terms).
(B. 112.880)

© 1994 International Bureau of Fiscal Documentation

FROMM, Rüdiger; VOGT, Hans.
Richtig schenken und vererben. Steuertips und Gestaltungshinweise.
Munich, Verlag C.H. Beck. 1993.
Beck Rechtsberater im dtv, Band 5614.
pp. 205. 12.90 DM.
Civil law and tax hints, as well as planning advice with regard to donation and inheritance.
(B. 113.247)

HILLE, Hans-Eduard.
Freie Mitarbeit und andere Formen freier Zusammenarbeit. 2nd Edition.
Bonn, Stollfuss Verlag. 1993, pp. 141.
39.80 DM.
Freelance and similar types of joint work.
(B. 112.562)

UMSATZSTEUERGESETZ 1993.
USt-Binnenmarktgesetz.
Munich, Verlag C.H. Beck. 1992, pp. 234.
19.80 DM.
A collection of VAT related laws and guidelines.
(B. 112.305)

NOLL, Bernd; RÖDDER, Thomas.
Das neue Umsatzsteuerrecht des Exports und Imports. Ein anwendungsorientierter Leitfaden zu den ab 1.1.1993 massgeblichen Regelungen.
Düsseldorf, IDW Verlag GmbH. 1992,
pp. 325. 68.- DM.
VAT law of export and import. Guide to the single market regulations having effect from 1 January 1993 with special regard to import- and export-related transactions.
(B. 112.301)

RONDORF, Hans-Dieter.
Das Umsatzsteuer-Binnenmarktgesetz. Die Umsatzbesteuerung ab 1.1.1993.
Munich, Verlag C.H. Beck. 1992.
DStR Schriftenreihe. pp. 274. 68.- DM.
The VAT Single Market Tax Act. A guide to VAT taxation as of 1 January 1993.
(B. 112.307)

PETTO, Wolfgang.
Das Ausfuhrverfahren ab 1.1.1993.
Munich, Jehle-Rehm Verlagsgruppe, Postfach 801940, 81619 München. 1992, pp. 103.
36.- DM.
The export procedure as of 1 January 1993. An explanation of the amendments to German customs law as a result of the EC Customs Codex (2913/92/EEC).
(B. 113.128)

LAMMSFUSS, Franz; MIELKE, Klaus.
Fallsammlung Internationales Steuerrecht. Einkommensteuer, Körperschaftsteuer, Aussensteuergesetz, DBA-Schweiz. 4. Auflage.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 219. 48.- DM.
Collection of case studies with regard to international tax law.
(B. 112.564)

KÖSTER, Harald.
Grundsätze ordnungsmässiger Zwischenberichterstattung börsennotierter Aktiengesellschaften.
Düsseldorf, IDW Verlag GmbH. 1992,
pp. 274. 58.- DM.
Basic principles of correct iterim reports of stock exchange quoted corporations. The implementation of the EEC Directive 82/121/EEC of 15 February 1982, with particular attention to the principles to iterim reports.
(B. 112.030)

OESTREICHER, Andreas.
Grundsätze ordnungsmässiger Bilanzierung von Zinsterminkontrakten. Das Prinzip der Einzelbewertung bei funktional verknüpften Finanzgeschäften.
Düsseldorf, IDW Verlag GmbH. 1992,
pp. 348. 98.- DM.
Basic principles of the correct auditing of interest rate futures. The principle of single valuation with regard to interest rate futures.
(B. 112.028)

PELTZER, M.; DOYLE, J.J.; ALLEN, M-TH.
Handelsgesetzbuch. Deutsch-englische Textausgabe mit einer englischen Einleitung.; German Commercial Code. German-English text.
2nd Edition.
Cologne, Verlag Dr. Otto Schmidt. 1993,
pp. 315. 118.- DM.
German Commercial Code.
(B. 113.317)

BRAUN, Ursula.
EK50-Lücke bei der Internationalisierung der Geschäftstätigkeit deutscher Kapitalgesellschaften.
Bergisch Gladbach, Josef Eul Verlag GmbH., Postfach 100656, 51406 Bergisch Gladbach, Germany. 1993.
Reihe: Steuer, Wirtschaft und Recht, Band 101, pp. 298. 61.68 DM.
Loophole with regard to capital from 50% taxed income in corporations with international business.
(B. 113.293)

NIEHUS, Rudolf J.
Die Qualitätskontrolle der Abschlussprüfung.
Düsseldorf, IDW Verlag GmbH. 1993,
pp. 383. 98.- DM.
The development of the self-governing of certified public accountants in the USA and consequences for the German profession of auditors.
(B. 113.296)

SCHARPF, Paul.
Der neue Solvabilitätskoeffizient der Kreditinstitute. Die Umsetzung der EG-Eigenmittel- und EG-Solvabilitätsrichtlinie.
Düsseldorf, IDW Verlag GmbH. 1993,
pp. 253. 68.- DM.
The new solvency ability coefficient of banks. The implementation of the EEC Directives 89/299/EEC of 17 April 1989 and 89/646/EEC of 15 December 1989.
(B. 113.922)

KRONKE, Herbert.
Stiftungen in der Rechtsprechung, Band IV.
Düsseldorf, IDW Verlag GmbH. 1993,
pp. 191. 86.- DM.
Complete collection of German legislation on the topic of "foundation" covering the years 1984-1992.
(B. 113.187)

PRINCIPLES AND INSTRUMENTS OF the social market economy. Edited by Karl Fasbender, Manfred Holthus and Eberhard Thiel. Hamburg, Verlag Weltarchiv GmbH. 1992, pp. 310.
Principles of German-type post-World War II economy.
(B. 112.214)

Hungary

KÖHLE, Veronika; DEMETER, Georg.
Die Gesellschaft m.b.H. in Ungarn. Gesellschaftsrecht, Gesetzestext, Kommentar.
Vienna, Linde Verlag Wien AG. 1992,
pp. 245. 450.- S.
Description of the Hungarian type of limited liability company and a commentary to the text of the law. A comparison is made with German and Austrian limited liability companies. Taxation of Austrian corporations operating in Hungary is also covered.
(B. 111.680)

Ireland

SAUNDERS, Glyn; HARVEY, Eric L.
Tolley's Taxation in the Republic of Ireland 1993-94.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 356. £ 23.95.
A detailed annual guide covering income tax, corporation tax, capital gains tax, capital acquisitions tax, advance corporation tax, residential property tax and value added tax, including the provisions of the Finance Act 1993.
(B. 113.320)

Isle of Man

BOULDING, John.
Tolley's Taxation in the Channel Islands and Isle of Man 1993/94.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 260. £ 23.95.
A guide to tax legislation in Guernsey, Jersey and the Isle of Man, revised to include the Channel Islands' law for 1993 and the Manx law for
1993-94.
(B. 113.324)

Liechtenstein

RAMATI, U.E.
Liechtenstein's uncertain foundations. Anatomy of a tax haven.
Zurich, Hazlemore Limited, Tax Publications, Postfach 4603, CH-8022 Zürich, Switzerland.
1993, pp. 288. 89.- Sfr.

© 1994 International Bureau of Fiscal Documentation

The uncertainties involved in using Liechtenstein foundations as tax haven entities. Many practical issues such as information on Liechtenstein, company law requirements, trustees, establishments, the legal system and baking experiences are presented. Also contains draft statutes and bylaws of the foundation, a concept mandate agreement and a bibliography with critical comments on available literature.
(B. 113.271)

Netherlands

SONDEREN, J.C.M. van.
Fiscale aspecten van opties.
Deventer, Kluwer. 1993.
Fiscale Monografieën, No. 64, pp. 390.
Thesis on tax aspects of options.
Comprehensive coverage of individual income tax aspects (profits from enterprise, income from labour, capital income, capital gains from a substantial shareholding), corporate income tax aspects and the treatment of options in transfer taxes such as VAT and the succession and gift tax. Legal, economic and accountancy aspects of options are also discussed.
(B. 113.273)

KOUDIJS, Yvonne Nicoline.
Ondernemingswinstbelasting een rechts-vormneutrale belastingheffing naar de winst uit onderneming.
From: Yvonne Koudijs, Oudeveen 114, 3905 VW
Veenendaal. 1993, pp. 201.
Dissertation on the concept of an enterprise income tax applicable to both companies and individuals.
(B. 113.232)

VEERTIEN VRAGEN OVER HET gemeentelijk belastinggebied.
The Hague, VNG Uitgeverij, Postbus 30435, 2500 GK Den Haag. 1993, pp. 55.
Booklet dealing with various issues with respect to municipal tax law approach.
(B. 113.157)

DOEVE, G.O.R.; HAAN, P.M. de.
Het nieuwe belastingverdrag met de Verenigde Staten.
Deventer, Kluwer. 1993, pp. 184. 59.50 Dfl.
Commentary on the new USA–Netherlands tax treaty. Article 26 on limitation of benefits is clearly explained.
(B. 113.272)

BELASTINGVERDRAGEN EN ENIGE andere regelingen van inter- en supranationaal belastingrecht.
Samengesteld door C. van Raad. 6th Edition.
Deventer, Kluwer. 1993, pp. 947.
Sixth edition of monograph on double taxation treaties concluded by the Netherlands and other regulations concerning international tax law. The book includes texts of the OECD Model Convention 1992, selections from the EC Treaty and jurisdiction of the EC Court of Justice.
(B. 113.319)

BASOSKI, A.J.
Kredietverzekering voor bedrijven. Een korte inleiding.
Deventer, Kluwer; The Hague, Fenedex. 1993
Fiscale en juridische documentatie voor internationaal zakendoen, No. 30, pp. 110. 55.- Dfl.
The insurance of business claims, factoring and other related subjects. Important documents are appended.
(B. 113.310)

FETERIS, M.W.C.; WATTEL, P.J.
Fiscale boete. Debat naar aanleiding van de inleidingen "De fiscale boete, ontwikkelingen en toekomst" door P.J. Wattel en "Verdragsrechtelijke aspecten van de fiscale boete" door M.W.C. Feteris.
Deventer, Kluwer. 1993.
Geschriften van de Vereniging voor Belastingwetenschap, No. 192, pp. 45. Printed text of debate following the lectures on fiscal penalties and international aspects of fiscal penalties.
(B. 113.237)

DE INVLOED VAN DE AWB OP HET fiscale procesrecht. Rapport van de Commissie ter bestudering van de betekenis van de Algemene wet bestuursrecht voor het fiscale procesrecht.
Deventer, Kluwer. 1993.
Geschriften van de Vereniging voor Belastingwetenschap, No. 193, pp. 59.
Consideration on the impact of the General Management Law with respect to tax case procedures. Full text of the Draft General Management Law is appended.
(B. 113.238)

Poland

KÄMPFE, Martina.
Standortbedingungen für ausländische Investitionen in Polen. Ein Leitfaden für Berater und Investoren. Herausgegeben von Berthold Fege.
Düsseldorf, IDW Verlag GmbH. 1992, pp. 81. 54.21 DM.
A guide to Poland as a business location. The conditions for foreign investments in Poland and the German border regions.
(B. 112.026)

United Kingdom

TOLLEY'S TAX PLANNING 1993-94. Volume 1 and 2.
Edited by Glyn Saunders.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 1696. £ 64.-.
Comprehensive guide to practical taxation strategies. This updated annual edition contains two completely new chapters (Profit-related Pay and Stock Dividends)
(B. 113.327)

TAX TECHNICAL REVIEW 1993-94.
Oxford, The Professional Training Partnership, 1-5 Buckingham Street, Oxford OX1 4LH, England. 1993, pp. 340. £ 15.-.
The book comprises 28 separate chapters each written by an acknowledged expert on an area of tax on which there have been significant developments in the last 12 months. Covers both personal and business tax and includes chapters on national insurance contributions, value added tax and stamp duty as well as income, corporation and capital gains tax.
(B. 113.248)

TOLLEY'S INTERNATIONAL TAX Planning. 2nd Edition. Volume 1: Corporate; Volume 2: Non-corporate. Edited by Malcolm J. Finney and John C. Dixon.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 1200. £ 97.50.
Practical strategies for effective tax planning in an international context, including a detailed examination of a number of areas of key importance and particular complexity. Includes a mass of data on the corporate and personal tax regimes of all 12 EC Member States and on the corporate taxes in Switzerland, Canada and the USA. In addition, new chapters on acquisitions and joint ventures in Eastern Europe, asset protection, personal taxes in Europe and transnational tax enforcement. The UK international tax law is stated as of 31 May 1993.
(B. 113.323)

PINCHER, R.A.
U.K. taxes and duties in the internal market.
London, Sweet & Maxwell. 1993, pp. 374. £ 48.-.
Analysis of the changes brought about by the adoption of European legislation into domestic law. Details the fundamental changes to VAT, customs and duties procedures, and direct taxes.
(B. 113.325)

GOY, David; WALTERS, John.
VAT and property. 2nd Edition.
London, Sweet & Maxwell Ltd. 1993, pp. 320. £ 38.-.
Examination of all recent changes to VAT brought about by the Finance Act 1989 and EC Commission v. UK and consideration of their practical effect on the taxing of property matters. Includes a comparison of the current treatment of VAT with the pre-1989 treatment for each type of transaction.
(B. 113.326)

INTERNATIONAL

TOLLEY'S INTERNATIONAL TAX Planning 2nd Edition. Volume 1: Corporate; Volume 2: Non-corporate. Edited by Malcolm J. Finney and John C. Dixon.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 1200. £ 97.50.
Practical strategies for effective tax planning in an international context, including a detailed examination of a number of areas of key importance and particular complexity. Includes a mass of data on the corporate and personal tax regimes of all 12 EC Member States and

© 1994 International Bureau of Fiscal Documentation

on the corporate taxes in Switzerland, Canada and the USA. In addition, new chapters on acquisitions and joint ventures in Eastern Europe, asset protection, personal taxes in Europe and transnational tax enforcement. The UK international tax law is stated as of 31 May 1993.
(B. 113.323)

GRUNDY, Milton.
Grundy's tax havens. Offshore business centres: a world survey. 6th Edition.
London, Sweet & Maxwell, 1993, 201 pp.
Information required for a basic understanding of today's offshore world. The expression "Offshore Business Centres" is used in order to bring within the purview of this book all the jurisdictions relevant to offshore transactions in the world. Countries are classified according the following subjects: offshore companies with no-tax jurisdictions; taxing jurisdictions offering fiscal inducements; reduced rates; special regimes for holding companies; taxing jurisdictions offering non-residents company; jurisdictions on territorial bases. Includes a description of the European holding company, offshore trusts, the individual resident and international tax planning.
(B. 113.077)

WORLD PETROLEUM TAXATION
Legislation. Review of 1992.
New York, Barrows Company, 116 East 66th Street, New York 10021. USA. 1992, pp. 318. $ 305.
A world summary of all oil and gas contracts, taxes and laws that appeared in 1992. Countries are reviewed alphabetically.
(B. 113.190)

GUERARD, Yves; JENKINS, Glenn.
Building private pension systems. A handbook. Cambridge, Harvard Institute for International Development, Harvard University, Pound Hall
400, Cambridge, Mass. 02138, USA. 1993.
ICEG Sector Studies Series, No. 6, pp. 106.
Outline of the policy issues that arise when instituting a system of private-funded pension plans. Appendix provides a model pension law that contains the legal provisions necessary to facilitate implementation of the policies outlined in the text.
(B. 113.244)

OECD

VROUWENVELDER, M.
De "fictieve niet-vaste inrichting" artikel 5 lid 4 OESO-modelverdrag 1977.
Amsterdam, Moret Ernst & Young, Drentestraat 20, 1083 HK Amsterdam. 1993, pp. 40.
Thesis describing the concept of "deemed not-considered permanent establishment" under Article 5, paragraph 4 of the OECD Model Convention 1977.
(B. 113.227)

EXCHANGE CONTROL POLICY.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 90.
(B. 113.229)

LATIN AMERICA

MERCOSUR. CONSIDERACIONES
básicas para la armonización tributaria. Primer congreso sobre armonización impositiva-aduanera de los paises miembros del Mercosur. Coordinación Raul Eduardo Roa.
Bueanos Aires, Asociacion Mutual Federal de Empleados de la Direccion General Impositiva "Criterios Tributarios". 1993, pp. 406.
Basic considerations on tax harmonization. Papers of the first conference on tax and customs harmonization of Mercosur's member countries.
(B. 18.806)

NORTH AMERICA

USA

HUFBAUER, Gary Clyde; ROOIJ, Joanna M. van.
U.S. taxation of international income. Blueprint for reform.
Washington, Institute for International Economics, 11 Dupont Circle, NW, Washington DC 20036-1207, USA. 1992, pp. 280.
A brief listing of taxes levied on corporations and the two theories have developed. The new theory holds that US corporate income tax is an imperfect sales tax on corporate output, while the older theory sees the corporate income tax as a tax on the income of the shareholders. Where the corporate tax operates as a tax on shareholder income, it reduces the ability of US firms to attract equity capital by comparison with foreign firms that are taxed less heavily. The USA has never provided meaningful integration of corporate and shareholder taxes. This study offers a blueprint for reforming US taxation of international income to accommodate the economic realities of 1990s. The author recommends the reform of the taxation of direct investment income on a territorial basis, the abolition of the foreign tax credit as well as suggests the allocation of US headquarters expense entirely.
(B. 113.224)

DOEVE, G.O.R.; HAAN, P.M. de.
Het nieuwe belastingverdrag met de Verenigde Staten.
Deventer, Kluwer. 1993, pp. 184. 59.50 Dfl.
Commentary on the new USA–Netherlands tax treaty. Article 26 on limitation of benefits is clearly explained.
(B. 113.272)

WHY PEOPLE PAY TAXES.
Tax compliance and enforcement.
Ann Arbor, The University of Michigan Press, 839 Greene Street, P.O. Box 1104, Ann Arbor, Michigan 48106-1104, USA. 1992, pp. 361. $ 49.50.
Determinants of tax compliance and a discussion of strategies to curtail tax evasion.
(B. 113.105)

THE GREAT FISCAL EXPERIMENT.
Edited by Rudolph G. Penner.
London, The Eurospan Group, 3 Henrietta Street, Covent Garden, London WC2E 8LU, England. 1990, pp. 202. $ 12.50.
The book focuses on the macro fiscal policy changes and asks what has been learned from this turbulent decade about the effects of fiscal policy on the economy.
(B. 113.225)

NIEHUS, Rudolf J.
Die Qualitätskontrolle der Abschlussprüfung.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 383. 98.- DM.
The development of the self-governing of certified public accountants in the US and consequences for the German profession of auditors.
(B. 113.296)

Looseleaf Services

Received between 1 and 31 January 1994

AFRICA

FISCALITE AFRICAINE
release 22
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
- Rulings and guidelines release 144
- International agreements release 19

Butterworths, North Ryde.

SUPERANNUATION AND RETIREMENT BENEFITS IN AUSTRALIA
Brown – Edstein
release 28
Butterworths, North Ryde.

AUSTRIA

DIE EINKOMMENSTEUER:
- Texte, release 15
- Kommentar, release 11

Anton Orac Verlag, Vienna.

© 1994 International Bureau of Fiscal Documentation

GEBÜHREN UND VERKEHRSSTEUERN, STEMPEL – UND RECHTSGEBÜHREN, GRUNDERWERBSTEUER
Fellner
release Z
Karl-Werner Fellner Verlag, Enns.

BELGIUM

BTW GECOORDINEERDE AANSCHRIJVINGEN
release 10
Deurne, Kluwer Rechtswetenschappen.

IMPORT-EXPORT. GUNSTREGELINGEN EN PROCEDURES IN DE BTW EN DOUANEREGLEMENTERING
Brassine – Koedijk – Marckx
release 13
Kluwer Rechtswetenschappen, Deurne.

L'INDICATEUR FISCAL
releases 88bis and 89
CED Samsom, Diegem.

VENNOOTSCHAP EN BELASTINGEN
release 21
Kluwer Rechtswetenschappen, Deurne.

CANADA

CANADIAN TAXATION OF CHARITIES AND DONATIONS
A. Drache
release 8
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
release 870
Prentice-Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Moms
  release 1
- Skattenyt – Kronologisk
  releases 1-3
- Skattebestemmelser – Systematisk
  release 1

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  releases 338 and 339

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – FISCAL
releases 5 and 6
Editions Francis Lefebvre, Levallois-Perret.

FISCALITE PRATIQUE – IMPOTS INDIRECTS
release 4
Editions Francis Lefebvre, Paris.

JURIS CLASSEUR – DROIT FISCAL – COMMENTAIRES – IMPOTS DIRECTS
release 1187
Editions Techniques, Paris.

GERMANY

HANDBUCH DER BAUINVESTITIONEN UND IMMOBILIEN-KAPITALANLAGEN
release 63
Peter Deubner Verlag, Cologne.

HANDBUCH DER RENTEBESTEUERUNG
Richer
release 27
Peter Deubner Verlag, Cologne.

SOZIALVERSICHERUNGS HANDBUCH FÜR DIE BETRIEBLICHE PRAXIS
Figge
release 53
Otto Schmidt Verlag, Cologne.

INTERNATIONAL

THE INTERNATIONAL TAX TREATIES
release 17
In-Depth Publishing Ltd., Dublin.

NETHERLANDS

BELASTINGHEFFING IN LAND EN TUINBOUW
release 17
Kluwer, Deventer.

BELASTINGWETTEN (DE BELASTINGGIDS)
release 162
Gouda Quint/D. Brouwer, Arnhem.

FISCALE MODELLEN
releases 57 and 58
Kluwer, Deventer.

FISCALE WETTEN
release 209
Fed, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 367 and 368
Kluwer, Deventer.

KLUWERS TARIEVENBOEK
releases 427-432
Kluwer, Deventer.

MODELLEN VOOR DE RECHTSPRAKTIJK
release 131
Kluwer, Deventer.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
release 171
Kluwer, Deventer.

NEDERLANDSE WETBOEKEN
release 241
Kluwer, Deventer.

PERSONENASSOCIATIES
Slagter-Zwemmer
release 9
Kluwer, Deventer.

PRAKTIJKBOEK SOCIALE VERZEKERINGEN
release 6
SDU, The Hague.

RECHTSPERSONEN
release 108
Kluwer, Deventer.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel, release 72
- AKBW, release 47
- AOW/AWW, release 64
- AWBZ, releases 107 and 108
- Coord. SV/Premieheffing, release 24
- Heffing over uitkeringen en loon, release 46

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
release 293
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  release 229
- Inkomstenbelasting 1964
  releases 887
- Loonbelasting
  releases 567-569
- Omzetbelasting
  releases 241-243
- Vennootschapsbelasting
  releases 314-316
- Vennootschapsbel. Jaarverslaglegging
  release 5

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, release 12
B, releases 18 and 19
Norsk Skattebetalerforening, Oslo.

PERU

CODIGO TRIBUTARIO
release 12
Editorial Economia y Finanzas, Lima.

IMPUESTO A LA RENTA
releases 18 and 19
Editorial Economia y Finanzas, Lima.

© 1994 International Bureau of Fiscal Documentation

IMPUESTO A LAS VENTAS
release 74
Editorial Economia y Finanzas, Lima.

TRIBUTOS MUNICIPALES
release 28
Editorial Economia y Finanzas, Lima.

SWITZERLAND

RECHTSBUCH DER SCHWEIZER BUNDESSTEUERN
release 90
Verlag für Recht und Gesellschaft AG., Basel.

UNITED KINGDOM

SIMON'S TAX CASES
releases 2 and 3
Butterworth, London.

SIMON'S TAXES
release 195
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE
releases 52, 1 and 2
Butterworth, London.

USA

UNITED STATES TAX REPORTER
releases 52, 1-3
RIA – Research Institute of America Inc., New York.

TAX TREATIES – REPORT BULLETIN
releases 9-12
Warren Gorham Lamont, Boston.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

APRIL 1994

Taxation one year after the start of the Single Market, Brussels, 13 April 1994 (English, French, German):

Confédération Fiscale Européenne, Postfach 13 40, D - 53003 Bonn, Germany, Tel.: 49-228-726 3944, Fax: 49-228-726 3952.

Licencing in Europe for 2002, Delft (Netherlands), 17-20 April 1994 (English):

Congress Office ASD, PO Box 40, 2600 AA Delft, The Netherlands, Tel.: 31-15-120 234, Fax: 31-15-120 250.

Tax treatment of derivative instruments, London, 18-19 April (English):

The International Faculty of Finance, IIR Ltd., 28th floor, Centre Point, 103 New Oxford Street, London WC1A 1DD, England, Tel.: 44-71-412 0141, Fax: 44-71-412 0145.

The European Tax Executive's Spring 1994 Briefing, Luxembourg, 20-22 April (English):

Marion Oakley, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, England, Tel.: 44-71-779 8601, Fax: 44-71-779 8599.

International Tax Planning Techniques, Amsterdam, 21-22 April 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MAY 1994

International Aspects of VAT, Amsterdam, 9-10 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

European/U.S. International Tax Planning, London, 23-24 May 1994 (English):

Corrine Simmers, International Tax Review, Nestor House, Playhouse Yard, London EC4V 5EX, England, Tel.: 44-71-779 8719, Fax: 44-71-779 8603.

7th East West Tax Conference, Sofia, 26-27 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Tax Treatment of Transfer Pricing, Amsterdam, 27-28 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Taxation Management Techniques, Brussels, 30-31 May 1994 (English):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

JUNE 1994

Recent Developments in International Tax Law: the New OECD Model Treaty of 1992, Vienna, 1 June 1994 (German):

Institut für Finanzrecht, Althanstrasse 39-45, A-1090 Vienna, Tel.: 43-222-313 36, Fax: 43-222-313 36.

Corporate Finance Centres and Tax Havens, Geneva, 2-3 June 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

International Tax Planning Association Meeting, Monte Carlo, 9-10 June 1994 (English):

Elizabeth Husband, ITPA Convention Bureau, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-762 910, Fax: 44-732-763 762.

Tax Avoidance and Tax Treaties, Amsterdam, 13-14 June 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1994

Leyden–Amsterdam–Columbia Summer Program in American Law, Leyden, 3-29 July 1994 (English):

Mrs B. Zaaijer, University of Leyden, Faculty of Law, Columbia Summer Program, Hugo de Grootstraat 27, 2311 XK Leyden, The Netherlands, Tel.: 31-71-277 632, Fax: 31-71-277 600.

Workshop on special economic zones in Asia (Asian Studies Association of Australia Biennial Conference), Perth, 13-16 July 1994 (English):

George Sanderson, Asian Studies, Griffith University, Nathan, Queensland 4111, Australia, Tel.: 61-7-209 8645, Fax: 61-7-875 5111.

AUGUST 1994

Principles of International Taxation, Amsterdam, 22 August-2 September 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Hong Kong:
Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Israel:
Taxation of Corporations 141

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

New Zealand:
Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Qatar:
Finbarr Sexton:
Taxation regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

United States:
Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41

IV. CONFERENCE DIARY 55, 81, 137

V. BIBLIOGRAPHY

– Books 45, 103, 150
– Looseleaf services 49, 107, 154
– List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 5 MAY 1994

INTERNATIONAL:
IMPLICATIONS OF FREE TRADE ARRANGEMENTS FOR INVESTMENT IN THE CARIBBEAN BASIN 211
David A. Gantz

Free or freer trade and the economic integration of national economies are ideas whose time has come for the Western hemisphere. This article first sets out several basic considerations that affect foreign investment driven by opening markets. It then reviews the major arrangements seeking free or freer trade affecting the Caribbean, i.e. NAFTA, CBI, the Andean Initiative and its possible extension to NAFTA, the intra-Caribbean arrangements now being formed, and GATT. Finally, the impact of these trends on investment trends in the region is assessed for the rest of the 1990s.

NEW ZEALAND:
AN OVERVIEW OF THE ACCRUAL PROVISIONS AND ISSUES ARISING THEREUNDER 218
Martin A. Smith

Sections 64B to 64M were inserted into New Zealand's Income Tax Act in 1987, but with application from the income year commencing 1 April 1985. Committees and reports were commissioned by the government to review the accruals area. This article makes an in-depth examination of the labyrinthine legislation applicable to financial and "synthetic" instruments.

NEW ZEALAND:
TAX SIMPLIFICATION: PROGRESS TO DATE 236
Lin Mei Tan and Stuart Tooley

Tax simplification is often advanced as the panacea to the growing concerns over the complexity of income tax and the burden of compliance costs on taxpayers. This article provides some insights on tax simplification in New Zealand and its effectiveness as perceived by tax practitioners.

AUSTRALIA:
STATE EXCISE TAXES AND THE CONSTITUTION:
CAPITAL DUPLICATORS PTY. LTD. V. AUSTRALIAN CAPITAL TERRITORY (1 & 2) 239
Abe I. Greenbaum

The Australian High Court recently decided, in cases challenging the Business Franchise ("X" Videos) Act, that an ACT franchise fee on wholesale and retail sale of "X" rated videos was an unconstitutional excise. However, the Court averted severe political disruption which would have been inevitable by going on to hold that similar State-levied franchise and licence fees for the sale of liquor, tobacco and petrol would be permitted to continue, notwithstanding the ruling regarding ACT.

AUSTRALIA:
FOREIGN BANKS: DEFINING THE PERSONALITY 243
Michael Kobetsky

This article first examines the deductibility of intrabank interest and the application of interest withholding tax to intrabank interest paid overseas under the new Australian regime for the taxation of Australian branches of foreign banks. Then the corresponding OECD approach as set forth in the 1984 Report is examined. The article ends with a comparison of the two approaches.

PEOPLE'S REPUBLIC OF CHINA:
IMPLEMENTING REGULATIONS FOR THE NEW INDIVIDUAL INCOME TAX LAW 250
Jinyan Li

The regulations for the implementation of the new individual income tax law were introduced at the end of January. The new regulations deal with many of the questions under the new individual income tax law, although they leave some questions unanswered.

© 1994 International Bureau of Fiscal Documentation

HONG KONG:
BUDGET BONANZA 257
Ian Harris
Despite tax cuts and real increases in expenditure tax reserves of Hong Kong are expected to continue to increase in the period up to 30 June 1997, after which Hong Kong becomes a Special Administrative Region of China.

BIBLIOGRAPHY
– Books 261
– Loose-leaf services 266

CONFERENCE DIARY 267

CUMULATIVE INDEX 268

IFA NEWS 260

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

INTERNATIONAL

IMPLICATIONS OF FREE TRADE ARRANGEMENTS FOR INVESTMENT IN THE CARIBBEAN BASIN

David A. Gantz

Associate Director, National Law Center for Inter-American Free Trade and Visiting Professor of Law, College of Law, University of Arizona; Of Counsel, Reid & Priest, Washington, D.C.

This paper was presented at the Second Caribbean Tax Conference, held 17 & 18 February 1994 in Cancun, Mexico.

Free or freer trade and the economic integration of national economies are ideas whose time has come for the Western hemisphere. The North American Free Trade Agreement (NAFTA), establishing a free trade zone encompassing more than 365 million persons and a gross national product of $ 6.5 trillion, entered into force on 1 January 1994, among the United States, Mexico and Canada. In 1993, trade between Mexico and Venezuela jumped to $ 2 billion, four times 1991 levels,[1] largely as a result of movement toward a free trade area among Mexico, Venezuela and Colombia. Trade among Latin America's 11 largest nations reached $ 19.2 billion in 1992, an increase of 28 percent.[2] The various intra-regional free trade agreements, discussed below, have lowered the average tariffs charged by Latin American nations to 15 percent in 1992, from 56 percent in 1985.[3]

NAFTA by its terms contemplates additional membership by countries within the Western hemisphere. Chile and Argentina, along with Colombia, Venezuela and several others in the Caribbean Basin,[4] are likely early candidates for NAFTA accession.[5]

Independently of NAFTA, the United States has provided preferential access to the US market for the region through the "Caribbean Basin Initiative" since 1983,[6] and it is possible, as discussed below, that this will evolve into a broader trading relationship. Since 1992 and in the case of Peru, 1993, similar privileges have been provided to most members of the Andean group (Bolivia, Peru, Ecuador and Colombia, but not Venezuela.)[7]

For the Clinton Administration, NAFTA (and the special trading relationships) are only the beginning. As Secretary of Commerce Ron Brown has stated, "Most of it [regional economic integration] could happen before the end of the century".[8] As one might have expected the United States has benefited enormously from the freeing of trade in Latin America; US exports to Latin America increased by 25 percent in 1992 alone, and half of Latin America's trade is now with the United States.[9]

However, NAFTA and the US preferential initiatives are by no means the only contemporary efforts to encourage free trade and economic integration throughout the region. In particular, Mexico, Venezuela and Columbia are in the process of creating a sub-regional preferential trading bloc encompassing not only these three countries but the CARICOM group and members of the Central American Common Market. Mercosur (Brazil, Argentina, Uruguay and Paraguay) is scheduled to eliminate intra-regional tariffs in 1995.[10] Under the stimulus of Mercosur, Brazil's exports to the other three members rose from 4 percent of total exports in 1990 to 12 percent in 1992.[11] Colombia alone is reported to be negotiating with 22 other Latin American countries. Colombian Foreign Minister Noemi Sanin has stated, "Before the end of the century, we aspire to achieve the planet's most important trading bloc – the American bloc."[12]

Globally, 117 nations recently completed a comprehensive revision and expansion of the world trading system, the General Agreement on Tariffs and Trade (GATT).[13] The

1. New York Times, 29 December 1993, at C2. For detailed statistics on Latin American and Caribbean region trade, see U.S.A.I.D., *Latin America and the Caribbean Economic and Social Data* 129-88 (May 1993)(hereinafter "USAID").
2. *Id.*
3. *Id.*
4. In this paper, "North America" means Mexico, Canada and the United States. The "Caribbean Basin" means the island nations of the Caribbean sea, the seven nations of Central America (Belize, Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica and Panama) and the South American nations of Venezuela, Colombia, Guyana and Surinam.
5. The other most likely candidates in the region are probably Jamaica, Trinidad and Tobago, Barbados, the Dominican Republic and Costa Rica, depending on the willingness of the NAFTA parties to negotiate individually with smaller nations rather than with groups such as CARICOM or the Central American Common Market. With Argentina, there is a question as to whether Argentina will seek accession to NAFTA alone or as part of the "Mercosur" group (Argentina, Brazil, Paraguay, Uruguay). Bureau of National Affairs, *International Trade Reporter* (23 December 1993), at 1.
6. Caribbean Basin Economic Recovery Act, P.L. 98-76, 5 August 1993, as amended, 19 U.S.C. §§ 2701 et seq.
7. Andean Trade Preference Act, Sec. 203, P.L. 102-82. 19 U.S.C. §§ 3201 et seq.
8. See *supra* note 1.
9. *Id.*
10. Mercosur recently reduced internal tariffs to 18% of the external tariff rates – from 25% in 1993 – and will eliminate internal tariffs on 1 January 1995. Bureau of National Affairs, *International Trade Daily* (13 January 1994), at 8.
11. *Id.*
12. See *supra* note 1.
13. See *Final Round Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations*, MTN/FTA, 15 December 1993 (hereinafter "Final Act").

© 1994 International Bureau of Fiscal Documentation

"Uruguay Round" agreements will further reduce tariff and non-tariff barriers worldwide, and extend GATT disciplines to services, intellectual property and trade-related investment, among others.

The movement toward freer trade is already having significant impacts on investment throughout the region, particularly in the smaller nations of Central America and the Caribbean. The Inter-American Development Bank reports that the Latin American region has attracted $ 100 billion in net capital inflows over the past three years, a "spectacular comeback" from the 1980s, where the region was largely absent from international capital markets.[14] US direct investment in Latin America increased from $ 71.142 billion in 1990 to $ 80.389 in 1991.[15] Eduardo McBride, president of the Peruvian Exporters Association, has predicted that almost all foreign investment in Peru over the next decade will be directed toward exports, particularly to the North American market being created by NAFTA.[16]

What does this movement mean for the nations of the Caribbean Basin and their efforts to achieve economic development and a higher standard of living for their people through the stimulus of trade and investment flows? This presentation first sets out several basic considerations that affect foreign investment driven by opening markets. Second, it reviews the major arrangements seeking free or freer trade affecting the region – NAFTA, CBI, the Andean Initiative and its possible extension to NAFTA, the intra-Caribbean arrangements now being formed, and GATT. Finally, it seeks to assess the impact of these trends on investment trends in the region for the rest of the century.

I. KEY FACTORS AFFECTING INVESTMENT

When considering the impact of free or freer trade on investment, it is useful to keep in mind several significant factors that in the final analysis may be as important as the provisions of the trade agreements themselves. First, investors thrive on predictability, rules of the game which once determined are not likely to be changed unilaterally, and security for their investments and technology. When such rules are embodied in an international agreement, whether a free trade agreement such as the NAFTA or an accord such as the "bilateral investment treaties" (BITs) concluded between the United States and many developing nations, investors enjoy an increased level of confidence.[17]

Secondly, the process by which a country prepares itself to participate in a free trade agreement can be almost as important as the agreement itself in improving the attractiveness of the country to new investment, both foreign and domestic. Mexico, for example, during the last eight years, and Chile, during the last five or six, have radically changed their economies in preparation for entry into NAFTA. Each has become a member of the GATT, reduced tariff and non-tariff barriers, introduced various domestic measures to encourage competition and reduce government interference in business, enacted new legislation on investment and protection of intellectual property, privatized many government-owned businesses, eliminated double taxation,[18] among others. In many instances, this has been a painful process, hurting inefficient industries and incurring the enmity of powerful interest groups. Yet the result in each instance has been to stimulate trade, foreign investment and new economic activity.[19] $ 19.4 billion worth of Latin American intra-regional trade was, after all, achieved in 1992, before any of the major intra-regional trading blocs, or NAFTA, had entered into force!

Third, regional trade agreements operate in part by establishing preferential trade within the group, reducing or eliminating tariffs on originating products below each countries "most favoured nation" (MFN) tariffs, those charged on imports from other nations, and by eliminating quantitative restrictions which otherwise exist. Free trade agreements are thus dependent on a differential between the MFN tariffs (and non-tariff barriers) determined by the GATT, and the preferential rates offered within the arrangement. As MFN tariffs decrease or are eliminated and non-tariff barriers are phased out as a result of GATT negotiations, the advantage provided by the free trade agreement also decreases. US tariffs on most other goods average about 4 percent, and will decrease by 34 percent in the aggregate as a result of the "Uruguay Round", to an average of about 3 percent, although tariffs on some sensitive items such as textiles and footwear remain high.[20] Also, the unilateral tariff preferences established by the United States for Caribbean Basin and most Andean nations, discussed below, has reduced or eliminated many tariffs on manufactured goods from the region. Thus, the *incremental* tariff benefits for the countries of the region under an expanded NAFTA may be less significant than other factors.

In contrast, where the average MFN tariffs are 15 percent, as with Latin American generally,[21] the advantage in free trade for members of intra-regional trading blocs is substantial, particularly if the dynamics of free trade create increased intra-regional demand for products produced within the region.

14. Frederick Z. Jasperson, quoted in *OAS Trade News* (October 1993), at 5.
15. USAID, at 198.
16. Bureau of National Affairs, *International Trade Daily* (22 December 1993), at 1.
17. For example, the United States and Jamaica executed a BIT on 4 February 1994. Bureau of National Affairs, *International Business & Finance Daily* (9 February 1994), at 10.
18. See Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 18 September 1992, which entered into force on 1 January 1994. Commerce Clearing House, *Tax Treaties* 35,807 (1993).
19. See US International Trade Commission, *Review of Trade and Investment Measures by Mexico and Prospects for Future US–Mexican Relations passim* (USITC Publ. 2275, April 1990).
20. Executive Summary, Results of the GATT Uruguay Round of Multilateral Trade Negotiations, at 7, 58 Fed. Reg. 76268, 76274 (20 December 1993) (hereinafter "Executive Summary").
21. See *supra* note 1.

© 1994 International Bureau of Fiscal Documentation

II. ARRANGEMENTS THAT ENCOURAGE REGIONAL TRADE

A. North American Free Trade Agreement

It is NAFTA, of course, that more than any other factor has sparked the interest of the Western hemisphere in free trade. This is understandable, since NAFTA offers not only benefits, but threatens serious adverse dislocations for many Caribbean Basin countries that are not part of the pact, as one knowledgeable observer, Jamaican Ambassador to the United States Richard L. Bernal, has noted:

> The structure of trade in the region, ensures that the impact of NAFTA will be substantial. Fifty to 70 percent of exports of CBI countries go to the three NAFTA countries. With such a significant proportion of the region's trade taking place with the United States, and given the importance of trade to economic growth, there is concern that NAFTA could result in trade diversion and not in trade creation.[22]

The principal reasons for this, as we shall see, are NAFTA's investment provisions and elimination over time of all tariff and non-tariff barriers, insofar as those provisions apply only to Mexico, or to Mexico and certain other developing nations within the region.

NAFTA is a comprehensive trade and investment agreement, covering, *inter alia*, elimination of tariff and non-tariff barriers; foreign investment; services; government procurement; protection of intellectual property; customs procedures; resolution of trade and other disputes; and, with its "side" agreements, protection of the environment and labour standards.[23] While a full analysis of NAFTA's provisions is beyond the scope of this article, several highlights relating to investment require emphasis.

First, NAFTA provides for elimination of all intra-regional tariffs. Tariffs on many products were eliminated or substantially reduced on 1 January 1994; others are removed over five, ten or fifteen years.[24] The tariff reduction schedules are implemented on a country-by-country basis; as between the United States and Canada, the tariff reductions under the US–Canada Free Trade Agreement (providing for tariff elimination in no more than ten years beginning 1 January 1989) are unchanged.[25] NAFTA also eliminates tariffs on textiles and apparel over ten years. Textile quotas on products that meet NAFTA rules of origin (normally, the yarn used in the product must be of North American origin) are eliminated as of 1 January 1994, and tariffs on Mexican textile products that do not meet NAFTA rules of origin are phased out over ten years.[26]

The only goods subject to free trade are those which originate in North America. Normally, this means all materials and inputs are North American, or a substantial manufacturing process takes place within the region. However, in some instances, a minimum percentage of the cost or value of the product must be of North American origin. For example, 55 percent of the net cost of most footwear must be of North American origin if the footwear is to receive NAFTA benefits.[27] Finally, in a few cases, a particular component, such as the picture tube for large screen colour television receivers, must be of North American origin.

Secondly, NAFTA establishes extensive protection for foreign investment, not unlike that provided in the series of BITs the United States has concluded with various countries. Chapter 11 of NAFTA provides for "national treatment" or "most favoured nation" treatment for foreign investments; eliminates most prior government approvals for investment; eliminates most performance requirements, such as minimum levels or exports or use of local parts and raw materials; assures repatriation of capital and profits; bars expropriation except under international law standards; and provides binding international arbitration for disputes between foreign investors and host governments.[28] A new Mexican foreign investment law already implements these provisions.[29]

Third, NAFTA provides unprecedented access to foreign-owned services, including but not limited to financial services (banks, insurance companies and brokerage houses) and transportation.[30] It is anticipated that US and Canadian investment in the Mexican financial sector will increase the supply of available credit for business, particularly small business, and consumers in Mexico.[31]

Fourth, NAFTA provides a high level of protection for intellectual property (patents, trade marks, copyright, trade secrets) and requires effective measures to deal with infringement and counterfeiting.[32] Again, Mexican law already implements these provisions through 1991 legislation.[33] Fifth, NAFTA opens the Mexican market to procurement by Mexican government entities, including Pemex, the petroleum monopoly, and Comision Federal de Electricidad, which controls electric power production and distribution, subject to certain minimum contracting thresholds.[34]

Other NAFTA provisions provide for harmonized and simplified customs procedures and various standards, as well as for settlement of disputes over application of anti-dumping and countervailing duty laws.[35] While US and Canadian trade laws are not changed, Mexico has introduced a new Foreign Trade Law that effects important procedural changes, guaranteeing a much higher level of transparency and procedural due process.[36] Trilateral commissions created under the NAFTA "side" agreements on the environment and labour,

22. Statement submitted to the US House of Representatives hearings on The Caribbean Basin Free Trade Agreements Act (H.R. 1403), 24 June 1993, at 3.
23. See David A. Gantz, "A Preliminary Assessment of the North American Free Trade Agreement," 46 *Bulletin for International Fiscal Documentation* (September 1992), at 424.
24. NAFTA, Arts. 102, 301, Annex 302.2.
25. NAFTA, Annex 302.2.
26. NAFTA, Ch. 3, Annex 300-B.
27. NAFTA, Ch. 4, Annex 401.
28. NAFTA, Ch. 11, Sec. A. See David A. Gantz, "Resolution of Investment Disputes Under the North American Free Trade Agreement," 10 *Arizona J. of Int'l & Comp. L* (1993), at 335.
29. Foreign Investment Law, *Diario Oficial*, 27 December 1993.
30. NAFTA, Ch. 14.
31. See "North American Free Trade Agreement: Mexican Government Keen to Increase Competition", *Financial Times*, 13 August 1992, at 3.
32. NAFTA, Ch. 17.
33. Law for the Development and Protection of Industrial Property, *Diario Oficial*, 27 June 1991.
34. NAFTA, Ch. 10.
35. See NAFTA, Chs. 5, 9, 19.
36. Foreign Trade Law of Mexico, *Diario Oficial*, 27 July 1993.

© 1994 International Bureau of Fiscal Documentation

will provide mechanisms to assure that the individual member countries effectively enforce their own environmental and labour laws, with the possibility of trade sanctions if such enforcement requirements are not met.[37]

NAFTA specifically provides accession by additional countries or groups of countries "subject to such terms and conditions as may be agreed between such country or countries... and following approval in accordance with the applicable legal procedures of each country".[38] However, NAFTA does not specify the requirements for such accession beyond this general statement, thus effectively leaving the terms of each future accession to negotiation among the affected nations.

B. US trade preferences for the Caribbean

While the United States currently has no free trade agreement with any nation of the Caribbean Basin, it has long maintained *preferential* trading relationships with most Caribbean Basin nations (except Cuba). The Generalized System of Preferences (GSP), a worldwide programme providing duty free entry to the US market for many manufactured products, has been in effect for 18 years.[39] The current US GSP programme expires 30 September, but is likely to be renewed as part of the implementing legislation for the GATT "Uruguay Round" agreements.

The United States also has a special programme for the region, Caribbean Basin Economic Recovery Act (CBERA), initiated in 1983 and expanded in 1991.[40] Unlike GSP, this is a permanent programme, not subject to periodic reauthorization. Under CBERA, duty-free exports from the region to the United States increased from $ 8.2 billion in 1991 to $ 9.4 billion in 1992, or by nearly 15 percent.[41]

Both GSP and CBI are subject to a variety of conditions and exceptions. With both programmes, articles must demonstrate 35 percent local or regional content to be eligible for duty-free benefits.[42] GSP excludes many sensitive products, such as colour televisions. CBERA has fewer exclusions, but they are significant: textiles and apparel, footwear, tuna, petroleum, watches and watch parts.[43] Unlike NAFTA, both GSP and CBERA are unilateral programmes; the beneficiary countries are not required to open their markets to US goods on a reciprocal basis.

Because of concerns that NAFTA will negate the benefits of CBERA by diverting trade and investment from the region to Mexico, legislation has been proposed by the Chairman of the Trade Subcommittee of the House Ways and Means Committee Sam Gibbons that would give the Caribbean Basin temporary "parity" with NAFTA for a three-year period, during which time the nations of the region would be expected to negotiate accession to NAFTA or separate free trade agreements with the United States.[44] Significantly, during the three-year grace period the free trade and other obligations of NAFTA would *not* be reciprocal. In this sense, the Gibbons bill would simply be a further extension of CBERA, although after the three-year period the nations of the region would either be required to accept reciprocal obligations or lose NAFTA benefits.

The Clinton Administration, perhaps reflecting domestic political concerns, has not formally endorsed the Gibbons approach. However, President Clinton, meeting recently with the presidents of Central America, confirmed that he had

> shared concerns about NAFTA's potential short-term effects on the flow of trade and investment to Central America... and pledged that my administration will work with Congress and Central American governments to design affirmative strategies to stimulate regional trade.[45]

More recently, the US Trade Representative, Mickey Kantor, who heads an inter-agency group studying the ways to expand free trade in the hemisphere, has endorsed the concept of a "building block" approach using interim bilateral agreements with smaller nations – presumably including many in the Caribbean and Central America – who do not and will not for some time be in a position to accept the full obligations of NAFTA membership, to protect the region from trade and investment diversions.[46] Under this approach, which might be incorporated in the US legislation implementing the "Uruguay Round" of GATT negotiations that is expected to be introduced late this spring, the Caribbean Basin nations would receive US market access equivalent to NAFTA, and would be expected in return to agree to long term US access to their markets, strong measures to prevent textile transshipment, and strengthened intellectual property legislation.[47]

It seems likely, therefore, at this writing (February 1994) that the Administration will work with Congress to deal with the diversion problem, although whether the solution will be either effective or prompt remains to be seen.

C. Intra-regional preferential trading agreements

There are, of course, two significant intra-regional trade agreements of long duration, the Central American Common Market (CACM) and CARICOM. CACM was formed in 1960[48] by Costa Rica, Nicaragua, El Salvador, Honduras and Guatemala, and until 1969 achieved considerable success at removing trade barriers to manufactured products. Unfortunately, the "Soccer War" of 1969 between El Salvador and Honduras, followed by civil strife in El Salvador, Guatemala and Nicaragua, made the CACM moribund for more than two decades. However, as interest in regional integration and NAFTA increases within the region, efforts are being made to resuscitate the CACM, in part because some suspect that the

37. See North American Agreement on Environmental Cooperation, North American Agreement on Labour Cooperation, 14 September 1993.
38. NAFTA, Art. 2204(1).
39. Title V, Trade Act of 1974, as amended, 19 U.S.C. § 2461 et seq.
40. Title II, Customs and Trade Act of 1990, 19 U.S.C.§ 2401 et seq.
41. *Journal of Commerce*, 29 November 1993, at 5A.
42. See Harmonized Tariff Schedules of the United States (1993), General Note 3(c)(v).
43. 19 U.S.C. § 2701.
44. Caribbean Basin Free Trade Agreements Act, H.R. 1403, 103rd Cong., 1st Sess., 18 March 1993.
45. Press Conference by President Clinton et al., The White House, Washington, D.C., 30 November 1993, at 3.
46. *Inside US Trade*, 28 January 1994, at 7-8.
47. *Inside US Trade*, 11 February 1994, at 6-7.
48. General Treaty for Central American Economic Integration of 13 December 1960, 455 U.N.T.S. 3 (1963).

© 1994 International Bureau of Fiscal Documentation

United States will not be willing to negotiate accession to NAFTA on a small country by small country basis.

CARICOM was formed in 1973;[49] its membership now includes 13 English-speaking nations. CARICOM's objectives include strengthening the respective economies through elimination of trade barriers and presenting a common front in international trade negotiations. However, repeated efforts to eliminate intra-regional tariffs have achieved only limited success due in part to the competitive nature of many of the Caribbean economies.

More recently, Mexico, Venezuela and Colombia have actively pursued sub-regional economic integration. A trilateral free trade agreement among Mexico, Venezuela and Colombia was concluded in principle in October 1993 and is expected to enter into force early in 1994. The agreement contemplates the reciprocal elimination of tariffs on virtually all products in intra-regional trade within a ten-year period (12 years for automobiles).[50]

Perhaps more significantly for the Caribbean Basin as a whole, these three larger countries, led by Venezuela, are seeking freer trade arrangements with the members of the Caribbean Common Market (CARICOM) and the Central American Common Market (CACM). Venezuela has concluded an agreement in principle with CARICOM which provides CARICOM nations with preferential access to the Venezuelan market for specified lists of products for which duties would be eliminated either immediately or over five years; over a second five-year period, full reciprocity is to be achieved, subject to certain exceptions. Venezuela would receive "most favoured nation" tariff treatment and no new quantitative restrictions would be imposed on Venezuelan goods.[51]

Discussions are now under way to formalize the CARICOM–Venezuela arrangements and expand them to include Colombia and Mexico. If these efforts are successful, they would give CARICOM access to a tri-country market of 160 million persons and an aggregate gross national product of $ 275 billion.[52] Some discussions along the same lines are apparently being pursued with the nations of Central America.

As noted earlier, several other regional economic integration movements exist, including Mercosur and the Andean Common Market. However, these have little practical impact on any of the Caribbean Basin countries, except for the Andean Group, of which both Columbia and Venezuela are parties.

D. Conclusion of the "Uruguay Round" GATT negotiations

On 15 December 1993, seven years of trade negotiations were formally concluded, although work on specific tariff reduction measures continues. When ratified by the member states, the revised GATT – a new Multilateral Trade Organization (MTO) – will enter into force on 1 July 1995.[53] Many of the GATT provisions, designed for worldwide application, will affect trade and investment in the Caribbean Basin.

A major feature of the Uruguay Round, as with the six earlier rounds, was tariff reduction. The major industrialized countries (United States, Canada, European Union and Japan) agreed to reduce tariffs overall by approximately one third, although the tariff reductions on specific items vary. Those countries will eliminate tariffs entirely on pharmaceutical products, construction equipment, agricultural equipment, medical equipment, steel, beer, distilled spirits, paper, toys and furniture, and other countries' tariffs on such products will also be reduced. Many other tariffs are reduced, usually over a period of five years beginning 1 July 1995.[54]

While the relatively high US textile and apparel tariffs are reduced by only about 12 percent, the US and other GATT parties agreed to eliminate textile quotas (through the Multifiber Agreement) within ten years.[55] This reduces, but by no means eliminates, the advantages afforded to Mexican textile producers by the NAFTA.

The new GATT agreement contains NAFTA-like provisions for the protection of intellectual property,[56] and limited coverage of service industries.[57] (Negotiations on the financial sector are continuing.) GATT investment provisions provide generally for national treatment and limit performance requirements, but the "Trade Related Investment Measures" fall far short of the comprehensiveness of Chapter 11 of NAFTA, and are not likely in themselves to encourage foreign investment in GATT member states.[58]

Other provisions of the agreement are intended to reduce non-tariff barriers, revise the international rules relating to unfair trade (dumping, government subsidies), facilitate customs harmonization and provide more effective dispute settlement mechanisms.[59]

In some respects, it is probably fortunate that the Uruguay Round agreements fall short of NAFTA in important respects. The interest in the United States of obtaining broader international acceptance of the more comprehensive NAFTA provisions, particularly in the investment, services and intellectual property areas, should help to assure that NAFTA or its equivalent will remain open to other hemispheric nations.

III. IMPACT ON INVESTMENT DECISIONS IN THE REGION

Foreign investment decisions other than those relating to unique natural resources are almost always based on a multi-

49. Treaty Establishing the Caribbean Community of 4 July 1973, 10 I.L.M. 1033 (1973).
50. *Journal of Commerce*, 15 October 1993, at A.
51. 1993 Agreement on Trade and Investment Between CARICOM and Venezuela.
52. *Journal of Commerce*, 15 October 1993, at A.
53. See Executive Summary, 58 Fed. Reg. 67264 (20 December 1993).
54. Executive Summary, at 2-3, 58 Fed. Reg. 67269, 67270 (20 December 1993).
55. Agreement on Textiles and Clothing, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, MTN/FA I-A1A-5, 15 December 1993; see Executive Summary, at 7, 58 Fed. Reg. 67274 (20 December 1993).
56. Agreement on Trade Related Aspects of Intellectual Property, Final Act, Annex 1C.
57. General Agreement on Trade in Services, Final Act, Annex 1B.
58. See Agreement on Trade Related Investment Measures, Final Act, MTN/FA II-A1A-7.
59. See Final Act, *passim*.

© 1994 International Bureau of Fiscal Documentation

plicity of factors, including not only the investment climate and access to the local market and important export markets, but quality of infrastructure; cost and skills of the local labour force; availability of parts and materials; shipping distances; local language and customs; stability and reliability of the host country's legal and political systems; level of environmental regulation; availability of special tax "holidays" or other benefits; availability of reliable joint venture partners, etc. It is obvious that these factors differ significantly from country to country, and will be affected by the type of investment, goods or product produced or services offered, etc.

It is evident, nevertheless, that the investment climate and access to the large markets of North America and the Caribbean Basin, particularly the United States, Mexico and Canada, and to a lesser extent, Venezuela and Colombia, are likely to be major factors influencing investment decisions, particularly where there exist more potential projects than there is capital to fund them. In this respect, in addition to NAFTA benefits for foreign investors, Mexico already enjoys significant advantages over many Caribbean Basin nations with regard to the attractiveness of the internal market, size of the labour force, proximity to the United States, availability of raw materials, etc., despite some drawbacks.[60]

In light of these apparent advantages, unless and until the Caribbean Basin nations are afforded the benefits of NAFTA or their equivalent, NAFTA is likely to create investment and trade diversion from the basin to Mexico, at least in the short term.

In terms of investment, with two exceptions (Panama and now, Jamaica)[61] the Caribbean Basin nations have not concluded BITs with the United States. This factor alone is likely to weigh in favour of Mexico when investment decisions are made by Canadian and US companies, simply because of the additional assurance a binding international agreement covering investment provides. To some extent this could be remedied in the short term by concluding BITs with the United States, without waiting for NAFTA, although to date few Latin American countries have chosen to do so.[62]

Trade barrier reduction is also important, particularly in the textile and clothing sector, which is very important to the Caribbean Basin. The fact that NAFTA provides both tariff elimination and quota elimination is significant. NAFTA originating goods will enjoy quota-free access to the US market immediately, and quotas on Mexican and Canadian textiles that do not meet the NAFTA rules of origin are liberalized.[63] In contrast, the GATT textile provisions will not eliminate US quotas until the year 2005.[64] US textile tariffs on NAFTA originating products are phased out by 1 January 2004, while US MFN tariffs will remain indefinitely, only 12 percent on the average below current levels.[65]

Many Caribbean Basin countries assemble garments made from fabrics formed and cut in the United States; when such finished goods are re-exported to the United States, duty is paid only on the value added abroad.[66] Under NAFTA, however, US duties on such garments when finished in Mexico were eliminated on 1 January 1994.[67] Given the mobility of textile production, it is reasonable to assume that some textile production will be shifted from the Caribbean Basin to Mexico as a result of NAFTA, unless the United States quickly takes steps, such as those discussed earlier, to assure comparable US market access.

US footwear tariffs are also relatively high, ranging from eight percent to more than 67 percent *ad valorem*.[68] The United States was apparently unwilling to reduce most footwear tariffs as part of the Uruguay Round GATT negotiations. Thus, for "rubber" footwear, particularly, where US tariffs are often in excess of 20 percent, even the gradual, phased tariff reductions under NAFTA will make Mexico a more attractive site for new production.

For other products, the impact of NAFTA tariff reductions is much less clear. The Caribbean Basin nations already benefit from duty-free access to the US market for most products under CBERA. Current producers of those products in the region have little incentive to shift production to Mexico. It is also likely that US duties and non-tariff barriers will be permanently reduced or eliminated under GATT for some additional products, including agricultural products, of interest to the region, although it will be difficult to assess the impact of these reductions on the Caribbean Basin until the GATT tariff reduction schedules are made public in March or April 1994.

It is more difficult at this time to determine to what extent Caribbean Basin access to the Venezuela–Mexico–Colombian market will affect investment decisions, where the alternative is direct investment in one of those three nations with a manufacturing operation designed to allow the product to be traded duty-free within the three country sub-group. Of course, where duty free access is granted to CARICOM and CACM for agricultural and other products that are indigenous to the region, the impact on trade-driven investment could be very beneficial. In any event, the rapid increase in intra-regional trade suggests that these subregional agreements could be helpful, particularly to the smaller countries in the region, in maintaining or increasing exports.

For those Caribbean nations whose economic activity is focused on the service sectors, particularly tourism and financial services, the impact of NAFTA is problematical. The removal of existing barriers to US and Canadian investment in the transportation, telecommunications, banking, insur-

60. The recent peasant uprisings in Southern Mexico may have some impact on some investment decisions regarding Mexico, until and unless it becomes clear that political stability will be speedily restored. See Tim Golden, "Left Behind, Mexico's Indians Fight the Future," New York Times, 9 January 1994, at 1E. Also, as was obvious to any participant in the Cancun, Mexico, conference for which this article was prepared, Mexico's telecommunications system is inefficient and expensive.
61. US Dept. of State, *Treaties in Force* 195 (1993); Treaty Concerning the Treatment and Protection of Investments of 27 October 1982 (entered into force 30 May 1991).
62. Argentina, Panama and Ecuador are the principal exceptions. See US Dept. of State, *Treaties in Force*, *passim*.
63. NAFTA, Annex 300B.
64. Art. 3, Agreement on Textiles and Clothing, Final Act, MTN/FA II-A1A-5.
65. See Executive Summary, Results, at 7, 58 Fed. Reg. 67274 (20 December 1993).
66. Item 9802, Tariff Schedules of the United States (1993).
67. NAFTA, Annex 300B, App. 2.4.
68. Ch. 64, Harmonized Tariff Schedules of the United States.

© 1994 International Bureau of Fiscal Documentation

ance and construction sectors could provide a further incentive for US investment in tourism, although apparently these measures have not significantly impeded US activity in this sector.[69] Nor is Mexico likely to offer competition as a "tax haven".

For the more traditional foreign investor, an investment decision will require in the first instance (a) assessment of the competing investment climates, including the availability of investment treaty protection; and (b) careful analysis of relevant tariff levels and non-tariff barriers under GATT, NAFTA and any regional free or preferential arrangements.

Under these circumstances, it seems evident that the countries of the Caribbean Basin that are parties to NAFTA, or are headed in that direction under the Gibbons "parity" approach or something similar to it, will have a decided advantage in attracting new investment (or preventing shifts of existing production to Mexico), provided that they are prepared to offer equivalent protection for US investment and intellectual property. In a highly competitive market for the foreign investment dollar, the NAFTA benefits of free access to the US market, protection of foreign investment and protection of intellectual property will be difficult to overcome in situations where investors have a choice of locations; "parity" in terms of US market access alone may not be sufficient.

Access by the smaller countries to the markets of Mexico, Colombia and Venezuela through the new free trade arrangements currently being completed will be helpful, but probably not as significant as the access to the US, Mexican and Canadian markets offered by accession to NAFTA. It can thus be hoped that both US and Caribbean Basin nations' foreign and economic policies will make expansion of NAFTA to the Caribbean region a high priority.

69. US International Trade Commission, *The Likely Impact on the United States of a Free Trade Agreement with Mexico* 4-41, fn. 178 (USITC Publ. 2353, February 1991).

TAXATION AND INVESTMENT IN THE CARIBBEAN

Key information for a successful investment or operational strategy in the Caribbean – the first independent (and only comprehensive) survey of the many and varied Caribbean tax systems. Individual country chapters include:

- investment climate and regulatory conditions; tax systems and tax incentives to investment;
- succinct country surveys, summarizing each country's economic situation and principal business activities;
- relevant company law, exchange control regulations, business licence fees and other essential information;
- in-depth explanations of the main forms of doing business, organization and taxing powers;
- details of income, indirect, transaction and property taxes, and the latest statistics from official sources; and
- coverage of all aspects of offshore business regimes.

Initial subscription: NLG 1,500 ***(includes basic volumes, 1994 updates, postage and handling)***
■ Updated twice per year ■ Annual renewal NLG 350

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD PUBLICATIONS BV,
PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

The following four articles were presented at the Sixth Annual Australasian Tax Teachers' Conference, held 19, 20 and 21 January 1994 in Sydney, Australia.

NEW ZEALAND

AN OVERVIEW OF THE ACCRUAL PROVISIONS AND ISSUES ARISING THEREUNDER*

Martin A. Smith

LL B(Hons.), LL M, Dip. Fin. Mgt., Director of Taxation Research, Ernst & Young, New Zealand.

* This article is based upon a paper presented to the 1994 Australasian Tax Teachers' Conference, but updated for a more recent Court of Appeal decision.

I. BACKGROUND

Sections 64B to 64M were inserted into New Zealand's Income Tax Act 1976 in March 1987, but with application from the income year commencing 1 April 1985. The proposal to implement these "accrual rules" (as they have become popularly called) was announced by the Minister of Finance in his 31 July 1986 Budget, in the following terms:

> One of the most important sources of domestic tax avoidance arises from the mismatch between the time at which deductions are allowed and income is recognized.... As a first move to overcome these problems, the Government will introduce rules which bring the tax treatment of certain expenditure and income closer to normal accounting treatment. With respect to expenditure, the rules will be modelled on Canadian legislation.[1] Interest income and other returns on debt securities will generally be assessable on a yield to maturity basis. Details of the proposed changes will be published within a month and a consultative committee will be established to examine them. The new rules will apply in respect of debt securities issued or acquired, and to certain categories of expenditure incurred, after tonight, except where a binding contract was entered into prior to tonight.

The promised consultative document materialized in October 1986, and a consultative committee was established under the chairmanship of Dr Donald Brash.[2] The Consultative Committee on Accrual Tax Treatment of Income and Expenditure reported in April 1987, and produced a shorter, supplementary report on tax reform and interim solutions in June 1987.[3] Subsequently, the government commissioned and received special reports from consultants on "Trusts and Estates and the Accrual Regime",[4] and "The Effect of the Accrual Regime on Property Transactions" (July 1988).

In May 1990, the Consultative Committee on the Taxation of Income from Capital (chaired by Mr Arthur Valabh) highlighted the accruals area as an area of taxation law requiring review. The Committee produced a discussion paper on the operational aspects of the accruals regime in October 1991, and its final report on these (and other) matters was released in October 1992.

In brief terms, the structure of Sections 64B-64M can be summarized as follows:

Section 64B – Definitions;

Section 64BA –	Meaning of the terms "acquisition price" and "core acquisition price" [necessary for the purpose of the "base price adjustment" – see Section 64F, below];
Section 64C –	Methods of accounting for income and expenditure during the term of a financial arrangement;
Section 64CA –	Treatment of a financial arrangement that includes an "excepted financial arrangement";
Section 64D –	Description of, and tax treatment to be adopted by, persons who may account on a cash basis;
Section 64E –	Power for the Commissioner to issue determinations on many detailed aspects of methods and sources of information to be used under the regime;
Section 64F –	Calculation to be undertaken on the maturity, remission or disposal of a financial arrangement [called the "base price adjustment"];
Section 64FA – and 64FB	Special provisions dealing with rural debt restructuring and new start grants for farmers;

1. Resulting in the current Sec. 104A of the Income Tax Act (hereinafter referred to as "ITA").
2. Now Governor of the Reserve Bank of New Zealand.
3. The Committee also produced a (different) supplementary report on the Bill introduced to Parliament, that was released in June 1987.
4. Not publicly released.

© 1994 International Bureau of Fiscal Documentation

Section 64G –	Rules for the tax treatment of amounts owing under a financial arrangement that are written off as bad debts;
Section 64H –	Disclosure requirements in respect of inter-related arrangements that together comprise a financial arrangement;
Section 64I –	Power for the Commissioner to adjust the income/expenditure of parties to a financial arrangement where those parties are associated and variations to the amounts payable occurred in an attempt to defeat the intent and application of the accrual provisions [such an adjustment being called a "post facto adjustment"];
Section 64K –	Transitional provision regulating the application of the accrual provisions with regard to debt instruments that expressly involve a variable principal;
Section 64L –	Regulation of the relationship between sections 64B-64M and the rest of the Income Tax Act, and particularly according the former priority in relation to the calculation of income and expenditure under a financial arrangement; and
Section 64M –	Exclusions from the operation of the accrual rules, including transitional exclusions, matrimonial agreements, non-resident withholding tax, and non-residents where the financial arrangement does not relate to a business carried on through a fixed establishment in New Zealand.

According to Chapter 1 of the Consultative Document, the objectives of the regime were as follows:

(a) to remove deficiencies in the Income Tax Act 1976 which allow expenditure to be deducted before the corresponding revenue is assessable;
(b) to require income and expenditure to be recognized on an accrual basis to minimize the scope for arbitrage between taxpayers on different tax rates; and
(c) to minimize the additional administrative and compliance costs of the new provisions by making them compatible with accounting practices, except where this conflicts with the other objectives listed above.

The qualification to objective (c) is of great practical importance, because (as we will see) there are many instances where a taxpayer's correct accounting treatment is not permissible for tax purposes under the accrual rules, either by virtue of the manner in which the rules operate or as a result of a specific requirement within the subsections of Section 64C. It would be wrong to assume that the introduction of New Zealand's accrual legislation has contributed significantly to tax simplification.

The Minister's statement referred to "interest income *and other returns* on debt securities" (emphasis added), and it would be expected that other types of fees, premiums and similar profits from the provision of credit would come within the regime. After all, there is nothing magical in the word "interest". But it is important to note that the regime goes well beyond this, and that foreign exchange gains and losses in respect of financial arrangements are automatically subject to the accrual provisions. As McClennan and Truman[5] put it, in November 1987:

> Foreign exchange are now assessable [sic] and losses deductible in the year they occur, rather than at the end of the life of the arrangement. The gain or loss resultant from conversion of the income or expenditure for that year, into New Zealand dollars, at balance date, is included as part of the total income or expenditure relating to the arrangement.

This outcome was justified by the Consultative Document as follows:

> The basic objective of the new accrual rules is to treat all forms of debt instruments in the same way, as far as possible, so that the influence of the tax system on the form in which debts are structured is minimized. Consistent with this objective, it is necessary in the case of foreign currency-denominated loans to take into account exchange gains and losses on an accrual basis. Exchange gains and losses are as much a part of income or expense as is interest.

But a strong argument can be put that foreign exchange fluctuations are frequently not identical or analogous to interest.

Submissions received by the Brash Consultative Committee raised a number of arguments against bringing foreign exchange gains and losses within the accrual calculations, but the Committee found them unconvincing.[6]

5. M. McClennan and P. Truman, "The Accruals Regime", presented as part of the New Zealand Society of Accountants', "Taxation: Accruals Workshop" (November 1987), at 3.

6. The following passage appears in paras. 56 and 57 of the Committee's report:

"...The arguments were:

56.1 The taxation of unrealized gains would cause cash flow problems for businesses required to make tax payments where there was no corresponding income flow.

56.2 Foreign exchange denominated instruments are often 'hedged' – either by the existence of a forward contract, or a matching asset or liability. Such matching assets or liabilities would often not be financial arrangements. Unless the accrued gains on these items were also brought to charge, there would be asymmetrical tax treatment.

56.3 The application of an accrual regime to foreign exchange denominated transactions could easily produce substantial income tax losses which could not be used in the current period of accrual or recognition.

56.4 A related argument to those presented in terms of paragraphs 56.1 (cash flow) and 56.3 (tax losses carried forward) was presented in terms of floating exchange rates, and the volatility of the market for the New Zealand dollar.

57. There is validity in the argument presented that the tax result of applying the accrual regime to foreign exchange transactions produces an asymmetrical result. The reason that there is a lack of symmetry is that New Zealand does not have a comprehensive definition of economic income which is inclusive of the judicial/traditional capital gains and losses. The important point in reply is this: it is not the treatment of financial arrangements, inclusive of foreign-currency-denominated instruments, which is incorrect. Accrued gains and losses on such instruments are measurable and clearly alter the wealth of the business; it is consistent over time to provide the same income tax treatment in this context as is provided for other debt instruments denominated in New Zealand dollars, where domestic interest rates move. Accordingly, our conclusion is that the better focus is on a comprehensive definition of economic income, rather than preserving arbitrary distinctions based on the timing of realization".

© 1994 International Bureau of Fiscal Documentation

II. DEFINITION OF "FINANCIAL ARRANGEMENT"

Two choices existed in relation to legislation of this type. An attempt could be made to describe the various types of financial instruments and transactions to which the new tax accounting rules were intended to apply. Alternatively, a very wide-ranging definition could be adopted, with the express exclusion of certain arrangements that were not to be targeted by the regime. In light of the fact that the accrual provisions were to perform an anti-avoidance role, and of the propensity of the finance industry to continually develop and construct new "synthetic" instruments and arrangements with commercial, accounting and taxation benefits in mind, it is hardly surprising that the latter route was adopted. Whether that is the best alternative, however, is not beyond doubt.

Section 64B defines the term "financial arrangement" as meaning:

> (a) Any debt or debt instrument; and
> (b) Any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice); and
> (c) Any arrangement which is of a substantially similar nature (including, without restricting the generality of the foregoing provisions of this paragraph, sell-back and buy-back arrangements, debt defeasances and assignments of income), but shall not include any excepted financial arrangement that is not part of a financial arrangement.

The term "excepted financial arrangement" is also defined, as any of the following arrangements:

> (a) An annuity for a term contingent upon human life or an annuity to which Section 204(2) of this Act applies;
> (b) A contract of insurance or membership of a superannuation scheme;
> (c) A debenture to which Section 192 or Section 195 of this Act applies; . . .
> (e) A short term trade credit;
> (f) A specified preference share to which Section 194 of this Act applies;
> (g) In relation to a holder or an issuer, shares, other than withdrawable shares (as defined in Section 194A of this Act), or an option to buy shares, other than withdrawable shares (as so defined), where those shares were or that option was acquired or issued by the person before 8:00 p.m. New Zealand Standard Time on the 18th day of June 1987;
> (ga) In relation to a holder or an issuer, shares, other than withdrawable shares (as defined in Section 194A of this Act), or an option to acquire or to sell or otherwise dispose of shares, other than withdrawable shares (as so defined), where those shares were or that option was acquired or issued by the person after 8.00 p.m. New Zealand Standard Time on the 18th day of June 1987;
> (h) A lease;
> (i) A bet on any race, game of chance, lottery, New Zealand lottery, New Zealand prize competition or prize competition;
> (j) In relation to an issuer or a holder, an option to acquire or to sell or otherwise dispose of property (other than an interest in a financial arrangement) where the option was issued or acquired by the person after 8:00 p.m. New Zealand Standard Time on the 18th day of June 1987 for private or domestic purposes only;
> (k) A short term agreement for the sale and purchase of property;
> (l) A short term option;
> (m) A private or domestic agreement for the sale and purchase of property;
> (n) A farm-out arrangement, as defined in Section 214D(1) of this Act.

Hire purchase agreements were previously treated as "excepted financial arrangements",[7] but they are now subject to the accrual provisions (following the recommendations of the Valabh Consultative Committee).

Paragraph (h) refers to a "lease", and the subsection 64B(1) definition of that term directs attention to "a lease within the meaning of Section 222A(1)" of the Act (and arrangements of the same nature that relate to real property, livestock or bloodstock). Such leases are excluded from the accrual rules because Sections 222A-222E deal with "specified leases"[8] in a separate regime that deems ownership of the asset to pass and interest to be payable. The Valabh Consultative Committee has recommended that specified leases also be brought within the accrual provisions, and this would seem to be a logical rationalization of treatments.

In undertaking the calculations required by the accrual provisions, it is intended to exclude the effect of "excepted financial arrangements". To this end, Section 64CA provides:

> The amount of the income deemed to be derived or the expenditure deemed to be incurred by a person in respect of a financial arrangement under Sections 64B to 64M of this Act shall not include the amount of any income, gain or loss, or expenditure, that is solely attributable to an excepted financial arrangement that is part of the financial arrangement.

However, as a practical matter, difficulties can often be encountered in attempting to establish the amount of any income, gain, loss or expenditure that is "solely attributable" to such an arrangement. Furthermore, it is not clear from the section which of two possible slants or emphases is to be accorded to the words "solely attributable" where the excepted financial arrangement "is part of" a wider financial arrangement.[9]

---

7. By former para. (d).
8. A "specified lease" is essentially a lease with a guaranteed residual value, or one for a period in excess of 36 months where one of the following applies:
(A) Ownership of the lease asset is to be transferred to the lessee at the end of the lease term:
(B) The lessee has the option to purchase on the expiry of the lease term the lease asset at a price which, in the opinion of the Commissioner, will be significantly lower than the value which will at the time of that expiry be the market value of the lease asset:
(C) The sum of the aggregate of the amounts of the lease payments and the amount of the guaranteed residual value, if any, exceeds an amount that is equal to, or to a small extent less than, the cost price of the lease asset:
(D) It is agreed between the lessor and the lessee that the lessee shall be liable for the payment of all, or nearly all, expenditure incurred in respect of the costs of repair and maintenance and any other incidental costs arising during the lease term in respect of the use of the lease asset.
9. The point is summarized by D. Martin in "Accrual Rules – Practical Problems", a paper presented at the Joint Tax Conference (of the NZSA and the NZLS) (October 1990), at 3-4, as follows:
> As has been noted by other commentators [see e.g. S. Glazebrook and R. Oliver, *The New Zealand Accrual Regime – a practical guide* (CCH

© 1994 International Bureau of Fiscal Documentation

It is necessary to observe that another definition within subsection 64B(1) is also likely to impact upon the meaning of "financial arrangement". The expression "implementation date", which is intended to perform a transitional function, refers to a number of specific instruments and transactions that were – presumably – thought by Parliament to be "financial arrangements". The provision states:

> 'Implementation date' means –
> (a) In the case of –
> (i) Forward or future contracts including, but not limited to, contracts for –
> (A) Foreign exchange;
> (B) Commodities;
> (C) Financial arrangements;
> (D) Excepted financial arrangements; and
> (ii) Futures contracts; and
> (iii) Trade credits; and
> (iv) Annuities; and
> (ivA) Agreement for the sale and purchase of property; and
> (v) Convertible notes, –
> 8:00 p.m. New Zealand Standard Time on the 23rd day of October 1986; and
> (b) In the case of debt defeasances and assignments of income, the 20th day of December 1986; and
> (c) In the case of variable principal debt instruments the 1st day of April 1987; and
> (ca) In the case of a financial arrangement under which –
> (i) The monetary obligations of the parties are expressed in New Zealand currency; and
> (ii) It is contemplated that the holder may, upon demand or call, require the return of sums advanced to the issuer; and
> (iii) It is not contemplated that the holder may advance further sums to the issuer upon demand or call pursuant to the financial arrangement, – the 1st day of April 1987; and
> (d) In every other case 8:30 p.m. New Zealand Standard Time on the 31st day of July 1986.

Thus, it would seem relatively clear that the Parliament intended that the term "financial arrangement" should (subject to the "excepted financial arrangement" exclusions) cover debts (including debentures and variable principal debt instruments), sell-back and buy-back arrangements, debt defeasances, assignments of income, forward or future contracts, futures contracts, trade credits, annuities, agreements for the sale and purchase of property and convertible notes.[10] The expression also extends to "(m)ost guarantees, letters of credit, underwriting agreements and indemnities ..., except where they are bets or contracts of insurance".[11]

However, an examination of the "financial arrangement" definition suggests that the expression can extend well beyond these types of arrangements. It will be recalled that paragraph (b) of the definition refers to any arrangement "whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice)". The word "money" is defined so as to *include* "money's worth (whether or not convertible into money) and the right to money (including the deferral or cancellation of any obligation to pay money, whether in whole or in part)". Consequently, the accrual rules may (strictly) extend to dry-cleaning contracts and multi-ride bus tickets,[12] travellers' cheques and employment contracts.

However, this may depend upon the manner in which the (imperfectly drafted) definition of financial arrangement is approached. If paragraph (a) of the definition is seen as the key concept, with paragraphs (b) and (c) being merely supplementary, this could lead to a more restrictive interpretation of the expression.[13] However, such a particular focus on paragraph (a), with a consequential "reading down" of the "plain" words of paragraph (b), is not readily apparent from the drafting of the statutory definition,[14] and the more generally held view is that the wide meaning applies.[15]

Even the wording of paragraph (a) can give rise to questions. Given that the definition is attaching a specific meaning to a type of *arrangement* (rather than any document), and that paragraph (a) refers to a "debt", what is the purpose of also adverting to a "debt instrument"? The answer is probably that there is none, and the explanation would seem to lie in the pre-legislative history. The original Income Tax Amendment Bill (No. 2) 1986 referred only to "any debt instrument",[16] and the words "debt or" were subsequently added – presumably to ensure that undocumented debts were also covered.

New Zealand Limited, 1989), at 54-55], to make Section 64CA work in a meaningful way one must recognize that a strict or literal construction of the statutory language (the approach which the courts suggest should normally be adopted as a starting point) is not sufficient in itself to avoid all ambiguity, the reason being that, at least on one view, income is never 'solely attributable' to an excepted financial arrangement where that excepted financial arrangement is linked in a transactional sense to an overall financial arrangement. Accordingly, to make sense of the provision an approach must be adopted which almost reverses the statutory focus, viz., that amounts should be automatically regarded as 'solely attributable' to an excepted financial arrangement unless one can disprove that position by establishing with certainty that the amount in question was also attributable to the overall financial arrangement. While such an approach must be adopted in order to avoid rendering Section 64CA and the exemptions provided in the designated categories of excepted financial arrangement redundant, it is most unfortunate that such a central and crucial feature of the accrual regime requires one to manipulate the statutory language in this way to obtain a satisfactory outcome.

10. The accounting treatment in relation to convertible notes is outlined in *Determination G5C: Mandatory Conversion Convertible Notes*, and *Determination G22: Optional Conversion Convertible Notes*.

11. See Glazebrook and Oliver *supra* note 9, at 160.

12. See the Valabh Committee's October 1991 Discussion Paper, at 11.

13. This is the view proposed by A. Nannestad in "The Meaning of 'Financial Arrangement' in the Accrual Rules", 35 *New Zealand Current Taxation* (1991), at 134.

14. Although it must be said that the draftsperson's conjunction of the words "means", and "and" is unhelpful in the extreme.

15. This led Glazebrook and Oliver, *supra* note 9, to conclude that paragraph (b) of the definition was "likely to be the most critical". Those authors went on:

> A debt or debt instrument – definition (a) – is an unconditional liability to pay money. It is difficult to see how such a liability would not also constitute a financial arrangement under definition (b). Similarly, it is difficult to identify an arrangement which would fall under definition (c) without previously being included under definition (b). Thus, the examples given in the legislation of sell-back and buy-back arrangements, debt defeasances, and assignments of income would appear to be clearly within definition (b) of "financial arrangement". Therefore, financial arrangement definitions (a) and (c) are probably redundant. It is definition (b) which determines whether an arrangement constitutes a financial arrangement in terms of the legislation.

16. This was seemingly derived from the terminology of the October 1986 Consultative Document. Chapter 4 of that document is entitled "Instruments Subject To The Accrual Rules", and begins with the sentence: "The Government's objective is to introduce accrual rules for returns on all debt instruments".

© 1994 International Bureau of Fiscal Documentation

The fundamental nature of a "financial arrangement" was considered by Willy DJ. (of the Taxation Review Authority ("TRA")) in *Case Q2*,[17] a decision that produced a satisfactory result for the taxpayer concerned but left many other issues and difficulties unresolved. The taxpayer company was a commodity exporter which sold the commodity to overseas buyers. As the contracts for sale were generally for subsequent delivery and denominated in foreign currencies, the taxpayer entered into foreign exchange hedging contracts to protect itself against any fluctuations in currency values which might occur between the contract and settlement dates. A number of these contracts remained uncompleted at the taxpayer's balance date, and, for income tax purposes, the Commissioner sought to separate the two types of contracts.

In simple terms, the relevant balance date saw the company having unrealized gains of some $ 500,000 under the foreign exchange contracts, and unrealized losses of the same order under the relevant commodity contracts. The Commissioner sought to tax the unrealized profits under the accrual rules, while maintaining that the unrealized losses did not form part of the income tax computations at year-end. This was so, the Commissioner argued, because the accrual rules effectively did not operate upon the commodity contracts until their particular delivery dates. On the taxpayer's part, it was contended that a year-end valuation should be undertaken for both types of contracts whenever the end of an income year occurred between *the date on which the contract was entered into* and the date of payment.

It is noteworthy that both the taxpayer and the Commissioner initially contended that the commodity contracts *and* the foreign exchange contracts were "financial arrangements", but this was not the approach followed by Willy DJ. His Honour spent some time analysing the background to the enactment of the accrual provisions, and subsequent reviews and commentaries thereon, and came to the conclusion that only the foreign exchange contracts were "financial arrangements". The learned judge then went on to hold that (in the absence of any applicable accrual determination issued under Section 64E) the relevant "financial arrangements" were only to be valued when they had *matured* (rather than at year-end), at which time a base price adjustment under Section 64F was required. His Honour felt that this result accorded with the approach adopted in New Zealand Statement of Standard Accounting Practice No. 21 ("SSAP 21"), and also accorded with the commercial reality of the transactions in question.

It is important to understand that, subsequent to the year in question in *Case Q2* (on 4 May 1989, to be exact), the Commissioner issued *Determination G14*, which (as one might expect under such an accruals regime) does require unrealized gains or losses on foreign exchange contracts to be recognized for tax purposes at the end of a taxpayer's income year. Accordingly, the basis upon which the taxpayer in *Case Q2* escaped liability no longer applies.

Both parties appealed the case to the Court of Appeal, and the appeal was heard in December 1993. Interestingly, at the original hearing before the TRA both parties in the case requested that the matter be referred to the High Court by way of a case stated, but Willy DJ. declined to follow this course as he considered that his findings of fact and views on matters of law would be likely to assist a later court.

The conclusion of Willy DJ. that the commodity contracts were not "financial arrangements" was an interesting one, given the very wide definition of "financial arrangement" and "money" in Section 64B of the ITA. Further, as we have seen, the term "implementation date" in Section 64B is defined with reference to a number of arrangements affected by the accrual provisions, including "(f)orward or future contracts including ... contracts for ... (c)ommodities".

In effect, Willy DJ. held that sales of property could be "financial arrangements" only where there was an element of deferred settlement and a consequential quasi-interest charge inherent in the terms agreed. In his judgment, Willy DJ. indicated his opinion[18] that there was a legislative intention within the accrual regime that contracts for the sale of goods were only intended to be caught "to the extent that, collateral with the contract for the sale and purchase of the goods, or as a term of the contract the vendor allows the purchaser time to pay the purchase price, in return for which the purchaser will pay interest, or something the equivalent of an interest payment for the privilege of the deferral". Similarly, the learned judge referred[19] to a "crucial consideration necessary to bring the transaction within the accrual rules" being "that the vendor charges the purchaser some money or money's worth for the privilege of the deferred settlement".

While there is no doubt that this reasoning has some logical appeal, it seems to sit uncomfortably with the extreme width of the legislative wording. This is particularly so when, as an anti-avoidance regime aimed at ensuring the consistent taxation of all debt-related – or equivalent – cashflows and non-money equivalents, the accrual provisions might well be expected to exhibit a vast initial scope (leaving the bases of computation to determine whether any "interest"-type factors existed).

Thus, it will be seen that the actual result in *Case Q2* was misleadingly attractive because, if Willy DJ.'s analysis is correct, the particular taxpayer's good fortune lay only in the absence of an issued determination. The judgment suggested that the learned judge might have been far less comfortable with the outcome had *Determination G14* been a factor before the Court, as the result would then seemingly have displayed the very "loss of symmetry" which his Honour was clearly anxious to avoid.[20] From this perspective, it may have been preferable to treat the commodity contracts as "financial arrangements", and permit the taxpayer's accounting basis as satisfying paragraph 64C(3)(b) of the ITA.

In February 1994, the Court of Appeal delivered its judgment in the appeal from *Case Q2*, by then called[21] *CIR v. Dewavrin Segard (NZ) Limited*.[22] Not surprisingly, the Court examined

17. (1992) 15 NZTC 5005.
18. *Id.* at 5019.
19. *Id.* at 5027.
20. See e.g. *id.* at 5029-5030.
21. Cases in the TRA are named anonymously so as to conceal the objector's identity.
22. (1994) 16 NZTC 11,048.

© 1994 International Bureau of Fiscal Documentation

the expanded definition of "money" in Section 64B, and concluded that *both* forward foreign exchange contracts and forward contracts for the sale of commodities were "financial arrangements". The Court of Appeal rejected the finding of Willy DJ. that an additional element of a return or quasi-interest charge had to be present for the "financial arrangement" definition to apply.

The definition was also the subject of substantial discussion and detailed recommendations in the final report of the Consultative Committee on the Taxation of Income from Capital ("the Valabh Committee").

The Committee has proposed a new definition that comprises a "primary debt category" (paragraph (a)), a collection of other "arrangements" (paragraph (b)), special provisions dealing with options (in paragraph (c)), and a small number of exclusions, as follows:

'Financial arrangement' means –

(a) Any arrangement whereby –
  (i) Any person (hereafter in this paragraph (a) referred to as 'the first person') obtains money for a promise by any person to provide money to any person (hereafter in this paragraph (a) referred to as 'the second person') at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice); and
  (ii) Either –
    (A) It could reasonably be anticipated, at the time the arrangement is entered into, that the amount of money to be provided under the arrangement to the second person will or is likely to exceed the amount of money obtained by the first person under the arrangement; or
    (B) All or any part of the money obtained or to be provided under the arrangement is expressed in a currency other than New Zealand currency:

(b) Without limiting or extending the meaning of paragraph (a) of this definition,–
  (i) Any forward contract for foreign exchange:
  (ii) Any interest rate swap:
  (iii) Any arrangement whereby –
    (A) A person (hereafter in this sub-paragraph (iii) referred to as 'the first person') obtains at some time during the term of the arrangement money for the provision at some time during the term of the arrangement by any person of money to any person (hereafter in this sub-paragraph (iii) referred to as the 'second person'); and
    (B) Two or more parties to the arrangement are to discharge some or all of their respective obligations under the arrangement at some time or times after entry into the arrangement; and
    (C) It could reasonably be anticipated, at the time the arrangement is entered into, that the amount of money to be provided under the arrangement to the second person will or is likely to exceed the amount of money obtained by the first person under the arrangement;
  (iv) Any arrangement involving money lent which would be within paragraph (a) of this definition but for the fact that some part or all of the money to be provided under the arrangement is payable only upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice):

(c) Without limiting or extending paragraphs (a) or (b) of this definition, any arrangement whereby –
  (i) Any person has an option to acquire or dispose of an arrangement to which any of paragraphs (a) or (b) of this paragraph of this definition applies; or
  (ii) A payment is to be made to a person the amount of which is calculated by reference to the gain that would be made if an option to acquire or dispose of an arrangement to which any of paragraphs (a) or (b) or this paragraph of this definition applies were to be exercised, – but does not include –

(d) Any excepted financial arrangement that is not part of an arrangement to which any of the preceding paragraphs of this definition applies:

(e) Any arrangement (other than a forward contract for foreign exchange, an interest rate swap or an arrangement to which paragraph (c) of this definition applies) under which all the parties to the arrangement discharge their material respective obligations at the same time or with a difference in time which is not material:

(f) Any arrangement which involves only a person –
  (i) Disposing absolutely of any or all of the rights of that person in relation to any other arrangement to which any of paragraphs (a) to (c) of this definition applies; or
  (ii) Obtaining an absolute release from any or all of the obligations of that person in relation to any such other arrangement,– for the provision in full of consideration at the time of such disposal or release or with a difference in time which is not material.

At the outset, it may be said that the definition is not very much less complex than the existing provisions. It does, however, adopt the existing paragraph (b)'s approach as the central aspect of the "financial arrangement" concept, and also benefits from not relying upon the definition of "implementation date" in order to attract further specific financial arrangements which may, or may not, be encompassed within the primary definition. However, the recommended definition is still a conglomerate of general attributes and specific inclusions, rather than presenting any cohesive underlying policy.

A much more important weakness, however, lies in the fact that the Valabh recommendation requires (except in the case of foreign currency transactions) that "it could reasonably be anticipated, at the time the arrangement is entered into, that the amount of money to be provided under the arrangement to the second person will or is likely to exceed the amount of money obtained by the first person under the arrangement". Under subparagraph (i) of the "primary debt category", "the first person" is the person who obtains money at the start of the arrangement. Such money is obtained for a promise by any person to provide money to "the second person". The "financial arrangement" definition is therefore limited to situations where it "could reasonably be anticipated, at the time the arrangement is entered into", that there will be a "return" or excess of money provided to "the second person" in the future. [It is interesting that (as we have seen) the decision of Willy DJ. in *Case Q2* turned, in part, upon his Honour's view that the meaning of "financial arrangement" under the accrual rules *already* required this concept of a "return", but this approach was put to rest by the Court of Appeal in *Dewavrin*].

© 1994 International Bureau of Fiscal Documentation

The policy difficulty with this approach is that many would argue – with some force – that the accrual rules should seek to have most instruments which could involve a return encompassed within the "financial arrangements" definition, so that *the calculations* applied by Section 64B-64M will determine whether or not income or expenditure arises. Many of the derivative financial instruments now in frequent use, such as swaps, forward rate agreements and so on, involve no certainty whatsoever, at the outset, that either party will necessarily get a return or, if a return does eventuate, which party will receive it. The approach adopted by the Valabh Committee, and that adopted by Willy DJ. in relation to the present legislation, will exclude many arrangements where no certainty of return exists at the outset, without subjecting the question of any return to the accrual calculations. This would seem to be unsatisfactory, and is also seemingly inconsistent with the Valabh Committee's subsequent inclusion of interest rate swaps within the specific provisions of the regime.

Another difficulty with the "primary debt category" definition is that the definition is not flexible enough to cope with the situation where, for one reason or another, it is likely that the "first person" will receive more money than the "second person". There is no ability to interchange the parties to an arrangement as the first and second persons. The first person must obtain "money" at the start of the arrangement, while the second person receives only a promise. Although "money" includes money's worth (whether or not convertible into money), the fact that the requirement for the first person to obtain "money" is directly juxtaposed with the promise to provide money to the "second person", arguably suggests that "money" does not include a promise to provide money. If this is correct, the "first person" must actually receive money or money's worth, *not including a promise to pay money*, at the start of the arrangement, and it must be shown that the "second person", to whom the promise to provide money is made, is likely to receive *more* than the first person.

Where the arrangement is such that *each party* provides a *promise* to the other to provide money at some future time, arguably there is no "first person" within the "primary debt category" under the arrangement, as no party has obtained money at the outset. That this is the correct position is supported by the Consultative Committee's inclusion of subparagraph (b)(iii) within its "financial arrangement" definition. That provision specifically provides for the situation of *mutual promises* exchanged at the start of the arrangement where money is not paid by either party until after entry into the arrangement. However, in order to operate, subparagraph (b)(iii) still requires that the first and second persons obtain money at some time during the term of the arrangement and that the money provided to the second person will or is likely to exceed the amount of money obtained by the first person. In a situation of a forward rate agreement, for example, both parties will provide a promise to pay money to the other party at some time in the future. The party who will actually receive the money will not be known until the rate is determined on the appropriate date, and the party making the payment will never obtain any money under the arrangement. Arguably, therefore, a forward rate agreement will satisfy neither the primary debt category definition nor subparagraph (b)(iii).

A simpler alternative would be to combine these two provisions by making it clear that the "money" obtained by the first person under the primary debt category could include a promise by any person to pay money, although this will probably necessitate the use of contrasting (defined) terms – with the unavoidable increase in apparent complexity. The effect of the inclusion of a promise to pay within the relevant "money" for the purposes of the first person within the definition, would mean that the first and second persons would be interchangeable within the definition and, in the event that the "likely to exceed" criterion is maintained, at least the situation of either party obtaining more than the other would be covered.

If an appropriately drafted definition is adopted, it should be unnecessary to make specific reference to interest rate swaps, and the definition may well be flexible enough to accommodate new synthetic instruments that may subsequently be invented by the financial markets.

If it is intended to assist taxpayer compliance, and tax simplification, by excluding instruments where it is known that there will be no return, it may be more appropriate to do so by instead adopting a negative approach, so as to expressly exclude any arrangement where its terms are such that it is *certain* (at the time the arrangement is entered into) that the amount or value of the consideration to be obtained will not be greater or less than the amount originally provided.

III. TAX ACCOUNTING METHODS DURING THE TERM OF THE FINANCIAL ARRANGEMENT

The tax treatment of a "financial arrangement" during its term is generally regulated by Section 64C.

In making the calculations under this section, all relevant consideration passing is taken into account, apart from non-contingent fees (up to a maximum of 2 percent of the "core acquisition price"[23] of the financial arrangement).[24] The background to this exclusion is found in the Brash Committee's Report[25] (although it should be noted that the original form of the legislation referred to the "acquisition price"):

> Section 64C now begins by defining the contingent and non-contingent payments that must be included in the calculation of the yield on a financial arrangement. Contingent payments (e.g. interest instalments) are included because by definition they are paid as a result of the financial arrangement being issued or transferred. Non-contingent payment (e.g. fees), to the extent that they exceed 2 percent of the acquisition price, are included to prevent the return on the financial arrangement being disguised as a non-contingent payment, and therefore outside the accrual rules. The 2 percent threshold follows the Consultative Document.

23. Defined in subsec. 64BA(2).
24. See subsec. 64C(1).
25. At 6.

© 1994 International Bureau of Fiscal Documentation

The Valabh Consultative Committee has now recommended that "the distinction between contingent and non-contingent fees be dispensed with",[26] on the basis that all fees increase the cost of funds.[27]

By virtue of subsection 64C(2), the primary[28] calculation method to be applied is "the yield to maturity method" ("so as to result in the allocation to each income year of an amount that is fair and reasonable"), and the ordinary operation of the yield-to- maturity (or "YTM") method has been outlined by the Commissioner in *Determination G3: Yield To Maturity Method* (issued in May 1987). However, a proviso to subsection (2) requires the Commissioner to accept an alternative method adopted by a taxpayer *if* that method

- "has regard to the principles of accrual accounting";
- "conforms with commercially acceptable practice";
- "is adopted by the person and is or will be consistently applied in respect of all such financial arrangements for financial reporting purposes"; and
- "results in the allocation to each income year of amounts that are not materially different from amounts that would be calculated (under the YTM method)".

The Commissioner has publicly considered two general methods in the context of this proviso, namely the "Rule of 78" (or sum of the digits) and "straight-line" methods. In Technical Policy Circular ("TPC") 88/2 (October 1987), the Commissioner acknowledged that the Rule of 78 method "may be acceptable in some circumstances", but noted that it may frequently fail the fourth requirement of the proviso as it "may produce results materially different from YTM". The materiality of the divergence from the results of the yield-to-maturity method was also stressed in relation to straight-line accounting,[29] with the TPC concluding that "[w]hether this difference is material is something that needs to be considered in relation to each particular case".

As part of the tax simplification process, subsection 64C(2A) now specifically permits certain persons to account for their financial arrangements on a "straight-line" basis, where the total value[30] of all their financial arrangements does not exceed $ 1,000,000. The spreading of finance charges in such cases is regulated by *Determination G24: Straight Line Method.*

Where it is "*not possible*" to use the YTM method (or the straight-line method, if available) to calculate income or expenditure under a financial arrangement, subsection 64C(3) provides an alternative. If the Commissioner has not issued a determination (under Section 64E) setting out a method to be used in relation to the financial arrangement, a taxpayer may adopt a method that

- "conforms with commercially acceptable practice";
- "is adopted by the person and is or will be consistently applied in respect of all such financial arrangements for financial reporting purposes"; and
- "results in the allocation to each income year of an amount that, having regard to the tenor of subsection (2) of this section, is fair and reasonable".

If the Commissioner has issued an applicable determination, a taxpayer who is unable to use the YTM or straight-line methods is to apply the method prescribed by the determination, subject to a proviso that

> ... the Commissioner shall accept an alternative method to the method prescribed in any such determination that has regard to the principles of accrual accounting, and –
> (i) Conforms with commercially acceptable practice; and
> (ii) Is adopted by the person and is or will be consistently applied in respect of all such financial arrangements for financial reporting purposes; and
> (iii) Results in the allocation to each income year of amounts that are not materially different from the amounts that would be calculated, but for this proviso.

Provision is also made for certain persons, and all persons in certain circumstances, to adopt a market valuation method in respect of their financial arrangements at the end of each income year.

Subsection 64C(4) permits a method that "has regard to market valuation"[31] to be applied by a person whose "business ... comprises dealing in such financial arrangements", or by any person where the relevant financial arrangement is "a forward or future contract for foreign exchange, or a futures contract". However, a market value method may not be used where any two or more of the parties to the financial arrangement are "associated persons",[32] and it is also necessary that the relevant method "conforms with commercially acceptable practice" and "is adopted by the person and is or will be consistently applied in respect of all such financial arrangements for financial reporting purposes"; and "the market, the method, and the source of information used to determine the market values have been approved by the Commissioner pursuant to a determination issued under Section 64E(1)(d) of this Act".

As has been mentioned previously, certain natural persons are entitled to account for financial arrangements on a cash basis where they qualify as "cash basis holders" under Section 64D. Shortly stated, such persons must satisfy three requirements in this context, namely:

- their income from the financial arrangements under ordinary accrual rules calculations must not exceed $ 70,000 in the income year;
- the total value of financial arrangements held by them in the income year must never exceed $ 600,000; and
- the difference between their cash basis income, and income that would result from a method available under Section 64C, in respect of their financial arrangements in the income year must not exceed $ 20,000.

26. See the Committee's Final Report (October 1992), at 103.
27. See the Committee's Discussion Paper (October 1991), at 60.
28. In Part II of the Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure (April 1987), the third major heading reads "YTM is the general rule".
29. As the TPC observes, in "certain limited circumstances", the straight-line method can produce a result identical to YTM.
30. Ascertained in accordance with subsec. 64C(2B).
31. The potential width of the words "has regard to ..." is somewhat troubling in this context, as it is possible that methods far removed from strict marking-to-market values could be seen as satisfying this description.
32. Within the meaning of ITA Sec. 8.

© 1994 International Bureau of Fiscal Documentation

Certain terms and expressions used in these provisions warrant more detailed consideration.

A. "Consistently applied ... for financial reporting purposes"

Prior to an amendment in 1993, the provisions contained an unqualified requirement that the relevant method "is adopted by the person and is or will be consistently applied in respect of all such financial arrangements for financial reporting purposes".

It had been the view of the IRD's technical staff that the accrual provisions did not permit distinguishing between financial arrangements that are entered into for hedging purposes, and similar financial arrangements that are entered into for the purpose of trading or speculating – on the basis that the words "such instruments" is not sufficient to support a characterization of this nature.[33] That view was seemingly shared by the members of the Valabh Consultative Committee, and it is noteworthy that that Committee recommended against specifically permitting such a distinction due to the technical and practical difficulties inherent in clearly distinguishing between the two purposes and the manipulation/avoidance dangers involved.[34]

The original (Brash) Consultative Committee certainly did not believe that the regime, as designed, took hedging transactions into account.[35]

The Valabh Committee's reservations were at least partly based on serious practical difficulties which also arise from *allowing* the different treatments. For example, should this be permitted only in relation to *perfect* hedges (as specific legislation in France has done), or (if not) how imperfect can the correlation be? Furthermore, what *evidence* should be required of the hedging (or trading) purpose (especially when, in the case of banks, the practical attribution of "hedge" and "trade" status is a very inexact matter)? Can a taxpayer *change* the purpose of the taxation treatment during the term of the financial arrangement? These, and other, similar, questions suggested to many that the matter was not at all clear-cut, even from a policy perspective.

When used in a statute, the word "such" generally requires reference to a distinction or classification *expressly stated* elsewhere in the legislation or provision.[36] Ordinarily, this will be to an earlier description,[37] but in some cases the reference may be to a subsequent one.[38] However, there was no distinction between hedging and trading instruments (or purposes referable to them) outlined elsewhere in the accrual sections. While it could be argued that Section 64C contained no relevant listing (referable to "such") either, descriptions of a number of financial arrangements did appear, by type, in the Section 64B definitions of "financial arrangement" and "implementation date". Further, if "such" was to be taken to mean "similar" in some way, it could reasonably be asked why purpose should be the fundamental criterion (particularly in view of the practical difficulties in establishing purpose, and the fact that quite different types of "financial arrangements" can be used to achieve exactly the same purposes).

Another possibility might be to classify "such arrangements" by reference to accounting treatment, but this suffered from being too subjective and (in the context under consideration) giving rise to a nonsensical circularity.[39]

Thus, the situation was quite unsatisfactory, as the statutory wording could operate so as to preclude taxpayers who were party to a number of financial arrangements of the same type from using an (otherwise) appropriate method whenever they (quite correctly) accounted for them in different ways in their financial statements. In recognition of this practical anomaly, the IRD sought to have the legislation rectified.

The Income Tax Amendment Act (No. 3) 1993 addressed the issue by adding an exception to the prerequisite of consistency with financial accounting, where new subsection 64C(4A) is satisfied. That provision now *deems* a method to *satisfy* the accounting requirement where, instead, that method -

(a) Appropriately reflects the dominant purpose for which the person acquired or issued the financial arrangement (or each such arrangement); and
(b) Has been and will be consistently applied by the person in respect of the particular financial arrangement (or each such financial arrangement) for the purposes of Sections 64B to 64M of this Act for every income year during its term (except to the extent that the Commissioner approves or may approve a change in method under the circumstances or conditions specified in a determination under Section 64E(1)(da) of this Act); and
(c) Is not adopted for purposes that include the purpose of tax avoidance (within the meaning of Section 99 of this Act); and
(d) Has been approved by the Commissioner for adoption in the circumstances applicable to the taxpayer either by notice in writing to the taxpayer or in a determination issued under Section 64E of this Act.

This would seem to have resolved the problem for taxpayers whose *only* difficulty was that they were parties to a number of financial arrangements of the same type that were entered into for different purposes.

33. This was an important aspect in relation to *Case Q2*, as that case demonstrated that, unless the underlying transaction also involves a "financial arrangement", the accrual provisions are too specific to permit reference to be had to it in the computations that must be undertaken at balance date.
34. See e.g. the October 1991 Discussion Paper, "Operational Aspects of the Accruals Regime", at 42-43, and reference may also be made to Glazebrook and Oliver, *supra* note 9, at para. 804.
35. In its supplementary report on the 1987 Bill, that Committee said:
A consequence of the new regime is that the gain or loss on the financial arrangement (including the hedging contract) is brought to account on an accruals basis while the gain or loss on the 'other leg' (the expected future sale or purchase, the share portfolio value) is brought to account on a realization basis or perhaps not at all. This was recognized at the earliest stage in our deliberations. We were not able to resolve the conflict that arises because it is a result of the piecemeal nature of tax reform: while financial arrangements are to be treated for tax purposes according to their economic effect, the same treatment does not apply to other gains or losses. To deal with the problem we would have had to provide exceptions to the new regime (which, in view of the ease with which an exception may be exploited, was unacceptable), or to go far beyond our brief.
36. *Re Godfrey* [1921] SASR 148, at 152.
37. *Re Ninnes* [1920] SALR 480, at 488.
38. *Stolworthy v. Sancroft* [1864] 33 LJCh 708, at 710-711.
39. It would have reduced the relevant statutory requirement to one which demanded that the method be consistently applied for financial reporting purposes in respect of all financial arrangements to which that method was applied for financial reporting purposes.

© 1994 International Bureau of Fiscal Documentation

It is also relevant to mention the Court of Appeal decision in *Dewavrin Segard (NZ) Limited* in this context. In delivering the Court's judgment, Gault J. held the mark-to-market method of accounting to be available to the taxpayer under paragraph 64C(3)(b) of the Act[40] irrespective of the method of accounting adopted in its financial statements. The learned judge said:[41]

> It would not be open for a taxpayer to avoid the operation of the accrual rules by claiming to have adopted a different method of accrual accounting in its financial reporting and claiming that therefore no alternative method provided for in Section 64C can be adopted.

With the greatest respect, it is suggested that this attempt to apply an anti-avoidance gloss to the wording is inappropriate. The plain wording of the statute, and the relevant legislative history, shows that the requirement in question was instead aimed at easing taxpayer compliance in limited circumstances. It was intended to allow taxpayers to put forward an *alternative* method of their choice; but *only* where they also adopted it for financial reporting purposes.

As will be mentioned later in this paper, the absence of any method required by, or available under, Section 64C does not necessarily lead to any catastrophic outcome, as the drafting of Section 64L suggests that Parliament was, in such a case, willing to let the ordinary provisions of the Income Tax Act operate in the usual way.

As we have seen, the same wording – requiring a method to be adopted for financial reporting purposes – also appears in paragraph (b) of subsection 64C(4). However, in that context, the Court of Appeal seemed to construe the requirement as being no more than a possibility:[42]

> It is a method that meets the requirements of Section 64C(4) in that it ... *can be adopted* by *Dewavrin* and consistently applied in respect of all such financial arrangements for financial reporting purposes. [emphasis added].

It is also relevant to briefly consider some of the other expressions used in Section 64C to describe the types of accounting methods permitted, the circumstances in which they are available, and the taxpayers who may elect to use them.

B. "A method ... that has regard to the principles of accrual accounting"

This limitation appears in the proviso to subsection 64C(2) and the proviso to paragraph 64C(3)(a). This location – in provisions concerned with methods not materially different to YTM and similar – and the structure of subsections 64C(2), (3) and (4) suggest that the expression does not mean precisely the same as either YTM or mark-to-market. As the draftsperson has used the phrases "principles of accrual accounting" and "tenor of subsection (2)" in the same provision, it is difficult to equate the two in meaning. (The subsequent insertion of a specific straight-line alternative is also of interest in this context.)

A number of submissions made to the Brash Consultative Committee centred upon the vagueness of expressions such as "has regard to the principles of accrual accounting", but the Committee wished to leave them able to reflect accounting and commercial practice. In its supplementary report on the original Bill, the Committee said:[43]

> Some submissions, including submissions from chartered accountants, queried the meaning of the phrases "has regard to the principles of accrual accounting" and "has regard to market valuation". These queries surprised us because we are aware that accrual accounting and market-value based accounting methods are common practice at any time. It is not our intention to provide guidance in this matter because a fundamental element of the new regime is its reliance on accounting and commercial practice. In that context any attempt to codify practice is inappropriate, for accounting and commercial practice is flexible and develops to fit circumstances.

Unfortunately, the reality is that the accounting writings do not necessarily provide an agreed precise meaning for the expression "accrual accounting" either, and *Tax Information Bulletin*, Vol. 3, No. 1 describes it as "a widely used, but largely unspecified concept". The original Consultative Document of October 1986 defined "accrual basis" in the following terms: "taxation of income on an accrual basis means that the income is taxed in the income year in which it accrues", and added that "(t)his is generally the income year in which it is earned and a legal right to receive it arises".[44] Regrettably, this is of no real assistance in giving meaning to the words "accrual accounting" (and the latter of the foregoing quotations would not encompass the YTM approach in any event).

Perhaps the best that can be said is that an "accrual accounting" method is one that accounts other than on a purely "cash" basis. This may suggest that a method based upon market valuation might arguably qualify as a method that "has regard to the principles of accrual accounting" as some form of non-cash *spreading* of income and expenditure can be achieved in this way. Certainly, the IRD has stated that it considers that the reference to "the principles of accrual accounting" contemplates "a number of generally accepted 'correct' ways in which a taxpayer might accrue income and expenditure" and a "wide scope of choice" on the part of taxpayers.[45]

The approach of contrasting "accrual accounting" with actual cash receipts is consistent with the following extract from the judgment of Dixon J. (as he then was) in *C of T (SA) v. Executor Trustee & Agency Co. of SA Limited* [Carden's case]:[46]

> The distinction, if not opposition, between the mode of accounting sometimes called the accrual system, and that based upon actual receipts and disbursements is widely known. The foundation of the accrual system is the view that the accounts should show at once

40. A conclusion that will be discussed further below.
41. At 11,057.
42. At 11,056.
43. See p. 49 thereof.
44. See *Consultative Document on Accrual Tax Treatment of Income and Expenditure*, "Glossary of Terms", at 226.
45. See *Tax Information Bulletin*, Vol. 3, No. 1 (July 1991), at 5.
46. (1938) 5 ATD 98, at 133.

© 1994 International Bureau of Fiscal Documentation

the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due.

The New Zealand Society of Accountants' Statement of Concepts (issued recently, but formally applicable from 1 January 1995) gives the following explanation (at para. 5.5):

> Accrual Basis: Under the accrual basis, the effects of transactions and other events are recognized when they occur. They are then recorded in the accounting records, and reported in the financial reports, of the periods to which they relate. The time that event or transaction occurs may or may not coincide with the time that cash is received or paid. Financial reports prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

Siegel and Shim's *Dictionary of Accounting Terms*[47] contains this passage:

> ACCRUAL ACCOUNTING recognition of revenue when earned and expenses when incurred. They are recorded at the end of an accounting period even though cash has not been received or paid. The alternative is CASH BASIS ACCOUNTING.

As to whether market valuation can be an "accrual" method, cases such as *Pattison v. Marine Midland Ltd.*,[48] *Capcount Trading v. Evans*[49] and *Bentley v. Pike*[50] are not particularly helpful, as they merely adopt market-type accounting approaches in the context of the relevant provisions (generally the UK capital gains tax). Some small support can, however, be gained from two passages in *Canadian General Electric Co. Ltd. v. MNR*,[51] where a method of revaluation at balance date was upheld, and the judges referred (in passing) to this as an "accrual" method. In that case, Martland J. (of the majority) said:[52]

> The expert accountants, who gave evidence for the appellant, were all in agreement that the 'accrual' system was the only suitable one for the appellant company and that, from an accounting point of view, it was proper and necessary, in order to give a true picture of the Company's position, to revalue the amount of Canadian dollars necessary at each balance-sheet date to pay off the outstanding notes.

Similarly, the dissenting judge, Abbott J., said:[53]

> The fact that appellant used the accrual system of accounting in calculating its trading profits for each year had no relevance to this purely bookkeeping operation. No doubt the entries made by appellant in its books were proper from an accounting standpoint in order to present from time to time, as accurate a balance sheet as possible, but in my opinion they had no bearing upon the appellant's liability for income tax.

Accordingly, it is the writer's view that a method will have regard to "the principles of accrual accounting" if it adopts some approach of attributing income or expenditure over the relevant period – including by reference to market valuation – as distinct from relying upon cash receipts and payments.

C. "Commercially acceptable practice"

Subsections 64C(2), (3) and (4) refer to a method that "(c)onforms with commercially acceptable practice". Many commentators have noted the nebulous nature of this expression in the context of financial arrangements. Does it require an "industry standard"? Is it a test of whether "some" other taxpayers account in the same way? In *some* circumstances, can it be "commercially acceptable" if *only* the taxpayer accounts in that way?

Tax Information Bulletin, Vol. 3, No. 1 acknowledged that the expression "commercially acceptable practice" is "imprecise and open to interpretation", but concluded that, in essence, it means "the commercial application of accounting principles". Accordingly, it is seen as being closely linked to the statutory references to the principles of accrual accounting.

D. "Not materially different"

These words can be found in paragraph (c) of the proviso to subsection 64C(2), and in subparagraph (iii) of the proviso to paragraph (a) of subsection 64C(3). Their purpose is to ensure that, where an alternative method to the one specified is proposed, that method does not differ too radically from the specified method in its result. In *Tax Information Bulletin*, Vol. 3, No. 1, the Commissioner has indicated that, subject to the circumstances of any particular case, a difference will generally be regarded as "materially different" if it is equal to or greater than either 5 percent of the amount calculated under the specified method, or $ 500,000.

E. "The allocation to each income year of an amount that, having regard to the tenor of subsection (2) of this section, is fair and reasonable"

This wording appears as a requirement in paragraph 64C(3)(b) (and in paragraph 64D(2)(a)), and (*notably*) is also effectively a constraint upon determinations made under paragraph 64E(1)(b). The issue that arises is what characteristics must be exhibited by a method that is fair and reasonable "having regard to the tenor of subsection (2)".

The wording does not refer to the tenor of the accrual sections (or even to Section 64C) generally, but to subsection (2) only – which incorporates YTM and not materially dissimilar methods.[54] Furthermore, many commentators would nominate the mark-to-market method as being the most likely (objectively derived) alternative method, but subsection 64C(4) specifically provides for market valuation-based methods, and its limitations upon the circumstances and persons that may justify such a method would suggest that it is intended to act as a code for the adoption of mark-to-market accounting.

47. J.G. Siegel and J.K. Shim, *Dictionary of Accounting Terms*, (Barron's), at 12.
48. [1984] STC 10.
49. [1993] STC 11.
50. [1981] STC 360.
51. [1961] 61 DTC 1300.
52. At 1303.
53. At 1309.
54. Some may find this puzzling, however, as subsec. 64C(3) cannot even *begin* to apply unless "it is *not possible to*" utilize the YTM or straight line methods (emphasis added).

© 1994 International Bureau of Fiscal Documentation

This view of subsection (4), and the sequential structure of subsections (2), (3) and (4), of Section 64C are supported by reference to the pre-legislative history. In the original Bill, the provisos to (what are now) subsections 64C(2) and (3) permitted an alterative method to YTM or that provided for in a determination, that "has regard to accrual *or market valuation*" (emphasis added). Subsequently, the reference to market valuation was removed, and subsection 64C(4) was inserted, on the recommendation of the Brash Consultative Committee. In its Report of April 1987, the Committee noted that the market value method had been removed from the provisos, and was "now contained in subsection (4)", and explained the change as follows:

> Because we accepted the submissions that 'market value' could be quite different in result from a YTM/accrual analysis (e.g. where there is a move in the interest rate upwards, after the debt instrument is issued, such a debt instrument will be discounted by the market to reflect the real loss in comparative yield), we have separated out the market value approach to avoid any confusion between the different concepts. The market value method effectively allows a deduction for bad debts since the bad debt is reflected in a reduction of the market value. At present only dealers in financial arrangements are able to claim a deduction for bad debts of both income and capital. Non-dealers are able to claim a deduction for income bad debts. To preserve this distinction, the market value method is restricted in most cases to dealers in financial arrangements. However, there are some arrangements where the risk of bad debts is slight, and where a market valuation method is the only easily applied approach. This is the case with futures and forward contracts, where the 'mark to market' method is ubiquitous. In respect of those contracts, Section 64C(4)(c)(ii) permits the market value method to be used by anyone who satisfies the other four criteria. The market value method is open to manipulation, and this is the reason for paragraphs (d) and (e) of subsection (4).

This strongly suggests that a method of systematically spreading income or expenditure over the term of the financial arrangement is what is comprehended by the expression "tenor of subsection (2)". If this is so, however, it would seem that neither a mark- to-market method nor some full deferral approach based on SSAP21 would be acceptable.

Nevertheless, the IRD has appeared willing to depart from this strict view in circumstances where a market-based method stands out as the obvious (objective) alternative.[55] For example, *Determination G19: Exchange Traded Option Contracts* permits a mark-to-market method to be used by all taxpayers in relation to exchange traded options, ostensibly under subsection 64C(3). This pragmatic approach is to be commended, as determinations in such cases would otherwise have to ignore the existence of an organized and accessible market, and instead outline fanciful and highly artificial methods of tax accounting. It is hoped, however, that the legislation will be amended so as to expressly allow the use of market valuation methods in appropriate cases.

Unfortunately, the present position has also been clouded by the decision of the Court of Appeal in *Dewavrin*. In delivering the Court's judgment, Gault J. held that a market valuation method was available to the taxpayer at year-end under paragraph 64C(3)(b) of the Act. This stands in stark contrast to the statutory scheme and legislative history outlined above, and the brevity of Gault J.'s discussion of this issue raises questions about the extent to which the matter of the correct interpretation should be regarded as settled.

F. "Business ... comprises"

Subparagraph 64C(4)(c)(i) refers to a taxpayer where "(t)he business of the person comprises dealing in such financial arrangements" (and the same wording also appears in the proviso to subsection 64F(6), and in paragraphs 64G(2)(a) and 64J(3)(b)). As a matter of strict statutory interpretation, it is the writer's view that "comprises" is not synonymous with "includes", and this would severely limit the availability of the subsection 64C(4) method. In the context of bad debts, however, the IRD has taken a concessional view[56] and treated "comprises" as (effectively) meaning "includes" (see Appendix C to *Tax Information Bulletin* No. 3). Nevertheless, it is to be hoped that the matter will be clarified by the specific incorporation of the words "or includes", and it is noted that this was the subject of a specific recommendation by the Consultative Committee on the Taxation of Income from Capital.[57]

G. "The market, the method, and the source of the information ... have been approved by the Commissioner pursuant to a determination"

Paragraph 64C(4)(d) permits a market value method under subsection (4) only where: The market, the method, and the source of the information used to determine the market values have been approved by the Commissioner pursuant to a determination issued under Section 64E(1)(d) of this Act. In many situations, there has been no such formal approval by the Commissioner of some or all of these matters, and this can frequently give rise to difficulties for taxpayers who would otherwise be entitled to utilize a method under subsection (4). As is discussed further below, these problems are rarely solved by the operation of *Determination G12: Accounting For A Financial Arrangement In The Absence Of A Determination.*

It is noteworthy that the IRD itself made submissions to the Consultative Committee on the Taxation of Income from Capital as regards the relatively inflexible nature of subsection 64C(4), which were endorsed by the Committee. The following passage appears in the Committee's final report:[58]

> The Department in its submission to the Committee identified what it considers to be a number of defects in Section 64C(4), the market valuation provision in the accrual rules. The Department recommended that Section 64C(4) should be amended to:
>
> • allow taxpayers to mark to related markets if there is no (or inadequate) market in the FA itself (for example, over the counter trad-

55. Arguably, this could be seen as according with the Consultative Committee's desire to permit the mark-to-market method in circumstances where it is "ubiquitous", provided there is no risk of manipulation.
56. Although it is understood that the IRD does not consider this to be a "concessionary" interpretation.
57. See the Committee's Final Report (October 1992), at 104.
58. *Id.* at 99.

© 1994 International Bureau of Fiscal Documentation

ed options marked to the futures market and swaps marked to the market in the indicator rates);

• allow taxpayers to use methods which have regard to such things as volatility (provided that they satisfy the current paragraph (a) and (b) of Section 64C(4)); and

• remove the requirements for the Commissioner to approve the market, methods and source of information used to determine market values (as provided for in paragraph (d) of Section 64C(4)), though the Department recommends that the Commissioner's approval be retained as an alternative in order to provide certainty in advance for taxpayers.

> We agree with the Department in that Section 64C(4) is not sufficiently flexible, given the sophistication of the taxpayers who are most likely to avail themselves of the market value methods. Accordingly, we agree with the Department's recommendations, which will have to be implemented by way of amendments to Section 64C(4).

It will also be anticipated that there may be cases where the terms of a financial arrangement are *amended* prior to its maturity. If the variation is such as to effect a rescission of the original financial arrangement, a base price adjustment must be undertaken under Section 64F (see further below). If, however, the original arrangement continues subject to variation,[59] there will frequently need to be an adjustment to the accrual tax calculation under Section 64C (as a YTM computation, for example, has regard to figures derived – for the whole period – from the original terms). This issue is addressed in *Determination G25: Variations in the Terms of a Financial Arrangement* issued by the IRD in May 1992. Shortly stated, that determination requires that a calculation adjustment be effected in the year of variation, so that the total income or expenditure up to the end of that year is equal to what would have been the case if the variations had been known at the beginning.

IV. DETERMINATIONS

So as to facilitate practical solutions and flexibility, and to avoid the need to prescribe detailed methods and other minutiae in the statutory provisions, Section 64E empowers the Commissioner to issue determinations prescribing methods, the manner of application of methods, and relevant markets and sources of information to be used under the accrual provisions. At the time of writing, there are 24 general determinations on issue (some are revised versions of earlier determinations),[60] and a series of three determinations outlining the persons who are exempt from the disclosure requirements of Section 64H.[61]

Determinations are deemed to be made when signed by the Commissioner (subsection 64E(8)), and they must then be published in the Gazette within 30 days (subsection 64E(7)). Where a party has relied upon an issued determination that is subsequently varied or repealed, it is important to note that subsection 64E(6) of the Act contains the following proviso:

> Provided that no such fresh determination shall be required to be applied by any person in relation to financial arrangements acquired or issued by that person prior to the notification of, or publication by, the Commissioner of that fresh determination until the expiry of 4 years from the notification of, or publication of, that fresh determination.

Where no determination exists covering a taxpayer's situation, reference may be made to *Determination G12*. However, the actual role and utility of that determination is somewhat doubtful. The example included within it[62] might suggest that it is only intended to apply to natural persons, but this would leave corporate taxpayers who are not covered by a determination unaided.

If, however, *Determination G12* is also intended to relieve the situation of a corporate taxpayer, the extent of any such relief is difficult to discern. For example, the wording of clauses 1(1)(c), 3(b) and 6(1)(b) is inconsistent, as the first two refer to a taxpayer *not reporting* the income or expenditure for financial reporting purposes, and the third refers to not reporting the income or expenditure in financial reports "using a method that has regard to the principles of accrual accounting".

Of more importance, however, is the fact that *Determination G12* only permits a method that –

(c) Has regard to the principles of accrual accounting; and
(d) Conforms with commercially acceptable practice; and

59. A somewhat difficult distinction to draw, on occasions! The matter may sometimes have to be resolved by reference to contract law cases on variation, novation and rescission (and the Statute of Frauds requirements) such as *Morris v. Baron & Co.* [1918] AC 1, *United Dominions Corporation (Jamaica) Ltd. v. Shoucair* [1969] 1 AC 340 and *Besseler Waechter Glover & Co. v. South Derwent Coal Company* [1938] 1 KB 408. These issues are briefly adverted to in Susan Glazebrook and Marie Pallot, "Tax Aspects of Insolvency and Restructuring", a paper presented by Ms Glazebrook at the Joint Tax Conference (of the NZSA and the NZLS) (October 1990), at 11-12.

60. The list of general determinations having present effect is as follows:

G1A:	Apportionment of income and expenditure on a daily basis
G2:	Requirements as to precision
G3:	Yield to maturity method
G4:	Unit trusts with repurchase obligations
G5C:	Mandatory conversion convertible notes
G6D:	Foreign currency rates
G7C:	Futures and options markets
G9A:	Financial arrangements that are denominated in a currency or commodity other than New Zealand dollars
G10B:	Present value calculation methods
G11A:	Present value based yield to maturity method
G12:	Accounting for a financial arrangement in the absence of a determination
G13A:	Prices or yields
G14:	Forward contracts for foreign exchange and commodities
G15:	Exemption from sec 64C for small debtors
G16A:	Discounted value of amounts payable in relation to trade credits denominated in New Zealand currency
G17B:	Deferred property settlements denominated in New Zealand currency
G19:	Exchange traded option contracts
G20:	Discounted value of amounts payable in relation to trade credits denominated in a foreign currency
G21:	Discounted value of amounts payable in relation to deferred property settlements denominated in a foreign currency
G22:	Optional conversion convertible notes denominated in New Zealand dollars convertible at the option of the holder
G23:	Specified rate
G24:	Straight line method
G25:	Variations in the terms of a financial arrangement
G26:	Variable rate financial arrangements

61. See *Determinations D1, D2, D3* and *D4*.
62. An individual with a reviewable rate mortgage.

© 1994 International Bureau of Fiscal Documentation

(e) Results in the allocation to each income year of an amount that, having regard to the tenor of Section 64C(2) of the Act is fair and reasonable.

The only obvious intent behind *Determination G12* is to deal with taxpayers who exhibit an inherent inability to comply with subparagraph 64C(3)(a)(ii), and therefore with *that requirement* in paragraph 64C(3)(b). Accordingly, *Determination G12* may be seen as doing no more than "waiving" the financial reporting requirement and *reiterating* the other requirements under paragraph 64C(3)(b) – if the argument is accepted that the "accrual accounting" condition is implicit in "a method that satisfies subparagraphs (i) and (ii) of the proviso to paragraph (a) ...". However, it is by no means certain that this is the correct interpretation of paragraph 64C(3)(b), insofar as it refers to "a method that satisfies subparagraphs (i) and (ii) of the proviso to paragraph (a)" (rather than to "a method that otherwise satisfies paragraph (a)"). Consequently, the function of *Determination G12*, in the context of corporate taxpayers, becomes somewhat indistinct.

It is now commonplace for practitioners and taxpayers to encounter instruments that cannot embrace a YTM or "similar" method under subsection 64C(2). Frequently, the taxpayers cannot qualify under subsection 64C(4), and no determination exists. Such taxpayers will generally, then, be adopting a mark-to-market method or an SSAP 21-type approach. Arguably, both these methods are prohibited as a result of the *cumulative* requirements of paragraphs (c) and (e) outlined above, and so *Determination G12* is of little or no real help to such taxpayers in any event.

V. THE "BASE PRICE ADJUSTMENT"

A taxpayer who has applied Section 64C (or Section 64D) during the term of a financial arrangement[63] is required to perform a final calculation (the "base price adjustment" or "BPA") when that financial arrangement matures, or is remitted or disposed of, and this obligation is found in Section 64F. In summary, that provision contains a formula that computes the taxpayer's ultimate gain or loss in respect of the financial arrangement, compares this result with the income and/or expenditure brought to account in previous years, and makes the appropriate adjustment in the final year.

Fewer difficulties have arisen as a result of the "wash-up" function performed by Section 64F. However, it is noteworthy that the timing of the BPA under that provision can be very different from the non-tax accounting treatment. In relation to a forward rate agreement, for example, the financial arrangement matures (and is cash settled) on the settlement date, and a BPA is undertaken. The correct accounting in such a case (for non- dealers) is to spread the settlement payment over the (subsequent) contract period.

It should be noted, however, that a party to a financial arrangement does not always automatically obtain a deduction for a loss computed under the BPA. According to the terms of subsection 64F(4), the *holder* of a financial arrangement is deemed to derive income where the BPA gives a positive amount, and to obtain an allowable deduction where it gives a negative figure. An issuer, on the other hand, is deemed to have derived income where the BPA produces a negative amount, but a positive BPA amount is only "deemed to be expenditure incurred by the issuer in the income year". Thus, an issuer will have to justify an allowable deduction for such deemed "expenditure incurred" according to ordinary income tax principles.[64]

It is also important to note that the "holder" of a financial arrangement (generally the creditor or lender) will be deemed to have received any amounts "remitted" under the arrangement, with paragraph 64F(1)(c) providing that:

A financial arrangement shall be deemed to be remitted where –
(i) The issuer has been discharged from making all remaining payments under that financial arrangement without fully adequate consideration; or
(ii) The issuer has been released from making all remaining payments under that financial arrangement by the operation of the Insolvency Act 1967 or the Companies Act 1955 or by any deed of composition with its creditors; or
(iii) All of the remaining payments under the financial arrangement have become irrecoverable or unenforceable by action through the lapse of time.

Thus, no deduction will be permitted under the BPA calculation in Section 64F for debts released, and the lender/creditor must seek to separately justify any deduction under Section 64G (see further below). However, the *issuer's* (debtor's) BPA calculation under Section 64F does not take amounts remitted into account, as subsection (2) refers simply to the amount of consideration paid or payable by the issuer. Consequently, a release of debt for less than fully adequate consideration will effectively give rise to deemed income on the issuer's part.

This "economic income" approach to the issuer of a financial arrangement whose debt is wholly or partly discharged has given rise to numerous practical difficulties, and has frustrated many attempts at resolving receiverships and insolvencies by way of schemes of arrangement.[65] For these reasons, the Consultative Committee on the Taxation of Income from Capital has recommended that the accrual rules be amended so that no deemed income is derived by an issuer as a result of a debt remittance. In the Committee's view, the taxability of any economic advantage to such an issuer should be tested according to the ordinary provisions of the ITA. Where these provisions do not subject the issuer to tax, however, the Committee has suggested that there should be some clawback of the remittance amount. In view of the fact that the fungibility of money would make the precise tracing of deductions previously allowed virtually impossible, the Committee considered that this clawback should occur by way of offset – from the year following the remittance[66] – against the taxpayer's carry-forward tax losses (if any) and future deductions. To

63. And even one who has not!
64. Principally by reference to ITA Secs. 104 and 106.
65. A number of these issues are discussed in S. Glazebrook and M. Pallot, "Tax Aspects of Insolvency and Restructuring", (October 1990), and reference may also be made to *Tax Education Office Newsletter* 71 (June 1993), at 3-5.
66. The timing proposed is intended "to reduce the extent to which clawback would interfere with commercial reconstructions".

© 1994 International Bureau of Fiscal Documentation

date, the New Zealand government has yet to enthusiastically embrace the Committee's recommendations on the treatment of debt remission under the accrual rules, but it is noted that the proposals announced by the *Australian* government in December 1993 have picked up the clawback approach.

VI. BAD DEBTS WRITTEN OFF

Section 64F does not apply where a financial arrangement is merely written off as a bad debt, but the approach adopted by that section to amounts remitted would suggest that the accrual provisions are likely to be wary of bad debt write-offs in relation to "financial arrangements". Consequently, it will come as no surprise to learn that deductions in such cases are carefully limited by the terms of Section 64G.

That provision basically operates in two parts. Subsection (1) applies where there is an *income* amount written off that has already been brought to account under any of ITA Sections 64C, 64D, 64F or 64I, and few complications arise in this context.

More importantly, though, subsection 64G(2) applies where a party to a financial arrangement desires to obtain a deduction for a *principal* amount written off as bad, and in such a case subsection 64G(2) expressly precludes any deduction where the parties are "associated persons", except where an ordinary trade credit is involved. This limitation can cause very significant mismatches in intra-group situations, and has caused many such taxpayers to search elsewhere in the ITA for a bad debt deduction. In particular, the *general* bad debt provision (paragraph 106(1)(b)) has been thought to offer some satisfaction in this regard, and its potential application in an appropriate case had been conceded by the IRD.[67] However, the Income Tax Amendment Act (No. 3) 1993 has subsequently removed this possibility, and elevated Section 64G to the status of a code in relation to bad debt write-offs where "financial arrangements" are concerned.

VII. PROPERTY TRANSACTIONS

As has been recognized in the Section 64B definition of "money", financial transactions can be readily undertaken with property being substituted for monetary consideration. In light of this effective equivalence, it is not surprising that New Zealand's accrual rules may apply to many property transactions where there is a question as to the timing of taxable receipts/gains or deductible expenditures/losses, or where an "interest" component is inherent in an agreement concerning the deferral of payment or settlement.

Paragraph (b) of the definition of "financial arrangement" is clearly wide enough to catch virtually any agreement for the sale and purchase of property where settlement (and payment) is not immediate. However, a variation in the value of property sold from the consideration originally agreed may often be unrelated to any time-value-of-money component, as it may merely reflect changing market factors or the "good or bad bargain"[68] obtained by each party. Consequently, the accrual provisions could play the part of a tax on unrealized capital gains, and change the taxation timing in relation to ordinary assets on revenue account, rather than their intended role of determining the taxability and timing of income and expenditure from debt arrangements.

These (and related) concerns led to the appointment of a "Committee of Consultants on the Accrual Tax Treatment of Property Transactions", and that Committee reported to the Minister of Inland Revenue and the Commissioner in July 1988. The Committee made a number of recommendations that were incorporated within the legislation including definitions of "agreement for the sale and purchase of property" and "property",[69] a mechanism for determining whether a deferred consideration contained an "interest" element, and a number of important exclusions (that became "excepted financial arrangements").[70]

Following these changes, it is still the case that agreements for the sale and purchase of property may be subject to the accrual rules where they satisfy paragraph (b) of the "financial arrangement" definition. It is clear from the definition of "implementation date" (in subsection 64B(1)) and the terms of subsection 64C(4) that the rules apply to "forward or future contracts" and to "futures contracts", although the exact distinction between these terms is not entirely clear. The Committee of Consultants considered that the term "future contract" should be removed from the legislation "as there is no such contract in common commercial parlance"[71] (but this suggestion was not implemented by the government). The Committee also expressed the view that the term "futures contract" "has a generally accepted meaning as a contract traded on a futures exchange", and this also appears to be the meaning assumed to apply by tax practitioners and the IRD. Thus, a forward contract will seemingly be regarded as a "futures contract" if it is traded on an organized exchange and a "forward contract" if it is not, and the concept of a "future contract" will most likely remain a mystery to all.

As mentioned, certain "short term" and "private or domestic" property agreements do not attract accrual tax accounting methods as they have been designated as "excepted financial arrangements". Other such agreements fall within the accrual provisions, but are not treated as "agreements for the sale and purchase of property", as such (namely, options and futures contracts). That said, other agreements for the sale of property which incorporate deferred payment terms are tested by

67. See Appendix C to *Tax Information Bulletin No. 3* (issued in September 1989).
68. To borrow the terminology of the Committee of Consultants' Report (at 14).
69. "Property", for these purposes, now means any capital asset that is not foreign exchange or a financial arrangement, trading stock (including livestock and real property), consumable aids, and private or domestic property.
70. These include "short term" agreements for the sale and purchase of property (where settlement is to take place within 93 days of agreement for real property, and 63 days of agreement for other property) and "private or domestic" agreements for the sale of property (where the agreement is entered into for private or domestic purposes, settlement is to occur within 365 days, and the purchase price is less than $ 750,000, for real property, and $ 250,000 for other property).
71. See the Committee's Report, at 42.

© 1994 International Bureau of Fiscal Documentation

the accrual rules to ascertain whether the agreed consideration contains any time-value-of-money ("interest") element. This is achieved, in essence, by comparing that consideration with what is called the "core acquisition price" of the relevant property,[72] being[73] "the lowest price that the parties would have agreed upon for the property ... at the time at which the agreement for the sale and purchase of the property was entered into ... on the basis of payment in full at the time at which the first right in the specified property is to be transferred" (Section 64BA). Thus, reference is to be had to the lowest price the parties *would have agreed* in the event that full payment occurred when the first right in the property passed,[74] and it should be noted that Section 64B defines "right in the specified property" as meaning:

> (a) The right to possession of the property; or
> (b) The right to any income or the right to control or influence the disposition of income derived from the property; or
> (c) The right, directly or indirectly, to exercise, or to influence any other person in the exercise, of any decision-making in respect of the property; or
> (d) Any other right of a substantially similar nature:
>
> Provided that the mere right to enforce any agreement for the sale and purchase of property or any specified option shall not of itself constitute a right in the specified property.

According to Section 64F, the difference between this hypothetical price and the actual consideration is to form the basis of the parties' accrual income/expenditure, and one might think it logical for such amount to be spread over the period from the date on which the "first right" in the property passes to the date of final payment. However, the actual tax accounting treatment of many arrangements, in the years prior to the base price adjustment being undertaken, has been thrown wide open by the Court of Appeal's decision in *Dewavrin*. Because no specific wording linked Section 64C (regulating the accounting during the term of the arrangement) with Section 64F (the "wash-up" computation at the end), the Court found that the terms of the latter section could not influence the manner of calculation adopted under the former one. The scheme of the legislation and the intentions of the Committee of Consultants in 1988 were not seen as sufficient to outweigh the absence of explicit connecting words in the provisions:

> The difficulty with this argument is that nowhere in Section 64C is there any reference to Section 64F nor any wording that incorporates by reference the definition of 'core acquisition price' which is the key to the base price adjustment.... While consistency is obviously desirable, that cannot be achieved unless the words are reasonably capable of construction to that end.[75]

This staggering conclusion has very significant practical implications, and effectively means that taxpayers can be required to adopt one basis of computing (and spreading) income/expenditure over the term of a financial arrangement, and to apply *an entirely new and inconsistent* accounting treatment in computing the total income/expenditure at the end.

In the case of the *Dewavrin* company, this meant that (in addition to the foreign exchange contracts) the wool contracts had to be brought to account at balance date, notwithstanding the fact that delivery had not occurred (and, therefore, "the first right in the property" had not passed). Gault J. said:[76]

> We are unable to see how the words of Section 64C(1) can be construed so as to exclude assessment of the value of the consideration expressed at the balance date even though possession of the wool had not passed. It follows that if there were fluctuations in value between the date the contract was entered and the balance date there will be income or expenditure to be accounted for on an accrual basis. That the result might be modified when the base price adjustment is made subsequently cannot affect that.

If this conclusion is correct, many taxpayers with forward orders for commodities at balance date, and taxpayers who have contracted to sell or purchase significant investment assets prior to year-end, will be required to apply the accrual provisions to those agreements. The fact that the impact of the provisions (up to the date on which the first right in the property passes) will be automatically reversed out by Section 64F later on is, according to the Court of Appeal, not a relevant consideration. In the writer's view, legislative intervention is both necessary and likely.

To return to the "real" world once more, where the parties have agreed upon the lowest price for these purposes, the reciprocal tax impacts upon them will ordinarily mean that arm's length bargaining can be left to dictate the result. In any event, the decision of Maller J. in *Industrial Steel and Plant Ltd. v. Smith*[77] has been seen by at least one commentator[78] as suggesting that it may be difficult for the Commissioner to overturn an artificial, manipulated agreed price.[79] Nevertheless, it is the writer's view that a sham figure could be challenged by the IRD on the simple basis that it was not the lowest price the parties "would have agreed upon" in the circumstances envisaged by Section 64BA,[80] and so the ITA would proceed as if no such agreed figure existed. If the parties do not nominate an agreed lowest price for these purposes, ITA subsection 64BA(1) deems a price computed on the basis of a discounted value of the consideration payable "as determined pursuant to a determination made by the Commissioner".

That determination is *Determination G17B: Deferred Property Settlements Denominated in New Zealand Currency*, and it essentially requires that the discounted value be computed using the "specified rate", which (according to *Determination G23: Specified Rate*) is derived from the equivalent bank bill rate (for financial arrangements of up to 12 months duration) or government stock rate (for financial arrangements of over 12 months).

72. The "acquisition price" (for the purposes of the BPA) is the "core acquisition price" plus non-contingent fees of up to 2%: subsec. 64BA(3).
73. Plus any consideration provided by the vendor other than "the specified property".
74. A concept borrowed by the Committee from the Credit Contracts Act 1981.
75. At 11,054.
76. *Id.*
77. [1980] 1 NZLR 545, at 550 – a case under the Hire Purchase Act 1971.
78. See Martin, *supra* note 9, at 23.
79. For example, one party may have abundant tax losses, and be unconcerned about deemed interest income.
80. See also *Tax Education Office Newsletter* 41 (June 1991), at 8-9.

© 1994 International Bureau of Fiscal Documentation

Determination G17B is also noteworthy in that (unlike its predecessor) it extends these principles to deferred property settlements where "the amounts payable or the dates on which those amounts are payable are not known with certainty at the first balance date after the transfer date".[81] This aspect is relevant where, for example, a business or a building is sold on a deferred basis with the consideration varying according to subsequent profits, takings or rentals received. According to the determination, a "best estimate method" must be utilized by the parties at the outset, with a re-estimate and adjustment becoming necessary "when actual cash flows and/or factual circumstances have rendered the original estimate (or previous re-estimate) no longer fair and reasonable". This can give rise to significant practical difficulties in such cases, and there is also the distinct possibility of taxation mismatches as the parties' "best estimates" are not required to be the subject of mutual agreement.[82]

VIII. ANTI-AVOIDANCE

Three provisions warrant brief mention for their (supposed) role in combating tax avoidance in the financial arrangements context.

Section 64H requires parties to a financial arrangement to disclose various details to the Commissioner "where a financial arrangement ... consists of 2 or more arrangements, whether or not those arrangements are themselves financial arrangements". This requirement to disclose such inter-related financial arrangements was intended "to identify to the Commissioner any schemes that are structured to avoid the accruals regime, and any other sections of the legislation",[83] but its value is questionable given that – as a practical matter – it seems to be more honoured in the breach than the observance. In addition, the Commissioner has power (in subsection 64H(2)) to exempt certain taxpayers from the disclosure requirement, and has done so in *Determinations D1 to D4*. The Valabh Consultative Committee has recommended that Section 64H "should be repealed, on the basis that the Commissioner can request information from a specific taxpayer pursuant to Section 17 of the Inland Revenue Department Act".[84]

The other two sections are actually anti-avoidance provisions, rather than disclosure requirements. Section 64J permits the Commissioner to adjust the consideration for the issue or transfer of a financial arrangement between connected parties, where he is satisfied "that the parties were dealing with each other in relation to the issue or transfer in a manner that has the effect of defeating the intent and application of Sections 64B-64M of this Act".

Section 64I implements what is termed a "post facto adjustment" in circumstances where:

(a) Any of the amount or amounts payable under the financial arrangement are determined in the terms of the financial arrangement, as to whole or part, at the discretion of either the issuer or the holder, or both of them, or at the discretion of any other person where either the issuer or the holder and the other person are associated persons; and

(b) The change in the amount or amounts payable under the financial arrangement upon the exercise of a discretion as provided for in paragraph (a) of this subsection does not reflect changes in economic, commodity, industrial, or financial indices or banking or general commercial rates; and

(c) The making of such financial arrangements is not generally accepted commercial practice; and

(d) The effect of the arrangement is to defeat the intent and application of Sections 64B to 64M of this Act.

IX. INTERRELATIONSHIP BETWEEN THE ACCRUAL PROVISIONS AND THE REST OF THE INCOME TAX ACT

Subsection 64L(1) of the Act is in the following terms:

> Notwithstanding any other provision in this Act, in an income year in which a person is required to take into account income or expenditure in respect of a financial arrangement under Section 64B to 64M of this Act, that income or expenditure shall be calculated pursuant to those sections.

This would seem, at first glance, to be a relatively straightforward and uncontentious provision according priorities within the statute. However, it is not completely devoid of interpretational issues.

First, subsection 64L(1) only operates where a person "is required to take into account income or expenditure ... under Sections 64B to 64M" in the relevant income year. If the accrual rules are applied in a particular year with the result that there is no income or expenditure deemed to be derived or incurred in that year, can the other provisions of the ITA operate so as to give rise to assessable income or allowable deductions? In the writer's view, the answer is a negative one, as the taxpayer will still have been "required to take into account" (in that year) whatever amount of income or expenditure the accrual calculations produced – in the instant case being nil. If the answer was otherwise, subsection 64L(1) – and the other provisions – could oscillate between operation and inactivity during the term of a financial arrangement, according to whether Sections 64B-64M gave rise to income or expenditure, or to a nil result, in any particular year.

Where, however, the accrual provisions do not require or provide a method of tax accounting for a "financial arrangement" in any year, the wording of subsection 64L(1) arguably permits the ordinary provisions of the Act to operate in the usual way. In the final year, of course, Section 64F will still apply, so as to reassert the priority of the accrual provisions, dictating the overall quantum (rather than the timing) of the taxpayer's expenditure.[85]

81. The "transfer date" is the date on which the first right in the property is transferred.
82. Although the Commissioner reserves the right to reject estimates he considers not to be "fair and reasonable", and to re- estimate on his own motion.
83. See McClennan and Truman, *supra* note 5, at 14.
84. See the Consultative Committee's *Final Report* (October 1992), at 101.
85. This analysis is admittedly inconsistent with the approach of Gault J in the *Dewavrin* case, at 11,057. However, it is suggested that his Honour's comments are quite contrary to the plain words of subsec. 64C(3), and must be considered in that light.

© 1994 International Bureau of Fiscal Documentation

Secondly, the subsection does not entirely exclude the other provisions of the Act in any event – rather, it gives primacy to the accrual sections in relation to the calculation of the party's relevant income or expenditure.[86]

It is interesting to contrast the wording of the present provision with that of subsection 64C(4) proposed in the original Bill:

> To the extent that any provision of this Act, other than Section 99,[87] conflicts with Sections 64B to 64J of this Act that provision shall apply subject to the treatment of income and expenditure in relation to financial arrangements prescribed by the said Sections 64B to 64J.

The Consultative Committee said of the change:

> The section places the treatment of financial arrangements within the scheme of the Act by stating that income or expenditure from such arrangements shall be calculated pursuant to the provisions of Sections 64B to 64M of the Act. The section still allows special treatment for income and expenditure subsequent to its initial calculation provided elsewhere in the Act to have effect; for example Section 204 life insurance companies.[88]

It should also be noted that *non-residents* are generally excluded from the accrual regime. Section 64M provides that the accrual provisions "shall not apply" to "the determination of income of or expenditure incurred by a person not resident in New Zealand in relation to a financial arrangement where and to the extent that the financial arrangement does not relate to a business carried on by that person through a fixed establishment in New Zealand". Non-resident withholding income is also expressly excluded from the operation of Sections 64B-64M.[89]

It is self-evident that the exclusion of non-residents from the accrual rules may produce significant income/expenditure mismatches where transactions occur between resident and non- resident parties. In some situations, these can be exploited as tax planning opportunities, but in others they can have a seriously detrimental effect on a party's financial or competitive position.

X. CONCLUSION

There are certain fundamental issues which require consideration, and resolution, before a comprehensive accrual taxation system is implemented. Hopefully, the brief excursion through New Zealand's Sections 64B-64M undertaken in this paper may serve to highlight some of those issues, their practical importance, and the benefits and pitfalls that different "solutions" may produce.

Those seeking to regulate the taxation treatment of financial arrangements must give careful thought to the following (among other) questions:

– How should the regime be targeted? Should an expansive definition be adopted (giving anti-avoidance advantages, but producing anomalies and the risk of "over-reach"), or should the regime focus tightly on the specific timing and capital/revenue issues thought to prejudice the revenue?

– How can flexibility be provided to taxpayers in their choice of accounting methods (thereby assisting tax simplification and taxpayer compliance) without permitting manipulation and inconsistency?

– Should accruals under the regime take foreign exchange gains and losses into account, and what should be done about hedging transactions?

– How should the regime approach remissions of debt (so as not to unfairly complicate or discourage the resolution of business insolvencies)?

– Should the regime seek to apply to non-residents (and how would this interact with existing double tax treaties)?

– How should deferred settlement property transactions be approached (and what will be the relationship with any provisions taxing capital gains)?

– How should the regime be administered, so as to assist certainty of application, accommodate market developments, and fill in the inevitable details (dealt with, in New Zealand, by way of determination)?

The New Zealand provisions were a bold step into a hazardous arena, and there are important lessons to be learned from their adventure so far – for both Australia and New Zealand.

86. Glazebrook and Oliver noted this issue, when they said of subsec. 64L(1):

> That provision is not without some obscurity. However, the correct interpretation would seem to be that Sec 64L(1) means that where there is a conflict between timing and spreading under the accrual rules, and timing under other provisions of the Act, the accrual rules override the other provisions. Sec. 64L(1) does not override other provisions of the Act as far as they relate to deductibility or assessability.

See *supra* note 9, at 78.

87. The ITA's general anti-avoidance provision.

88. *Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure* (April 1987), at 11.

Martin (*supra* note 9) describes the preceding interpretation as a "calculational approach", and (while he thinks it correct) notes that arguments can be raised in support of a different view. For example, it could be said, with some force,

> ... that the line between matters of calculation and matters of, say, assessability is not necessarily that clear-cut since not only does the former task in a loose sense merge somewhat into the latter but the accrual rules are not purely calculational in themselves, Section 64F(4) giving rise to a deemed assessability in certain circumstances.

Martin also points out that many sections of the ITA "have statutory objectives that go well beyond those involving the calculation of income, for example, tax avoidance objectives", and these objectives could be frustrated by the operation of subsec. 64L(1). This issue is of considerable practical importance, as the calculational approach could in such cases permit the avoidance of tax where the accrual provisions and determinations made thereunder are deliberately attracted and applied. Nevertheless, it would seem from the words of the provision that that approach is the correct one.

89. This approach avoids the difficulties inherent in having to "deduct" non-resident withholding tax from deemed interest income, but related problems have emerged with the introduction of a resident withholding tax on interest.

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND

TAX SIMPLIFICATION: PROGRESS TO DATE

Lin Mei Tan and Stuart Tooley

Massey University, Palmerston North, New Zealand.

INTRODUCTION

Tax simplification is usually advanced as the panacea to the growing concerns over the complexity of income tax and the burden of compliance costs on taxpayers that many of the tax reforms imposed. Over the years, governments in several countries, such as Canada, the United States and Australia have responded in one way or another to the call of simplification. The approaches to simplifying a tax system and structure have been many and varied. Nevertheless, the main thrust of most recommendations includes: making the law readily understandable, removing uncertainties, simplifying record keeping requirements, user friendly tax system, streamlining tax collection, production of readily understandable educational material to help minimize learning costs, stability in taxation, simple tax structure, simple and easy to complete tax forms and simple and low cost appeal mechanisms (Sandford et al. 1989; Sherbaniuk, 1988; Strain, Dodge and Peters, 1988; Stikeman 1975).

However, even though governments in various OECD countries have appeared to support tax simplification, not much progress has been made in simplifying their tax system (Pechmann, 1987; Owens, 1990).

This article provides some insights on tax simplification in New Zealand and its effectiveness as perceived by tax practitioners.

NEW ZEALAND TAX SIMPLIFICATION INITIATIVES – AN OVERVIEW

In 1989, the New Zealand government placed tax simplification high on its agenda. Such a move was seen as necessary as the New Zealand tax system had become more and more complex as the many tax reforms undertaken since 1985 began to take effect (Valabh Committee, 1989, p. 6).

Stephens (1989) alluded that such comprehensive tax reform was seen as necessary by the Labour government which had come into power as there was a perceived need to improve the efficient use of resources and to introduce greater equity into the tax and benefit system. At the same time, the changes were made to ensure the collection of the desired amount of tax revenue in view of the deficit-ridden government's cash flow (Budget 1987, p. 28).

Such reforms, which have also been described as the most far-reaching in New Zealand's history (Groenewegen, 1987), gave rise to highly complex legislation. In addition, the escalating speed in which the government had enacted new legislation made it even more difficult for taxpayers to cope with the new rules. Hoare & Weston (1990, p. 36) reported that these recent reforms gave rise to 77 Amending Acts (20 in the last two years) since the principal Act was updated in 1976. The government's concentration in closing tax loopholes appears to have bred further complexity as it was done on a piecemeal basis. As a result the Valabh Committee suggested that "many of the important parts of the legislation do not work well together due to the different terms and tax concepts used" (quoted in Weston & Hoare, 1990, p. 36). This was also supported by the Waugh Committee (1990) which felt that parts of the tax legislation were confusing and unclear making compliance difficult for the ordinary taxpayer.

Furthermore, small businesses which constitute about 92 percent of the business population in New Zealand, had lobbied for some time for a simpler tax system. The massive changes since 1984 made it not only difficult but also costly for them to comply with the tax requirements. In addition, several studies (for example, Sandford and Hasseldine, 1992) investigating tax compliance costs suggest that compliance costs are regressive as they tend to fall disproportionately on small businesses. These findings provide further support that the burden of compliance costs imposed on small businesses resulting from the tax reforms ought to be addressed.

In response to the growing pressure over the increased complexity of the tax system due to the radical reforms (Waugh Committee, 1990; Hasseldine, 1989), the (then) Labour Government finally appointed the Tax Simplification Consultative Committee, more commonly known as the Waugh Committee to recommend measures which could reduce taxpayer's compliance costs but without diminishing the tax revenue intake, unless there were significant savings to the economy as a whole.

Based on the submissions received from the public, the Committee put forward a number of recommendations (176 in total) based on the following key principles:

- it should be recognized that most taxpayers honour their responsibilities and are honest;
- taxpayers generally should be able to understand and fulfil their own obligations with a minimum of outside help, and without fear of making errors;

© 1994 International Bureau of Fiscal Documentation

- as many taxpayers as possible should be removed from the provisional tax system;
- tax rules should have empathy with good business practice;
- there should be common approaches to problems between taxpayer classes and tax types;
- pay-in dates should be as standardized as possible, existing tax systems should be used for any new taxes;
- thresholds should be seen to be appropriate;
- the system for the payment of interest by or to the Inland Revenue Department ("IRD") should be made workable;
- the penalty regime that applies should be accepted as reasonable by the taxpayer;
- the IRD should help to increase the level of taxpayer understanding by themselves maintaining a high standard of knowledge and efficiency;
- the impact of social welfare policies on the tax system should be minimized subject to delivering social welfare policies at minimum cost (p. 4).

Many of these recommendations have now been adopted by the Government. The government also promised that tax simplification would be an ongoing process. It is perceived that for small and medium-sized businesses which were overburdened with tax compliance obligations, these changes will save them money, time and inconvenience.

With the implementation of many of these tax simplification initiatives, the remainder of this article provides an analysis of a questionnaire which was sent to tax practitioners to obtain their views as to the effectiveness of the tax simplification measures to-date. The suggestions together with the principles set out by the Waugh Committee in the Final Report were used as the framework for designing the questions. Tax practitioners were asked to give their views as to whether the initiatives implemented did make compliance easier for taxpayers, in particular for small businesses.

RESULTS AND DISCUSSION

Out of a total of 37 initiatives put forward in the questionnaire, the tax practitioners perceived that a majority of the initiatives did make compliance easier for taxpayers. Most of the dissatisfaction with the initiatives arises in the readability of the tax legislation and determinations, the change in payment dates in particular for Goods and Services Tax and the IRD staff's technical and communication skills. Based on comments received, a number of practitioners felt that there are still too many dates for the various taxes and to make compliance easier they should all be standardized.

OVERALL COMMENTS

Numerous comments were received regarding the number of rules emerging at the same time. Positive comments received include the improved record-keeping requirements for small businesses with the introduction of GST. However, many expressed discontentment over new rules such as entertainment tax, livestock valuation methods and depreciation rules. These new rules further complicate compliance for small businesses, in particular, those who do not have the available administration and record-keeping staff and procedures. The general view is that the new rules do not seem to take into account compliance and collection costs. Taking these new rules into account, many respondents suggested that the simplification process had regressed. The overall perception is that there is considerable scope for further simplification and that compliance issues must be considered on a pre-implementation basis rather than post-implementation.

CONCLUSION

In recent years, tax simplification seems to have become a major objective of tax reforms. In 1991, a number of measures were implemented to simplify the tax system. This study shows that tax practitioners generally perceived that most of the measures have made compliance easier for taxpayers, in particular small businesses. However, the complexity of the new rules has actually wiped out the benefits gained from the changes.

Although the results may not be generalizable beyond the questions selected for use in the study, it does provide some insights into the compliance complexity that taxpayers still have to face. First, although practitioners generally support the removal of the needless complexity of the tax system, it is perceived that too frequent changes in the tax legislation make compliance difficult and therefore become an impediment to tax simplification. Second, the tax legislation is still very difficult to read and understand and its intent remains unclear. Third, the IRD staff (especially the junior staff) still lacks adequate technical and communication skills necessary to assist taxpayers with their compliance requirements. Lastly, to achieve any progress in tax simplification, there is no doubt that it should be viewed as an ongoing process. Otherwise as this study shows, not much progress can be made beyond the initial rhetoric stage if the government fails `to continually check the effects of tax reform against the need for simplicity'.

REFERENCES

Cohen M.A. (1976): "Tax Simplification: A Government Perspective", 27th conference 1975. Report of Proceedings of the Twenty-Seventh Tax Conference. Canadian Tax Foundation, Quebec City, 10-12 November 1975. Canadian Tax Foundation 1976.

Couzin, R. (May-June 1984): "The Process of Tax Simplification", *Canadian Tax Journal*, 32, 487-500.

Creech, W. (1991): "Tax Reform – Progress to date", New Zealand Society of Accountants Residential Taxation Seminar, 1-2 November, 1991.

© 1994 International Bureau of Fiscal Documentation

Owen, J. (1990): "Tax Reform in OECD Countries: Objectives and Achievements", *Taxation and International Capital Flows*. Paris: OECD.

Pechman, J.A., ed. (1987): *World Tax Reform: A Progress Report*, Washington: The Brookings Institution.

Sandford, C. (1981): *Economic aspects of compliance cost. The Political Economy of Taxation*. Peacock A and Forte F, New York: St Martin's Press.

Sandford, C., Godwin, M. & Hardwick, P. (1989): *Administrative and compliance costs of Taxation*. Bath: Fiscal Publications.

Sandford, C. and Hasseldine, J. (1992): *The Compliance Costs of Business Taxes in New Zealand*. Wellington: Institute of Policy Studies.

Sherbaniuk, D.J. (1988): "Tax Simplification – Can anything be done about it?", Report of the 40th Tax conference, Canadian Tax Foundation.

Waugh, J.C.(1989): *Consultative Document on Tax Simplification*, Wellington: Government Printing Press.

Waugh, J.C. (1990): *Final Report of the Tax Simplification Consultative Committee*, Wellington: New Zealand Government.

© 1994 International Bureau of Fiscal Documentation

AUSTRALIA

STATE EXCISE TAXES AND THE CONSTITUTION:

CAPITAL DUPLICATORS PTY. LTD. V. AUSTRALIAN CAPITAL TERRITORY (1 & 2)

Abe I. Greenbaum

BA, LL B, LL M (Labour), LL M, Senior Lecturer ATAX Program,
University of New South Wales.

I. INTRODUCTION

The High Court recently decided,[1] in cases challenging the Business Franchise ("X" Videos) Act 1990 (A.C.T.), that an Australian Capital Territory ("ACT") franchise fee on wholesale and retail sale of "X" rated videos was an unconstitutional excise. The implications of this decision on State revenue collection could have been dramatic. The High Court, however, averted severe political disruption by going on to hold that similar State-levied franchise and licence fees for the sale of liquor, tobacco and petrol would be permitted to continue, notwithstanding their holding regarding the ACT tax. This article discusses the High Court decisions in *Capital Duplicators Pty. Ltd. v. Australian Capital Territory et al.* (No. 1)[2] and *Capital Duplicators Pty. Ltd. v. Australian Capital Territory et al.* (No. 2),[3] and their implications for tax law and policy as well as the Australian Constitution.

II. CONSTITUTIONAL LAW BACKGROUND

Australia has a federal constitutional structure. The Commonwealth Constitution (hereinafter "Constitution")[4] provides the basic structure of the federal system and outlines which level of government will have legislative and administrative power in which subject areas.

Excises – taxes imposed on certain classes of goods based on their production or use – are controlled by Section 90 of the Constitution. Section 90, in part, provides:

> On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and of excise, and to grant bounties on the production or export of the goods, shall become exclusive.

Section 90 allows only the Commonwealth Parliament to impose any excise. This means that any State which imposes an excise would be acting in violation of the Constitution and the law imposing the excise would be *ultra vires* and therefore of no force or effect.

The operation of Section 90 turns on two points. First, the status of the legislator – is it a State or the Commonwealth? Second, the nature of the tax – is it an excise or not?

A. Constitutional status of the legislator

In most situations this first point will be obvious. The legislature of a State or the Commonwealth will clearly fall within their respective categories. In *Capital Duplicators* this was not the case since the legislator was the ACT. The constitutional status of the ACT for purposes of Section 90 of the Constitution was the issue before the High Court in the first *Capital Duplicators* case.[5] Simply stated, the question considered was whether the ACT, for the purposes of enacting excise legislation, was acting as a State or was it exercising delegated Commonwealth powers?

In 1988 the constitutional status of the Capital Territory changed. This change occurred with the enactment of the Australian Capital Territory (Self-Government) Act 1988 (Cth).[6] The Australian Capital Territory self-government law established the legislative framework to give the Territory some governmental responsibility. Section 22 of this Act provided that the ACT Legislative Assembly would have the power to make laws for the "peace, order and good government of the Territory".

"Peace, order and good government" is the terminology used in many British Commonwealth constitutions to describe a plenary legislative power, i.e. an all-encompassing legislative power, not constrained by or answerable to, some other superior legislature. The majority of the High Court in *Capital Duplicators* (No. 1) concluded that the exercise of legislative power for "peace, order and good government" was one independent of the Commonwealth Parliament and was not a del-

1. *Capital Duplicators Pty. Ltd. v. Australian Capital Territory et al.* (No. 1) (1992) 177 CLR 248; 109 ALR 1 and *Capital Duplicators Pty. Ltd. v. Australian Capital Territory et al.* (No. 2) (1993) FC 93/053; 27 ATR 1.
2. (1992) 177 CLR 248; 109 ALR 1.
3. (1993) FC 93/053; 27 ATR 1.
4. Commonwealth of Australia Constitution Act (63 & 64 Victoria, Ch. 12), as amended.
5. (1992) 177 CLR 248; 109 ALR 1. The specific question answered by the court in *Capital Duplicators Pty. Ltd. v. Australian Capital Territory* (No 1) was: "does Ch. IV of the Commonwealth Constitution operate so as to preclude the Legislative Assembly of the Australian Capital Territory from exercising the power to impose duties of excise within the meaning of Section 90 of the Constitution?"
6. Self-government had already been granted to the Northern Territory of Australia (the only other territory on Continental Australia) in 1978 under the Northern Territory (Self-Government) Act 1978 (Cth).

© 1994 International Bureau of Fiscal Documentation

egated power of the Commonwealth Parliament.[7] The reasoning of the High Court was that the broad legislative power granted the ACT legislature was consistent with status as an independent legislature rather than a subsidiary legislature of the Commonwealth exercising powers delegated by the Commonwealth.

The High Court conclusion that the ACT was exercising legislative power independent of that of the Commonwealth is important to the final conclusion of *Capital Duplicators* (No. 2). If the High Court had found that the ACT was exercising legislative power as delegated by the Commonwealth Parliament, there would have been no need for the second *Capital Duplicators* case because the ACT, exercising delegated power from the Commonwealth Parliament, would be considered to have all of the constitutional scope to legislate as the Commonwealth Parliament.

The ACT legislature could have imposed an excise since they would have had power delegated under Section 90 of the Constitution. The High Court concluded, for purposes of Section 90, that the ACT had the legislative power of a State. This meant that the High Court was faced with a further question: did the ACT legislation impose an excise or not?

B. Definition of "excise"

As the term "excise" is undefined in the Constitution, the High Court had to decide on its meaning. The meaning of "excise" was considered by the High Court in an early case, *Peterswald v. Bartley*, where Griffith CJ. held:[8]

> . . . the conclusion is almost inevitable that, whenever it is used, it is intended to mean a duty analogous to a customs duty imposed upon goods either in relation to quantity or value when produced or manufactured, and not in the sense of a direct tax or personal tax. Reading the Constitution alone, that seems to be the proper construction to be put upon the term.

The early view of the High Court was that excises had to be related to goods being manufactured.

The High Court progressively expanded the definition in subsequent cases. In *Matthews v. Chicory Marketing Board*,[9] the majority of the High Court held that a Victorian tax of 1.1 for every half acre of chicory planted was an excise. The High Court concluded that the tax was an excise because it was imposed on goods produced in Australia for sale within Australia. This conclusion was reached notwithstanding the fact that the tax was not related to the quantity of chicory actually produced. In *Parton v. Milk Board (Vic)*,[10] Dixon J., for the majority of the High Court, held that any tax on commodities which was charged at any time prior to final consumption of the goods was an excise. Dixon was of the view that there was no difference between a tax which was charged at some point in the distribution process as opposed to a tax imposed at the manufacturing stage.

This "high watermark" of Commonwealth excise power would preclude any scope for State taxes on commodities. State taxes are, however, levied on alcohol, tobacco and petrol. This is explained by a series of High Court decisions where the Court concluded that certain taxes, when imposed in a particular manner, were not excises.

The first of these cases was *Dennis Hotels Pty. Ltd. v. Victoria*,[11] where the constitutionality of the Licensing Act 1958 (Vic) was at issue. The law provided that only persons licensed under the Act could sell liquor in the State. The licence fee for a hotel owner was 6 percent of the price of all liquor purchased by the hotel owner for a 12-month period ending 1 June prior to the date of licence application. The plaintiff, a hotel owner, asserted that the licence fee amounted to an unconstitutional State excise.

The central question considered by the High Court was the scope of the definition of the term "excise". In *Dennis Hotels*, three judges (Dixon CJ., McTiernan and Windeyer JJ.) adopted the broad view of the definition of excise in *Parton* and found that the licence fee was an unconstitutional excise; two judges (Fullagar and Menzies JJ.) followed the narrow definition of excise in *Peterswald* and concluded that since the tax was not a tax on local production it was not an excise; the final two judges (Kitto and Taylor JJ.) applied the broad definition of excise but held, however, that the licence fee was not an excise since it was related to the holding of a licence rather than being based on goods. Kitto J. seized upon the idea that since the licence fee was based on sales in a past period it was therefore a fee related to the licence rather than the sale or distribution of goods.

This case, with its variety of minority judgments, has since stood for the proposition that State licence or franchise fees which were based on past sales were not unconstitutional under Section 90. This reasoning was followed by the High Court in relation to a tobacco tax in Dickenson's *Arcade Pty. Ltd. v. Tasmania*,[12] and in relation to a tax on the sale of petrol in *H.C. Sleigh Ltd. v. South Australia*.[13]

III. THE HIGH COURT JUDGEMENT IN *CAPITAL DUPLICATORS* (NO. 2)

The first plaintiff, *Capital Duplicators Pty. Ltd.*, was a wholesale distributor of "X" rated videos. The second plaintiff was a retailer of similar videos. The plaintiffs challenged the constitutional validity of the Business Franchise ("X" Videos) Act 1990 (ACT).

The legislation mandated that "X" rated videos could not be distributed or sold without a licence. The legislation provided that the monthly wholesaler licence fee was calculated at 40 percent of the wholesale value of videos sold in the second month preceding the month of the renewal. For example, the June licence fee would be based on April sales.

7. Brennan, Deane and Toohey JJ. CLR, at 281; Gaudron J. concurring, at 284.
8. (1904) 1 CLR 497.
9. (1938) 60 CLR 263.
10. (1949) 80 CLR 229.
11. (1960) 104 CLR 529.
12. (1974) 130 CLR 177.
13. (1977) 136 CLR 475.

© 1994 International Bureau of Fiscal Documentation

In the litigation surrounding *Capital Duplicators*, the defendant (the government of the ACT) and the interveners from each of the States and the Northern Territory hoped that the High Court would conclude that the ACT legislation fell within the category of constitutionally permitted franchise or licence fees in the *Dennis Hotel* line of cases. This would allow the ACT and any of the States to continue to impose, or impose new business franchise fees in the area of pornographic videos (or even videos generally). The plaintiff sought to sell its product for as low a price as possible and saw the business franchise fee as interfering with that goal. In an attempt to improve its business environment, the plaintiff sought to have the tax declared unconstitutional.

The legislators must have been aware of the *Dennis Hotels* line of cases which permitted certain State franchise fees which were based on past sales. The ACT legislators decided that if they were to frame the legislation in this manner they would be able to avoid a constitutional challenge. The plaintiffs sought to have the franchise fee declared an unconstitutional excise since it violated Section 90 of the Constitution. The Territory government argued that the fee was not an excise and invited the High Court to follow *Peterswald* and narrowly read the definition of excise so that it would only apply to taxes imposed on the manufacture of goods.

The majority of the High Court gave a detailed explanation of the rationale for Section 90 and related sections of the Constitution. They explained that not only was Section 90 necessary to prevent the States and Territories from counteracting Commonwealth tariffs, but it was also necessary to ensure that differential taxes on goods as between States did not take place and thereby distort local markets within the Commonwealth. These problems would be averted by granting the Commonwealth Parliament the sole authority to impose taxes on goods and so ensure that those taxes would be imposed uniformly throughout the Commonwealth; this was arguably the intent of the framers of the Constitution in Sections 90 and 99.[14]

The Court reviewed the case law discussing the meaning of "excise". It considered whether a narrow view of the meaning of the term (as taken by the early High Court decision, *Peterswald*) or the more expansive definition which the High Court had developed in *Parton*[15] and cases following it should be taken. The majority of the High Court (Mason CJ., Brennan, Deane and McHugh JJ.) concluded that the weight of precedent was strongly in favour of continuing the broader reading of the meaning of excise. The majority explicitly rejected the definition of excise in *Peterswald* by endorsing the judgment of Dixon CJ. and Windeyer JJ. in *Dennis Hotels*. The High Court concluded that an excise was a tax directly related to goods which is imposed at some point in the production or distribution process prior to the goods reaching the consumer.[16] The High Court held that the ACT franchise fee was an excise.

The Court then addressed the issue of whether it would or should reconsider the earlier High Court judgments in *Dennis Hotels* and *Dickenson's Arcade*. The defendants sought that both cases be reconsidered so that the definition of excise could be narrowed. The Court said that it would not consider reopening the cases to narrow the definition of excise and return to the definition in *Peterswald*.[17] The High Court did, however, recognize that there was a problem with the rule in these cases. The High Court was concerned that the previous decisions of the court focused too heavily on form rather than substance,[18] and granted that a strong argument could be made that a reconsideration of this line of cases should take place. The High Court Justices, however, concluded that the decisions in these cases should not be reopened. They stated:[19]

> For one thing, there are some grounds for treating tobacco and alcohol products as constituting a special category of goods for the purpose of considering whether what purports to be a licensing fee under a regulatory scheme should be characterized as a duty of excise.

This passage refers with approval to the judgment of Taylor J. in *Dennis Hotels* where he held that the tax structure could be justified because of the acceptance of the need to regulate the sale of liquor. The tax was justified on the grounds that the tax revenue was necessary to fund the needed regulatory framework associated with the sale of liquor.[20]

The Court eventually gave a surprisingly candid and unguarded explanation and would not reconsider the earlier State franchise decisions. The majority said:[21]

> In refusing to reconsider the franchise decisions relating to liquor and tobacco, the Court has recognized the fact that the States (and the Territories) have relied upon the decisions in imposing licence fees upon vendors of liquor and tobacco in order to finance the operations of government. Financial arrangements of great importance to the governments of the States have been made for a long time on the faith of these decisions. If the decisions were to be overruled, the States and the Territories would be confronted with claims by the vendors of liquor and tobacco for the recoupment of licence fees already paid. That would certainly be the case if the Court were to hold that such licence fees could not properly be characterized as no more than the imposition of a licence fee for the privilege of engaging in the relevant activity. Hence, considerations of certainty and the ability of legislatures and governments to make arrangements on the faith of the Court's interpretation of the Constitution are formidable arguments against a reconsideration of *Dennis Hotels* and *Dickenson's Arcade*.

The High Court held that the ACT Business Franchise was unconstitutional. However, they specifically stated that they would not reconsider the previous cases validating similar taxes on liquor, tobacco and petrol sales. They did not reconsider the other taxes because they were aware that these taxes

14. FC 93/053, at 7; ATR, at 7. The Commonwealth Parliament, in exercising its taxing power, may not discriminate between States or parts of States (Sec. 99 Commonwealth Constitution).
15. (1993) FC 93/053 at 12; ATR at 11.
16. FC 93/053, at 10; ATR, at 9, per Gibbs CJ in *Hematite Petroleum Pty. Ltd. v. Victoria* (1983) 151 CLR 599, at 615.
17. FC 93/053, at 13; ATR, at 12.
18. The cases were decided on criteria more related to the form of tax (the fact that the tax was based on past sales) rather than its substance (whether the tax or franchise fee was, in actuality, an excise).
19. FC 93/053, at 13; ATR, at 12, referring to the judgment of Taylor JJ. in *Dennis Hotels*, at 576.
20. This reasoning was extended to tobacco sales in *Dickenson's Arcade*.
21. FC 93/053, at 15; ATR, at 13.

© 1994 International Bureau of Fiscal Documentation

were important sources of State tax revenue and invalidating these laws would have serious political repercussions.

IV. THE IMPLICATIONS FOR TAX AND CONSTITUTIONAL LAW

Capital Duplicators has important implications for both constitutional and tax law. First and foremost, the High Court ignored the rule in Section 90 of the Constitution and allowed State taxes to stand which should have been struck down as unconstitutional. Two constitution law implications arise out of this. First, by ignoring the Constitution, the High Court is engaging in constitutional amendment, something which it has no legal power to do. The High Court role is to interpret the Constitution not to effectively redraft it. The High Court has implied a new proviso in constitutional interpretation, i.e. constitutionally invalid laws will be struck down unless the impact of doing so would cause too much political dislocation.

The fact that the High Court has failed to follow the Constitution leads to the second main impact. If the High Court does not follow the rules outlined in the Constitution, there will be considerable uncertainty about High Court judgments in the future. If litigants cannot be certain the rules are not going to be changed in mid-case they will be less likely to settle matters and instead "take a punt on the High Court roulette wheel".

The implications for tax law and the fiscal relations between the States and the Commonwealth are minimal because despite the decision on the ACT tax, the High Court refused to reconsider the State liquor, tobacco and petrol taxes. The decision, however, created much uncertainty. These State taxes have a very uncertain future. The majority comments about the weak legal basis of *Dennis Hotels* are an invitation for a direct challenge to any or all of the three taxes.[22]

The *Capital Duplicators* decision also created problems in the interpretation of the term "excise". The tax in *Dennis Hotels* was justified on the basis that regulation of the liquor industry was accepted practice and that the tax revenue was used to fund this regulation. There are two problems with this rationale. First, when considering the importance of having a regulatory infrastructure, can a distinction be made between the sale of liquor or tobacco and the sale of pornographic videos? Arguably there is no difference because the perceived harm to society is great in all three instances. If no such distinction can be sustained, why didn't the High Court justify the franchise fee on the basis of requiring a regulatory scheme? The Court argued that unlike tobacco and liquor, there were no controls on the sales or advertising of "X" rated videos in the ACT and that as such it was not possible to argue that the taxes were made to support a regulatory scheme and therefore justify the excise.[23] Even if one were to accept the regulation argument of the High Court for the constitutionality of State taxes on liquor and tobacco, this justification cannot be sustained in relation to State petrol taxes.

The lack of justification for petrol taxes is the second problem with the rationale used by the High Court. State taxes on petrol had been approved by the High Court in *H.C. Sleigh Ltd. v. State of South Australia*.[24] Arguments about the need for regulation of petrol distribution and sale are much weaker than those in relation to the pornographic video industry. It is therefore difficult to sustain an argument that under the *Dennis Hotels* line of decisions, video licence fees are an excise, and liquor, tobacco and petrol licence fees are not. It should also be noted that in an earlier excise case, *Matthews v. Chicory Marketing Board*,[25] Starke J. explicitly rejected this argument. He was of the view that the use that the revenue was to be put had no bearing on whether it should be characterized as an excise or not.

V. CONCLUSION

The High Court did more harm than good with its decision in *Capital Duplicators* (No. 2). It avoided political dislocation in the short term by refusing to reconsider the State taxes on liquor, tobacco and petrol; however, it has by no means protected these sources of State tax revenue in the longer term. The High Court admission that these taxes are supported by dubious constitutional reasoning will ensure that they will be challenged in the near future.

By refusing to reconsider the *Dennis Hotels* line of cases the High Court has merely delayed briefly another better targeted constitutional challenge and they have secured this small victory for State revenue collection at the cost of their credibility as the interpreter and protector of the Constitution. This a price which the High Court can ill afford to pay.

22. Challenges have already been commenced which question the validity of the New South Wales petrol tax. Doubtless, challenges to State liquor and tobacco taxes will soon follow.
23. FC 93/053, at 18-19; ATR, at 15-16.
24. (1977) 136 CLR 475.
25. (1938) 60 CLR 263.

© 1994 International Bureau of Fiscal Documentation

AUSTRALIA

FOREIGN BANKS: DEFINING THE PERSONALITY *

Michael Kobetsky BEc (Syd) LLB (ANU)

Executive Officer, Legislative Services Group, Australian Taxation Office and Visiting Fellow (Teaching), Faculty of Law, Australian National University.

* The views expressed in this article are the views of the author and are not the official views of the Australian Taxation Office.

I. INTRODUCTION

The problems faced by national tax agencies in taxing multinational corporations were described by the Organisation for Economic Co-operation and Development ("OECD") Committee on Fiscal Affairs in 1979 in the following terms:

> While taxation problems arising from international investment are not new, they have become more important in recent years as a consequence of the growing internationalization of economic activities. One characteristic of this process is the development of so-called "multinational enterprises"... which have increasingly become powerful economic entities each with a large degree of common strategy. However, such an international economic entity generally operates in a legal framework which has remained national; it has therefore to conform with the varied and sometimes conflicting national laws of the countries in which it operates. This increasingly common phenomenon of related companies operating in a group with some degree of centralized management, yet with the individual members of the group operating under different national laws, has given rise to important problems regarding the taxation of corporate profits.[1]

On 18 June 1993, the Treasurer, the Hon. John Dawkins MP, announced in the *Banking Policy Statement* ("BPS")[2] a new tax regime for foreign bank branches[3] operating in Australia. The BPS stated that as a legal principle, a foreign bank branch is part of a single banking entity which includes its head office and other branches. This is called the "single entity" approach under which intrabank loans[4] are generally not recognized for tax purposes. However, for Australian tax purposes, it is necessary to determine the Australian taxable income of a branch; to do this in an efficient and precise manner, the Commonwealth Government decided to use the branch's books[5] as a starting point for the allocation of certain income and expenses. The practical effect of this approach is that transactions between the Australian branch and its head office or non-resident branches are notionally recognized for Australian tax purposes.

The approach taken in the BPS on its face differs from the "separate entity" approach on intrabank interest adopted in the OECD 1984 report titled *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* ("1984 Report").[6] This approach treats a branch of a foreign bank as though it were separate and independent from the rest of the bank for taxation purposes. Thus intrabank interest is recognized for the purpose of determining the profits of the branch. However, on the application of non-resident interest withholding tax ("IWT") to intrabank interest either paid or credited by a branch to its head office or overseas branches, the OECD reverts to a "single entity" approach, arguing that IWT should not be applied to intrabank interest. It is asserted that applying IWT to intrabank interest will deny the fact that a branch, its head office and overseas branches are merely parts of the same enterprise.

In this article I will firstly examine the deductibility of intrabank interest and the application of IWT to intrabank interest paid overseas under the new Australian regime for the taxation of Australian branches of foreign banks. Then I will examine the corresponding OECD approach contained in the 1984 Report. Finally I will discuss the similarities and differences between the Australian and OECD approaches.

II. BACKGROUND TO THE AUSTRALIAN FOREIGN BANK BRANCH TAXATION MEASURES

On 25 October 1990 the Commonwealth Government referred an inquiry into the Australian banking system to the House of Representatives Standing Committee on Finance and Public Administration, then chaired by Stephen Martin MP ("Martin Committee"). The report of

1. OECD, *Transfer Pricing and Multinational Enterprises*, Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1979), at 7.
2. *Banking Policy Statement*, statement by the Treasurer, the Hon. John Dawkins MP, 18 June 1993. The statement outlines a number of important aspects of Government policy for the banking industry, including the taxation of foreign bank branches in Australia. These proposals will require amendments to the Income Tax Assessment Act 1936 ("ITAA"). It is expected that the legislation giving effect to the BPS will be introduced into Parliament in the 1994 Budget Sittings.
3. In this article I will use the term "foreign bank branch" or "branch" instead of the term "permanent establishment" used in the *OECD Model Tax Convention on Income and on Capital* (Paris: OECD, 1992). ("OECD Model").
4. Intrabank transactions are transactions between a head office and its overseas branches or between the overseas branches.
5. The branch's financial records.
6. OECD, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, Report of the OECD Committee on Fiscal Affairs (Paris: OECD, 1984). The second paper in this publication is entitled "The Taxation of Multinational Banking Enterprises", and Chapter III "Banking and Financial Enterprises Operating Through Branches" (at 55-69) describes the method by which branches of international banks should be taxed. This is the only part of that report that I will be examining in this article.

© 1994 International Bureau of Fiscal Documentation

the Martin Committee, titled "A Pocket Full of Change"[7] was tabled in November 1991. The Martin Committee recommended that foreign banks be permitted to operate in Australia as branches.[8]

In the 1992 *One Nation*[9] statement, the Prime Minister, the Hon. Paul Keating MP, announced that the Commonwealth Government had taken the opportunity to "address some of [the Martin Committee's] major findings, so as to continue the process of making the financial sector more competitive and more flexible".[10] The statement[11] allows foreign banks to operate wholesale banks[12] in the form of branches in Australia. Prior to this statement, wholesale banking business could only be carried on in Australia through an Australian subsidiary[13] with a banking authority.[14] The 1992 *One Nation* statement did not however, deal with the taxation of foreign bank branches. As stated above, the Treasurer announced the tax treatment of foreign bank branches in the BPS.[15]

III. THE AUSTRALIAN FOREIGN BANK BRANCH TAXATION MEASURES

The measures I will be dealing with in this article are those described in the BPS[16] as the "ongoing taxation measures".[17] These measures provide the mechanisms for determining the Australian taxable income of a branch of a foreign bank operating in Australia. In this article I will examine the following taxation aspects of the BPS: determining a branch's deduction for intrabank interest, the notional equity requirement and the application of IWT to intrabank interest.

A. Calculation of the intrabank interest deductions of the Australian branch of a foreign bank

The BPS stated that an important element in the calculation of a foreign bank branch's profit is its interest expense[18]. If a foreign bank provides funds for use in its Australian branch, the branch will be allowed a deduction against its assessable income in Australia, for interest on those funds. It was initially thought that this allocation to the Australian branch of part of the foreign bank's interest expense could be achieved through a statutory formula. The formula approach was rejected after the banking industry stated that because of the complex nature of their worldwide operations, such a system would not be commercially feasible and would be administratively complex.[19]

The BPS stipulated that the Commonwealth Government had decided to accept a branch's books as a starting point for the calculation of a branch's interest deduction.[20] The intrabank interest expense shown in a branch's books is subject to a "ceiling deduction" of the London inter-bank offer rate ("LIBOR")[21] prevailing at the time of the transaction.[22] Intrabank interest up to, and at, LIBOR is an allowable deduction against the gross income of the branch. Any intrabank interest paid by a branch that exceeds the LIBOR ceiling will be disallowed as a deduction.

B. The notional equity of the Australian branch of a foreign bank

The BPS stated that branches of foreign banks will be required to have a certain level of equity funding[23] in their Australian operations[24]. The proposal is to treat a portion of an Australian branch's funding as equity funding. The banking industry submitted that the Australian branches of foreign banks would be funded exclusively from debt. In addition, Australian branches of foreign banks are not required to maintain the same level of equity capital in Australia as subsidiaries of foreign banks.[25] After considering the banking industry submissions,[26] the Commonwealth Government decided to give effect to the notional equity requirement by treating part of the branch's debt funding as equity and accordingly denying a deduction for the interest on this notional equity component.

7. Parliament of the Commonwealth of Australia, The House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change: Banking and Deregulation* (Canberra: AGPS, 1991).
8. *Id.* (Recommendation 11), at 160.
9. *One Nation* statement by the Prime Minister, the Hon. Paul Keating MP, 26 February 1992 (Canberra: AGPS, 1992).
10. *Id.* at 68.
11. *Id.* at 69.
12. Under the wholesale bank requirement, a branch of a foreign bank will be permitted to accept deposits and any other funds in any amount from: incorporated entities, non-residents and employees of the bank. The branch will not be allowed to accept initial deposits for amounts which are less than $ 250,000. Foreign bank branches are also required to disclose to their customers that the depositor protection provisions, Secs. 12-16 of the Banking Act 1959, do not apply to them. (Reserve Bank of Australia, "Policy Details on Foreign Banks", Press Release, No 92-13, issued 21 May 1992.)
13. Many aspects of wholesale banking may be undertaken by Australian subsidiaries, known as "merchant banks", without a banking authority and not subject to the supervision of the Reserve Bank of Australia. This article will not be focusing on the tax treatment of merchant banks.
14. Banking authorities are issued under Sec. 9 of the Banking Act 1959.
15. See *supra*, note 2.
16. BPS, *supra* note 2, Attachment A, at 4-6.
17. The BPS also sets out the "transitional taxation measures" dealing with special rules for an existing subsidiary transferring its business to an Australian branch of a foreign bank. These transitional measures have already been enacted in the Financial Corporations (Transfer of Assets and Liabilities) Act 1993.
18. BPS, *supra* note 2, Attachment A, at 4.
19. The concerns of the banking industry with the formula approach were expressed in two press articles on a speech I presented to the "Foreign banks in Australia" conference, 10-11 September 1992, Sydney, organized by AIC Conferences. ("Comments by tax officer send temperatures rising", *The Australian Financial Review* (11 September 1992), at 32 and "'New Wave' banks tipped to woo disgruntled business", *The Australian Financial Review* (14 September 1992), at 30).
20. BPS, *supra* note 2, Attachment A, at 4.
21. LIBOR is a benchmark offer rate. The rate is usually set daily by sampling the offer rates of a number of reference banks in London. LIBOR is used as the main interest rate benchmark in the Eurodollar market. While there is no single official LIBOR, information services, such as Reuter Monitor Money Rates Service, quote a LIBOR.
22. The BPS referred to the ceiling of LIBOR and the London interbank bid rate. Following submissions from the banking industry that LIBOR is the appropriate ceiling, it is anticipated that this will be accepted by the Commonwealth Government.
23. Also called shareholders' equity or owners' equity.
24. BPS, *supra* note 2, Attachment A, at 5.
25. "In satisfying the Reserve Bank's ongoing prudential requirements, foreign bank branches will *not* be required to maintain "endowed capital" in Australia and, consequently, the [Reserve] Bank will not impose any capital-based large exposure limits. These will be the responsibility of the home country supervisor", (Reserve Bank of Australia, "Policy Changes on Foreign Banks", Press Release No 92-06, 26 February 1992).
26. Three written submissions on the taxation of foreign bank branches were made to the Commonwealth Government.

© 1994 International Bureau of Fiscal Documentation

The basis for the notional equity requirement is that as a branch is part of a foreign bank, the branch should have the same proportion of debt and equity capital as the rest of the bank. The cost of debt is an allowable deduction against the income of a branch whereas a deduction is not available for the use of equity capital. Consequently if the Australian branch is funded wholly by debt from its head office, the branch's intrabank interest deduction will be larger than if it was allocated equity capital.

The Commonwealth Government accepted that it would be very difficult to precisely determine the foreign bank's equity attributable to its Australian branch. To overcome this problem the Commonwealth Government decided to use a simplified system and treat 4 percent of the cost of a branch's funds from all sources as equity capital. This is called the notional equity requirement and applies only for tax purposes. This rule will apply to funding from related parties and third parties. It will also apply to funds obtained from either offshore or onshore sources. The notional equity rule replaces the thin capitalization rules[27] of the income tax law for foreign bank branches. I will illustrate the application of the notional equity requirement in the following example:

Example 1

> Assume that under the new Australian measures the Australian branch of a foreign bank is entitled to an interest deduction of $ 200 million. Assume further that this interest expense is comprised of interest paid to resident third party lenders of $ 50 million and interest paid to non-resident lenders through its head office (intrabank interest) of $ 150 million at LIBOR. The notional equity rule will disallow 4 percent of the branch's total interest expense that would have otherwise been an allowable deduction. Under the notional equity rule, $ 8 million is disallowed as a deduction, reducing the branch's deduction to $ 192 million.

C. Interest withholding tax on intrabank payments of interest

A major aspect of the new branch banking measures is the payment of IWT[28] by foreign bank branches on interest payments paid indirectly to a non-resident through its head office or other overseas branches of the bank (intrabank interest). This approach relies on the notion that interest payments by a branch to other parts of the bank will ultimately be paid to the bank's non-resident third party lenders. The banking industry submitted that these interest payments should not be subject to IWT or alternatively that foreign bank branches should be able to use the Section 128F exemption.[29] In relation to Section 128F there was no satisfactory way of providing the exemption to foreign bank branches without placing at risk Australia's IWT revenue.

As a compromise, the Commonwealth Government decided that foreign bank branches will pay IWT on only 50 percent of interest paid to non-residents through their head office and overseas branches. In addition, a branch's intrabank interest expense that is disallowed as a deduction under the notional equity requirement (discussed above) will not be subject to IWT. The IWT will be applied at a rate of 10 percent to the intrabank interest charged in the branch's books. In other countries the Australian IWT may be either a creditable tax for foreign tax credit purposes or a tax deduction. In the following example I will illustrate how IWT will be applied to interest paid by a branch to its head office or overseas branches of the bank (intrabank interest):

Example 2

> Expanding on the facts in Example 1, where a branch paid interest of $ 150 million to non-resident lenders through the head office of the bank (intrabank interest), the notional equity requirement disallows as a deduction 4 percent of the $ 150 million. Thus the branch's interest deduction is reduced by $ 6 million to $ 144 million. IWT is applied to half of the deductible interest paid to the head office, and consequently $ 72 million will be subject to IWT at a rate of 10 percent. This will require the branch to pay $ 7.2 million IWT.

IV. THE 1984 REPORT: TAXATION OF MULTINATIONAL BANKING ENTERPRISES

As international banking enterprises prefer to operate around the world through branches rather than subsidiaries, the OECD Committee on Fiscal Affairs issued the 1984 Report dealing with, *inter alia*, the problems that arise in the taxation of international bank branches.[30] The parts of the 1984 Report that I will be examining are the application of the arm's length principle to intrabank interest paid by a branch to either its head office or overseas branches and the application of IWT to intrabank interest.

A. Background on the development of the arm's length principle by the OECD

In 1979 the OECD Committee on Fiscal Affairs published a report titled *Transfer Pricing and Multinational Enterprises* ("1979 Report")[31] on establishing an arm's length price for tax purposes for transactions between associated enterprises. The 1979 Report expressly stated that it did not deal with loans between enterprises engaged in banking or financing activities as part of their ordinary business.[32] The purpose of the 1984 Report is to supplement the 1979 Report by providing a detailed consideration of the treatment of intrabank interest for tax purposes in relation to international banks and financial corporations.

27. Division 16F of Part III of the ITAA.
28. BPS, *supra* note 2, Attachment A, at 4-5.
29. Sec. 128F of the ITAA exempts from IWT the interest paid to non-residents on certain widely distributed debentures issued overseas by companies resident in Australia. The requirement that the borrower be a resident of Australia prevents foreign bank branches, which are non-residents for tax purposes, from having access to this exemption.
30. 1984 Report, *supra* note 6, "The Taxation of Multinational Banking Enterprises", Chapter III "Banking and Financial Enterprises Operating Through Branches", at 55-69.
31. 1979 Report *supra* note I
32. *Id.*, at paras 181 and 198.

© 1994 International Bureau of Fiscal Documentation

B. Arm's length profit: Article 7 of the OECD Model

The 1984 Report commences with the general procedure contained in Article 7 of the OECD Model for attributing the profits of an international enterprise to a permanent establishment (branch). Article 7(2) and (3) state that:

> 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
>
> 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

The Commentary to the OECD Model says that there are some classes of payments between branches and head offices that require special treatment.[33] In relation to interest, the OECD commentary indicates that "special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances, etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises".[34] The Commentary then states that if an enterprise makes payments of interest to a third party and the payments are in part attributable to the activities of a branch, then a proportionate share of the cost should be taken into account in calculating the branch's profits. The Commentary does not cite any other reasons for taking this approach.

C. The OECD approach to determining a branch's intrabank interest deduction

The 1984 Report states that the majority of OECD Member countries[35] take the view that intrabank payments of interest must be taken into account in calculating the arm's length profits of a branch of an international bank. It is argued that this treatment of interest ensures that the taxation of the profits of a foreign bank branch is consistent, in principle, with the taxation of the profits of branches of other international companies. The reasons for the majority of OECD Member countries taking this view of intrabank interest are stated in paragraphs 48 and 49, of that report.

Paragraph 48 states that banks dealing independently with third parties pay interest to customers and receive interest from customers as an essential part of banking business. In this situation Article 7 requires intrabank payments of interest to be taken into account in assessing the profits of a branch.

Paragraph 49 states that the second reason for this approach is because of the nature of banking business. As the nature of banking is to borrow and lend money for profit making purposes:

> there is every reason to suppose that by far the greater part of money lent by head office to a branch and vice versa and money lent by one branch to another will in fact have been borrowed at some stage from an independent third party and will be lent eventually to independent third parties. Thus, the interest taken into account can be regarded as representing real outgoings or receipt of the enterprise as a whole and from the pragmatic point of view, to take account in this context of all intrabank interest payments ... produces a result consistent with that spelled out in the Commentary on Article 7 in the case of enterprises not carrying on the business of borrowing and lending money. These are the "special circumstances" related to banking activities, which have also been characterized in paragraphs 21-23[36] above.[37]

The 1984 Report does not state in detail why bank branches are entitled to receive a deduction because of these "special circumstances". It may be argued that the treatment proposed in the 1984 Report is merely a normal application of Article 7(3) of the OECD Model. Under Article 7(3) where a branch has used funds borrowed from third parties by another part of the bank it should bear the interest paid by the bank to these third parties:

> The only difference . . . is that for banks, for pragmatical reasons, it is supposed that no artificial loans within the enterprise – loans that do not stem from loans from third parties – are made. Funds used by the permanent establishment are supposed to be either money lent from third parties or capital.[36]

The difference between the treatment of bank and non-bank enterprises is that bank enterprises are allowed to make a profit on intra-corporate loans. This issue is discussed in paragraphs 50 and 51 of the 1984 Report. In the case of non-bank enterprises, if another part of the enterprise borrows funds from third parties for use in one of its branches, only the actual cost of the funds can be attributed to the branch.

For example, if the head office of a foreign bank borrows funds for use by a branch of the bank, the 1984 Report states

33. Commentary on Art. 7, OECD Model *supra* note 3, at C(7)-8 to 9.
34. *Id.*
35. The 1984 Report states that the United States and Japan did not accept the recognition of intra-bank transactions for tax purposes (para. 52). In the case of the United States the position is unchanged: "current IRS rules *completely* disregard the cross-border interbranch trading transactions of international banks even though these transactions are conducted on an arm's length basis (See e.g. Treas. Reg. Sec. 1.863-7(a)(1); Treas. Reg. Sec. 1.988-1(a) (10)). In other words, instead of applying an arm's length standard to interbranch trading transactions, the IRS currently treats the bank as if these transactions had never happened. The result is a discrepancy between tax and economic income that can lead to whipsaw of either the taxpayer or the government". (L.R. Uhlick, "International Bankers Present Position Paper on Cross-Border Interbranch Trading", 93 *TNT* 202-29 (30 September 1993) Submission at 3.)
36. Paras. 21-23 of the 1984 Report deal with the difference between the loan capital of international banks and non-bank enterprises. In general, commercial enterprises borrow money to acquire assets such as premises and equipment. In these enterprises the money borrowed is absorbed into the working capital of the enterprise.
On the other hand, it is contended that a bank accepts deposits from its customers and pays interest on these deposits as part of its normal trading business. The funds of the bank are used to make loans to its customers to generate interest income. The profit margin of the bank on these transactions is the difference between the interest received and the interest paid. Consequently, interest paid by a bank is a fundamental outgoing just as interest received is its business income.
37. 1984 Report, *supra* note 6, at para 49.
38. I.J.J. Burgers, *Taxation and Supervision of International Banks* (Amsterdam: IBFD Publications, 1991), at 456.

© 1994 International Bureau of Fiscal Documentation

that the head office is entitled to transact with the branch at arm's length rates as it would with an independent party:

> The deduction of interest expense calculated by reference to the arm's-length rate of interest for such a loan as if the branch and the head office were independent enterprises would, of itself, produce a figure of profit or loss attributable on the arm's-length basis to the branch, leaving to the head office, where appropriate, its own arm's-length element of the total profit or loss.[39]

Under this approach the head office is entitled to charge the branch a margin in addition to the cost of funds. This point is illustrated by the following example:

Example 3

> Assume that a branch of a foreign bank borrows from a third party at 5 percent and lends the entire amount to its head office at 6 percent. Assume further that 6 percent is the LIBOR and thus an arm's length rate. In this situation the branch is operating as a separate profit centre of the bank and in the same manner as any other independent bank. The branch's profit from this transaction is 1 percent and this amount should be included in its assessable income. If the head office lends these funds to a third party at 8 percent, it will make a 2 percent profit on the transaction. The profit of the bank on this transaction is 3 percent – the difference between the borrowing and lending rates. In this example, under the separate entity method the profit of the branch is 1 percent.

The same approach is taken where the head office borrows and lends the money to the branch at arm's length rates which incorporate a profit margin. The 1984 Report reveals that the majority of OECD Member countries allow international banks to allocate to their branches the cost of funds provided to the branches together with a profit margin that the bank would have charged a third party borrower. Under this approach the head office and branch are treated as notionally independent third parties dealing with each other at arm's length rates. In the case of many banking enterprises the head office and worldwide branches of a bank are separate profit centres and individually accountable. In these circumstances the separate entity method recognizes the economic independence of the branch for tax purposes.

In Article 7(3) of the OECD Model, a deduction is allowed to a branch for the costs incurred by other parts of an enterprise on behalf of the branch. This includes any incidental costs. Article 7(3) allows only the actual third party cost and this would obviously exclude the scope for the head office or other branches of an enterprise to include a profit margin in excess of the actual cost and incidental expenses. In the case of Example 3 above, the entire profit on the transaction would be attributed to the head office without any allocation to the branch. In effect the branch in this example would be entitled to be reimbursed for its interest cost but not entitled to a portion of the profit made by the foreign bank on the loan. This result is problematic as the branch in the example has contributed to the profit margin of 3 percent and arguably should have been allocated an appropriate share of that profit. The branch does not receive an economic reward for its contribution to the bank's profits on the particular loan. This in turn disentitles the country in which the branch is located to tax the branch's notional share of the profits.

D. The specific payments approach – the tracing method

The 1984 Report indicates that the United States and Japan do not accept the conclusions reached by the majority of the OECD Member countries that intrabank payments of interest should be taken into account in determining the profits of a bank branch. The United States and Japan take the view that the majority approach does not reflect the words or apparent intent of paragraph 17 of the Commentary to Article 7 of the OECD Model. This paragraph states that, in general, interest payments between a branch and a head office should not be taken into account and that special considerations apply to intrabank payments of interest.

The approach taken by the United States and Japan strictly applies Article 7(3) where only the cost of funds incurred by the bank to third parties on behalf of the branch and any incidental costs, may be allocated to the branch. This approach necessarily requires the tracing of fund flows within a bank. The head office must identify both the source and amount of funds lent to its branch. It is however, recognized by these countries that because of the complex nature of a bank's transactions and because money is fungible, the identification may be difficult.

An international bank would only be able to trace funds in exceptional circumstances. In the course of normal trading an international bank has a pool of funds, consisting of loan and equity capital, to use in operating its banking business. The pool of funds has numerous sources of debt funding in different currencies at different rates of interest. The advent of derivative products[40] adds a further level of complexity by allowing the bank to convert underlying obligations for either hedging or trading purposes. Therefore it will generally be impossible for an international bank to know precisely the source and cost of funds required under the tracing method. Consequently, under this approach simplification methods are used to estimate the cost of funds provided to a foreign bank branch. Some of the simplification methods look at groups or categories of transactions rather than individual transactions.[41]

Another simplification method is to use average rates of interest paid to unrelated parties in comparable situations. The 1984 Report states that the problems with the tracing approach cannot be ignored and the need for compromise is acknowledged, however "the majority of OECD Member countries are convinced that it does not follow that it is, in principle, permissible to ignore the actual payments of interest by the branch".[42] I assume that the "actual payments of interest" refers to the actual amounts of interest paid by a branch to other parts of the bank rather than the mere reimbursement by the branch to the bank for interest payments to third parties for funds used by the branch. This interpretation is confirmed by the fact that the latter alternative is the

39. 1984 Report, *supra* note 6, at para 50.
40. Derivative products are constructed from existing financial products, including loans, options, futures or forward rate agreements.
41. 1984 Report, *supra* note 6, at para 53.
42. *Ibid.*

© 1994 International Bureau of Fiscal Documentation

approach taken by the United States and Japan – that a branch can only have attributed to it the actual costs incurred to third parties on its behalf by other parts of the bank.

Where an international bank is required to use a simplification of the tracing system, the actual result will vary depending on the system used by the bank. It would appear that recognizing intrabank transactions is the better approach. It may also be argued that there is a higher degree of precision in recognizing intrabank transactions that are at arm's length rates. Moreover, recognizing intrabank transactions is an acceptance of the economic independence of a branch.

E. OECD comments on the application of IWT to intrabank interest

The last paragraph[43] of the 1984 Report directs that the arm's length principle only applies to the determination of the profits of a bank branch. The arm's length principle does not require a branch to deduct IWT from any intrabank interest paid or credited to its head office or overseas branches. It is argued that the application of IWT to intrabank interest would result in the whole banking enterprise being taxed in the country of the branch. The branch would be taxed on the arm's length profit attributable to the branch and any intrabank interest would also be taxed. To require a deduction of IWT on intrabank interest "would be to deny the fact that both parties to the deemed payment are merely parts of the whole enterprise"![44] The 1984 Report does not offer further reasons in support of its approach.

The OECD approach to IWT requires the country in which a branch is located to provide a deduction for intrabank interest in allocating profits to the branch. The denial of a country's right to apply IWT to intrabank interest results in a break of tax symmetry. It also places banks operating through branches in a preferential position to foreign banks operating through subsidiaries in that country. The OECD approach denies a country the right to tax interest sourced in that country and paid overseas in the form of intrabank interest. The OECD acknowledges at paragraph 49 of the 1984 Report that the bulk of a branch's funds provided by its head office will be sourced from loans from independent customers of the head office. If we assume that the branch were to pay interest directly to the head office's lenders and that banks are not exempted from IWT, then IWT would be applied to these interest payments. Under the OECD approach, routing the interest through the head office of the bank will allow a bank to avoid a country's IWT. The OECD approach denies a country the right to tax by IWT intrabank interest interest sourced in that country.

The OECD separate entity approach in the case of intrabank interest deductions attributable to a branch and the single entity approach in the case of IWT appear to be contradictory. The OECD has argued that any intrabank interest paid or credited should be allowed as a deduction as though the branch were a separate entity. On the other hand, in relation to IWT on intrabank interest the OECD changes to the single entity approach and says that IWT cannot be applied because the payments are not real but merely fund transfers within an international bank.

V. COMPARISON OF THE AUSTRALIAN MEASURES AND THE 1984 REPORT

In this part of the article I will compare and contrast the Australian approach to the taxation of foreign bank branches outlined in the BPS and the approach of the majority of the OECD Member countries stated in the 1984 Report.

A. Intrabank interest deduction

Under the BPS intrabank interest is recognized for taxation purposes. In the majority of cases intrabank loans will be provided by the head office to the Australian branch. The reason for this is that the head office will generally be able to obtain funds more cheaply. An Australian branch of an international bank that obtains a loan from its head office will be able to obtain a deduction for the cost of funds shown in its books. For this purpose the branch of the bank is treated as being an entity separate from the rest of the bank. This notional separate entity treatment recognizes the economic independence of a branch of an international bank. The maximum rate of interest allowed as a deduction is LIBOR. Generally the head office will be able to borrow at a rate below LIBOR. Therefore if the branch obtains the funds at LIBOR the head office will be able to make a profit when lending to its Australian branch.

The approach outlined in the 1984 Report is in effect the same. In paragraph 47, the majority of the OECD Member countries accepts that it is "necessary to take account of intrabank payments of interest in ascertaining the arm's-length profits of a branch of a bank".[45] Under the OECD approach if a branch of an international bank pays interest to other parts of the bank, it is entitled to a deduction for these payments. The qualification for recognizing intrabank transactions is that the loans must be at arm's length rates of interest. Intrabank loans at arm's length rates of interest allow the lending part of a foreign bank to produce a profit or loss on these loans.

B. Application of interest withholding tax to intrabank interest

There is a marked difference between the Australian and OECD approaches to the application of IWT to intrabank interest. Under the Australian approach if an intrabank interest deduction is allowed to the branch, IWT should also be applied. The concession given to foreign bank branches is that only half of a branch's intrabank interest will be subject to IWT. The OECD does not accept a country's right to tax

43. *Id.* at para. 87.
44. *Ibid.*
45. *Id.* para. 47.

© 1994 International Bureau of Fiscal Documentation

intrabank interest sourced in the country on the basis that this would subject intrabank fund transfers to tax.

VI. CONCLUSION

The new Australian regime for the taxation of foreign bank branches uses the single entity approach and does not formally recognize intrabank transactions. The Australian branch is not treated as being separate and distinct for tax purposes. In effect the Australian branch's payments of intrabank interest are recognized on the basis of being the only objective and efficient method of allocating to the branch its share of the bank's worldwide cost of funds. This recognition of intrabank interest allows other parts of the bank to charge the Australian branch a margin on the loans as they would any other borrower. The branch may pay an interest rate up to and at the LIBOR ceiling – which is internationally recognized as being an arm's length rate. At a conceptual level, the Australian approach is at odds with the OECD separate entity approach stipulated in the 1984 Report. Under the separate entity approach intrabank loans must be at arm's length rates and consequently it is accepted that a branch may be charged a profit margin as would any third party. The result is that in effect there is little difference between the Australian and OECD approaches.

The major difference between the OECD and the Australian regime in relation to interest is that Australia asserts the right to apply IWT to any payments of interest by an Australian branch to either its head office or an overseas branch. On the issue of IWT the OECD reverts to a single entity approach and argues that IWT cannot be applied to intrabank interest because this would subject intrabank fund transfers to taxation.

TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

- **Looseleaf in 10 volumes**
- **Updated 12 times a year**
- **38 countries covered**
- **Includes treaties**

Forms of doing business
Exchange control
Investment laws
Taxation of companies including special entities and businesses
Property and wealth taxes
Registration and licence (stamp) duties
Taxes on goods and services
Payroll taxes
Anti-avoidance provisions
Tax rates
Establishment and expansion of business, liquidation, amalgamation and mergers
Investment income
Group taxation
Tax-related incentives for investment
Tax treaties (full texts in English)
Bibliography

NLG 2,800, including basic volumes, binders, updates for 1994, postage by air and packing.
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD PUBLICATIONS BV
P.O. Box 20237 • 1000 HE AMSTERDAM • THE NETHERLANDS
Tel. +31 (0)20 626 7726 • Fax +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

PEOPLE'S REPUBLIC OF CHINA

IMPLEMENTING REGULATIONS FOR THE NEW INDIVIDUAL INCOME TAX LAW

Jinyan Li

Assistant Professor, Faculty of Law, University of Western Ontario.

The author wishes to thank Professor Tim Edgar and Carol Hargreaves for their comments on the earlier drafts of the article.

I. INTRODUCTION

The regulations for the implementation of the new individual income tax law (the "New IIT")[1] were introduced on 29 January 1994.[2] The new IIT regime replaces three previous taxes levied on individuals.[3]

An article analysing the New IIT Law was published in the *Bulletin*.[4] As discussed in the article, the New IIT law is a brief statute that, like many Chinese laws, leaves most key issues of interpretation to implementing regulations. The New IIT Regulations deal with many of the important questions, while leaving some unanswered. This article discusses major provisions under the new regulations.

II. MAJOR PROVISIONS

Chinese tax legislation generally takes two forms: statutes passed by the National People's Congress and implementing regulations adopted by the State Council. In China, implementing regulations are generally drafted in more detail than the law itself; they constitute as important a part of the tax legislation as the tax statute. The State Council is generally authorized not only to interpret the law, but to introduce new provisions within the legislative purposes of the law.

In keeping with the style of Chinese legislation, the New IIT Regulations contain 47 articles, whereas the New IIT Law has only 14. The New IIT Regulations flesh out the provisions under the New IIT Law with respect to who is liable to tax, what income is taxable and what expenses are deductible in computing taxable income. As required under the New IIT Law, the New IIT Regulations also specify the rate of surtax applicable to income from personal services and the amount of additional deductions in computing income from wages and salaries.

A. Liability to tax

Article 1 of the New IIT Law provides that an individual is liable to tax if he or she is domiciled in China, resides in China for a full year or derives income from Chinese sources. The terms "domicile", "residence" and "source of income" are now, to some extent, defined under the New IIT Regulations.

1. Domicile (*zhu suo*)

An individual domiciled in China is liable to tax on his or her worldwide income.[5] Under Article 1 of the New IIT Regulations, the concept of "individuals domiciled in China" is defined as individuals who, as a result of household registration, family or economic interests, "habitually" reside in China.[6] "Domicile" thus refers to habitual abode or permanent place of residence. Intention or reason for keeping a domicile in China also seem to be relevant in determining whether a person is domiciled in China.

Chinese citizens: Although citizenship or nationality is not directly used as a basis for taxation in China, it is a very important factor in determining whether an individual is domiciled for purposes of the New IIT. Chinese citizens are generally required under law to maintain a household registration in China and are consequently domiciled in China by

1. Individual Income Tax Law of the People's Republic of China, adopted by the 4th Session of the Standing Committee of the 8th National People's Congress on 31 October 1993 and promulgated by the President on the same date (hereafter the "New IIT Law").
2. Implementing Regulations for the Individual Income Tax Law of the People's Republic of China, issued by the State Council on 29 January 1994 (hereafter the "New IIT Regulations").
3. The New IIT was intended to consolidate and replace three previous taxes on personal income:
(a) the Individual Income Tax Law of the People's Republic of China, adopted by the 3rd Session of the 5th National People's Congress and promulgated 10 September 1980 (hereafter the "Old IIT Law"); Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China, approved 10 December 1980 by the State Council and promulgated 14 December 1980 by the Ministry of Finance (hereafter the "Old IIT Regulations");
(b) Interim Regulations of the People's Republic of China on Individual Income Regulatory Tax, promulgated on 25 September 1986 by the State Council (hereafter the "IIRT Law"); Detailed Rules and Regulations for the Implementation of the Interim Regulations of the People's Republic of China on Individual Income Regulatory Tax, promulgated by the Ministry of Finance on 10 December 1986 (hereafter "IIRT Regulations");
(c) Household Income Tax (1986) imposed on business income derived by industrial and commercial proprietorships operated by individuals Interim Regulations of the People's Republic of China Concerning Income Tax on Individually-Operated Industrial and Commercial Households, promulgated by the State Council on 7 January 1986.
4. Jinyan Li, "New Individual Income Tax – Unified Taxation of Citizens and Foreigners", 48 *Bulletin for International Fiscal Documentation* (February 1994), at 64.
5. New IIT Law, Art. 1.
6. New IIT Regulations, Art. 2.

© 1994 International Bureau of Fiscal Documentation

reason of the place of household registration. However, since the definition of domicile requires that a person domiciled in China habitually resides in China, citizens who live permanently outside China will not be considered domiciled in China. Citizens who work or live in a foreign country for a period of time while maintaining economic and family connections with China, and who live in China from time to time, may be considered to be domiciled in China. Whether a Chinese citizen is taxed as a domiciliary depends on the meaning of "habitual stay", which is undefined under the New IIT Regulations.

Foreigners: Foreigners may be considered to be domiciled in China if they make China their permanent home, rather than a place of work or temporary stay. To date, the Chinese government has not granted permanent residence status to many foreign individuals. Foreigners are normally issued a visa or residence permit to visit or stay in China, and are generally taxed on the basis of residency rather than domicile.

2. Residence (*ju zhu*)

Under the New IIT regime, individuals are also liable to tax on the basis of residency. The concept of "residence" is not defined under the New IIT legislation. The term has been interpreted to mean "physical stay" for the purposes of the Old IIT. The period of residency is calculated by counting the number of days of actual presence in China.[7] Where a taxpayer's stay in China straddles two tax years, the stay for each year is calculated separately.

The tax liability of foreign individuals depends on the length of their stay in China. Foreigners who live for one year or more in China are generally subject to Chinese tax on their worldwide income. Non-residents and individuals who reside in China for less than one year are taxed only on Chinese-source income (the "one-year rule"). Certain exceptions to the one-year rule were provided under the Old IIT regime, not all of which will continue under the New IIT Regulations.

(a) *One-year rule*

An individual is considered to have stayed in China for one year if he or she stayed in China for 365 days in a tax year. A tax year is defined to be a calendar year.[8] For the purposes of the one-year rule, temporary absences, which are defined as absences not exceeding 30 days at any one time, or an aggregate not exceeding 90 days in a tax year, are not subtracted in computing the period of stay.[9]

Individuals staying in China for one year or more will be subject to a different regime under the New IIT than in the past. Regardless of whether or not they remit non-Chinese source income to China, their worldwide income will be taxable. However, as was the case under the Old IIT regime, those who stay in China for one year or more, but not more than five years, may, upon approval by the tax authorities, pay Chinese tax only on non-Chinese-source income that is paid by a company, enterprise or individual in China.[10] Under the one-year rule, income received from companies or institutions outside China, if not remitted to China, is not taxable.[11] Foreigners who stay in China for more than five years are taxable on their worldwide income, with no exceptions and irrespective of the reason for the long-term residency.[12] Under the Old IIT system, foreign-source income was exempt from tax if the foreigner's presence was attributable to his or her employment by a foreign enterprise, joint venture, cooperative joint venture or wholly foreign-owned enterprise in China, and if the individual had no general intention to take up long-term residency in China.[13] The new rule may force foreign individuals to limit their stay in China to a maximum of five years in order to avoid taxation on worldwide income in China.

(b) *90-day rule*

The New IIT, like the Old IIT, taxes individuals whose residency in China is less than one year only on Chinese-source income. The special rule for those who stay in China for no more than 90 days – the 90-day rule – will continue under the new system. Under this rule, individuals resident in China for an aggregate of 90 days or less during the year are taxed on their Chinese-source income, but are exempt from tax on any compensation paid by an employer outside China for services performed within China as long as the compensation is not borne by the employer's China establishment. This exception applies to Chinese-source wage and salary income earned during the stay in China.[14] Since the 90-day rule is limited to wage and salary income, it obviously does not apply to foreigners who earn other types of income that are considered to be from Chinese sources under the Chinese source rules.

The 90-day rule is commonly modified by tax treaty. In that case, if the employer is a non-resident enterprise and the taxpayer is not present in China for more than 183 days in a calendar year, his or her employment income is not taxable in China.[15] Therefore, the 90-day rule will apply only to resi-

7. Old IIT Regulations, Art. 5(1).
8. New IIT Regulations, Arts. 3 and 44.
9. New IIT Regulations, Art. 3. Temporary absences from China during the taxable year were subtracted in calculating the period of stay in China for purposes of the one-year or more residency provision. Prior to 1988, however, foreigners with one-year residence permits or visas who left China and returned during the effective period of their permits or visas (including extensions approved after entry) were considered residents of China for one full year regardless of the amount of time actually spent abroad. See Ministry of Finance Notice (81) *Cai Shui Zi* No. 185 of 2 June 1981.
10. New IIT Regulations, Art. 6.
11. *Id.*
12. *Id.*
13. This exception was contained in an interpretive notice issued by the Ministry of Finance. See Ministry of Finance Notice Regarding the Exemption from Reporting and Payment of Individual Income Tax for Income Gained Outside China by Personnel of Foreign Nationality Working in China, (83) *Cai Shui Zi* No. 62 of 7 March 1983.
14. Old IIT Law, Art. 2; Old IIT Regulations, Art. 4(4).
15. See, for example, Agreement between the Government of the People's Republic of China and the Government of the United Kingdom of Great Britain and Northern Ireland for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on 26 July 1984 (hereafter the "China–UK Treaty"), Art. 16; and Agreement between the Government of the People's Republic of China and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, signed on 30 April 1984 (hereafter the "China–US Treaty"), Art. 14.

© 1994 International Bureau of Fiscal Documentation

dents of countries or regions that have not concluded tax treaties with China, such as Hong Kong, Taiwan and Macao.

Individuals who reside in China for more than 90 days, but less than one year, are taxable on income from Chinese sources, regardless of where the income is paid.

3. Dual residency

The problem of dual residency and double taxation may occur where foreign individuals who reside in China for more than one year are taxable on their worldwide income both in China and in the home country, if the home country imposes taxes on the basis of residency. The problem can be resolved where the individual's home country has a tax treaty with China. Under the standard tiebreaker rules contained in tax treaties, an individual is generally deemed to be resident in the country in which he or she has a permanent home or maintains closer residential ties.[16] Because most foreign individuals working in China do not take up permanent residence in China and maintain residential ties with their home country, under the tax treaties, these individuals will not be considered to be resident in China and will thus be taxable only on their Chinese-source income.

4. Source rules

Chinese-source income earned by foreigners is subject to tax under the New IIT. The New IIT Regulations have re-enacted the source rules under the Old IIT. These source rules are similar to those adopted in other countries. Chinese-source income is defined to include the following:[17]

- income from office or employment and compensation for services performed in China;
- rent for the lease of property for use in China;
- gains from the transfer of buildings, land-use rights and other property that are situated in China, and gains from the transfer of other property in China;
- fees for the use of proprietary rights in China; and
- interest, dividends and bonuses paid by companies, enterprises and other economic organizations in China.

Chinese source income is considered to have been "gained" in China regardless of actual payments being made in China or abroad.[18] Chinese-source income is computed separately from foreign-source income.[19]

B. Taxable income

Under the New IIT Law, nine categories of income are specified as taxable.[20] The scope of each category is defined under the New IIT Regulations.

1. Wages and salaries

"Wages and salaries" is defined to refer to wages, salaries, bonuses, year-end extras, labour dividends, benefits, allowances and other income earned by an individual from office or employment.[21] No further interpretation of the terms "labour dividends", "benefits" and "allowances" is provided under the New IIT Regulations.

Income from wages or salary is taxed at progressive rates ranging from 5 to 45 percent.[22] Taxes are generally withheld by employers on a monthly basis. An exception is provided for wages and salaries derived from industries such as mining, ocean shipping and fishing. Taxes on these salaries and wages may be levied on an annual basis and paid by monthly instalments.[23] Since wage income is taxed monthly at progressive rates, income averaging during a tax year is permitted in computing the monthly tax liability.

2. Income from production and business

IIT is imposed at progressive rates ranging from 5 to 35 percent on income from business and production. The New IIT Regulations define "income from production and business earned by individual households" as income derived from activities in industry, handcrafts, construction, transportation, commerce, catering, services, repair and maintenance, and other businesses such as education, health care and consulting.[24]

Costs, expenses and losses are deductible in computing taxable income from production and business. The concept of "costs and expenses" is defined as costs and expenses related to production and business, including marketing, management and administrative expenses. The term "loss" is defined as additional expenses incurred in the course of production and business, rather than as business losses sustained in other tax years.[25] Unlike the income taxes applicable to enterprises that allow a five-year loss carry-forward,[26] the IIT regime does not permit any loss carry-over for individuals.

Where a taxpayer keeps no or inadequate accounting records, the tax authorities are authorized to assess the taxpayer's taxable income.[27] The assessment is generally based on the average profit made by similar businesses during the same period of time.

3. Management or contractual fees

"Management fees from contracted operations or leasing of enterprises and institutions" refers to compensation in the nature of salaries or wages, paid on a monthly basis or according to each performance, received by an individual for contracting, or sub-contracting with an enterprise or institu-

16. China–US Treaty, Art. 4.
17. New IIT Regulations, Art. 5; Old IIT Regulations, Art. 5.
18. New IIT Regulations, Art. 5.
19. New IIT Regulations, Art. 30.
20. New IIT Law, Art. 3.
21. New IIT Regulations, Art. 8(1).
22. New IIT Law, Art. 3(1).
23. New IIT Law, Art. 9, para. 2; New IIT Regulations, Art. 38.
24. New IIT Regulations, Art. 8(2).
25. New IIT Regulations, Art. 17.
26. Provisional Regulations of the People's Republic of China on Enterprise Income Tax adopted by the State Council on 26 November 1993 and promulgated on 13 December 1993, Art. 11; Law of the People's Republic of China concerning Income Tax on Foreign Investment Enterprises and Foreign Enterprises passed by the 4th Session of the 7th National People's Congress on 9 April 1991 and promulgated on the same date, Art. 11 (hereafter "Foreign Income Tax Law").
27. New IIT Regulations, Art. 17.

© 1994 International Bureau of Fiscal Documentation

tion, to manage or operate the business of the enterprise or institution.[28]

Income from management or contractual fees is taxed on an annual basis net of related expenses. Unlike income from business and production, however, "expenses" deductible in computing income from management or contractual fees are not considered to be business expenses, instead, it refers to "the amount of monthly deduction of 800 yuan that is allowed for computing taxable income from wages and salaries".[29] In other words, in computing taxable income, an aggregate of the 12-month deduction of 800 yuan (annually 9,600 yuan) is allowed regardless of the actual amount of expense incurred in earning such income.

The treatment of management fees under the New IIT differs from the treatment of both wage income and business income. With respect to the deduction for expenses in computing taxable income, management fees are treated the same as wage income, and the deduction is limited to 800 yuan per month; whereas in computing taxable income from business, all costs and expenses incurred for the purposes of earning income are deductible and the amount of the deduction is not limited. With respect to the calculation of tax liability, however, management fees are treated the same as business income: taxable income is computed on an annual basis and taxed at the same progressive rates ranging from 5 to 35 percent,[30] whereas wage income is taxed on a monthly basis at higher rates.

Currently, individuals who enter into management contracts with the responsible government department to manage a state enterprise are generally former employees of the enterprise. It is therefore reasonable to apply the same rules with respect to deductions to wage income and management income. It is not clear from a policy perspective why management fees are taxed at lower rates than wage income.

4. Remuneration for personal services

"Remuneration for personal services" refers to remuneration received for providing designing, decorating, installation, drafting, testing, medical treatment, law practice, accounting, consulting, lecturing, news reporting, broadcasting, interpretation, editing, calligraphy and painting, sculpture, cinema, audio recording, video recording, performance, advertising, exhibitions, technical services, intermediary services, agency, brokerage and other services.[31]

Remuneration for personal services performed in China is taxable irrespective of the place of payment,[32] and is taxable on a per-payment basis.[33] Certain statutory deductions are allowed. If a single payment is 4,000 yuan or less, the deduction is 800 yuan; for a single payment exceeding 4,000 yuan the deduction is 20 percent of the payment.[34] Therefore, the amount of deduction is the lesser of 800 yuan and 20 percent of each single payment.

A "single payment of remuneration for professional services" is defined as income from a lump-sum payment or income earned from performing a single piece of work.[35] Payments of a continuing nature relating to the same item of income that cannot be divided into separate payments may be aggregated with respect to all such payments received within a month and counted as a single payment.[36]

Whereas wage income, business income and management fees are subject to progressive taxation, income from professional services is taxed at a flat rate of 20 percent.[37] In order to make the taxes on professional income more progressive, a surtax is imposed where a particular payment is "abnormally high". The New IIT Regulations provide that a payment is considered "abnormally high" if the taxable amount (net of the statutory deduction) exceeds 20,000 yuan.[38]

Additional tax is imposed at the following rates:

- 50 percent of the regular tax payable on taxable income exceeding 20,000 yuan, but not more than 50,000 yuan;
- 100 percent of the regular tax payable on any amount of taxable income exceeding 50,000 yuan.[39]

In other words, where the amount of taxable income from a single payment of professional income is more than 20,000 yuan, but less than 50,000 yuan, tax is levied at a combined rate of 30 percent (20 percent regular tax plus 50 percent of the regular tax); where the taxable amount exceeds 50,000 yuan, tax is levied at a combined rate of 40 percent (20 percent regular tax plus 100 percent of the regular tax). The tax burden on professional income is thus higher than the tax burden on wage income and business income: wage income is not taxed at 40 percent unless the taxable amount exceeds 80,000, and business income is taxed at the marginal rate of 35 percent.

5. Rent and royalties

The definition of "rental income" includes amounts received by individuals for the lease of buildings, land-use rights, machinery and equipment, vehicles and vessels and other property.[40] Rental income is taxed on a single-payment basis. A single payment for rental income refers to income from amounts paid during a month for the use of the rental property.[41] A statutory deduction of the lesser of 800 yuan or 20 percent of each payment is allowed in computing the taxable income. Taxable income is taxed at the flat rate of 20 percent.[42]

Royalties include both authors' royalties and royalties for the transfer or licence of technology or other proprietary rights. "Authors' royalties" refers to remuneration received by individuals for the publication of their works in books, journals or magazines.[43]

28. New IIT Regulations, Art. 8(3).
29. New IIT Regulations, Art. 18.
30. New IIT Law, Art. 3(2).
31. New IIT Regulations, Art. 8(4).
32. New IIT Regulations, Art. 5(1).
33. New IIT Law, Art. 3(4).
34. New IIT Law, Art. 6(4).
35. New IIT Regulations, Art. 21(1).
36. *Id.*
37. New IIT Law, Art. 3(4).
38. New IIT Regulations, Art. 11.
39. *Id.*
40. New IIT Regulations, Art. 8(8).
41. New IIT Regulations, Art. 21(4).
42. New IIT Law, Art. 3(5). This rate is normally reduced under tax treaties.
43. New IIT Regulations, Art. 8(5).

© 1994 International Bureau of Fiscal Documentation

The term "fees for the right to use proprietary rights" is similar to the concept of "royalties" used in tax treaties. It is defined to include income received for the transfer of the right to use patents, trade marks, copyrights,[44] know-how and other proprietary rights.[45]

Both authors' royalties and fees for the right to use proprietary rights are taxed on a single-payment basis.[46] A "single payment for authors' royalties" is defined as income from each payment for each publication; a "single payment for fees for the use of proprietary rights" refers to income from a lump-sum payment for each transfer of the right to use proprietary rights.[47] As is the case with income from personal services, a deduction of the lesser of 800 yuan and 20 percent of each single payment is allowed in computing taxable income.[48] No deduction is allowed for related costs and expenses.[49] Unlike income from personal services, no surtax is imposed. Where rents and royalties are paid to non-residents, tax is generally withheld by the payer on the gross amount.[50]

6. Interest and dividends

Under the New IIT, income from property is taxed differently, depending on whether the income is from the use of tangible property or from the use of money and intangible property. As discussed above, rental and royalties are taxed at a flat rate of 20 percent on a net basis. Interest and dividend income is taxed at a flat rate of 20 percent[51] of the gross amount received.[52] No deduction is allowed for carrying charges and other costs of earning such income.

"Interest, dividends and bonus dividends" is defined under the New IIT Regulations as amounts received by individuals for their debt or equity investment.[53] Tax on interest and dividends is levied on the basis of each single payment. A single payment for interest and dividends refers to every payment received by the taxpayer.[54]

Certain types of interest are specifically exempt from tax, such as interest on savings deposits, government bonds and financial bonds issued by the State.[55] The New IIT Regulations provide no further exemptions.[56] Dividends paid by a joint venture or wholly foreign-owned enterprise are exempt from tax under the Foreign Enterprise Income Tax.[57] Dividends from joint ventures were also exempt from tax under the Old IIT Regulations.[58] It has been reported that non-Chinese residents who purchased shares of Chinese companies through the Hong Kong stock exchange were exempt from the 20 percent withholding tax under the Old IIT. It is not clear why the New IIT Regulations provide no exemption for dividends paid to foreign investors. It is likely, however, that the State Council or the Ministry of Finance will introduce similar exemptions in the near future in order to encourage foreign investment in Chinese enterprises, especially state-owned enterprises that are seeking to attract equity investment from abroad.

7. Capital gains

(a) *General*

Capital gains are taxed at the flat rate of 20 percent.[59] "Gains from the transfer of property" refers to income received by individuals from the transfer of securities, shares, buildings, land-use rights, machinery and equipment, vehicles, vessels and other property.[60]

The terms "gains" or "income from the transfer of property" refer to proceeds from the transfer of property in excess of the original cost of the property and reasonable expenses.[61] "Original cost of the property" is defined to mean:

- for securities, the purchase price plus any expenses incurred in relation to the purchase;
- for buildings, the cost of construction or acquisition cost plus relevant expenses;
- for land-use rights, the aggregate of the amount of cost incurred on obtaining the right to use the land, cost on land development and other relevant expenses;
- for machinery, equipment, vehicles and vessels, the aggregate of acquisition cost, transportation cost, installation cost and other relevant expenses; and
- for other property, the cost determined by reference to the above methods.[62]

Under the New IIT Regulations, the concept of "reasonable expenses" for the purposes of calculating capital gains is defined as selling expenses that must be paid according to relevant laws and regulations.[63]

(b) *Gains from the sales of shares*

Gains from the transfer of shares and real estate may be taxed separately. The New IIT Regulations provide that gains from the transfer of shares will be taxable under special rules to be introduced by the Ministry of Finance.[64]

(c) *Gains from the sales of real estate*

Gains from the transfer of real estate are taxable under the New IIT. These gains may also be taxable under the newly-

44. Fees from the transfer of copyright do not include authors' royalties; New IIT Regulations, Art. 8(6).
45. New IIT Regulations, Art. 8(6).
46. New IIT Law, Art. 6(4).
47. New IIT Regulations, Art. 21(2) and (3).
48. New IIT Law, Art. 6(4).
49. In practice, the Chinese tax authorities may allow deductions for property taxes, maintenance and repair costs. See State Tax Bureau Notice *Guo Shui Han Fa* (1990) No. 1236 of 10 October 1990.
50. Old IIT Regulations, Art. 11.
51. New IIT Law, Art. 3(5). Tax treaties normally reduce the rate to 10 or 15%.
52. New IIT Law, Art. 6(6).
53. New IIT Regulations, Art. 8(7).
54. New IIT Regulations, Art. 21(2)-(6).
55. New IIT Law, Art. 4(2); New IIT Regulations, Art. 12.
56. See *South China Sunday Morning Post* (China Business Review), 26 September 1993, at 1. Tsingdao Brewery, Shanghai Petro-Chemical, Guangzhou Shipyard and Beiren Printing have all listed shares in Hong Kong. Maanshan Iron and Steel Company and Kunming Machine Tool Plant are expected to do the same.
57. Foreign Income Tax Law, Art. 19(1).
58. Old IIT Regulations, Art. 5(2).
59. New IIT Law, Art. 3(5).
60. New IIT Regulations, Art. 8(9).
61. New IIT Law, Art. 6(5).
62. New IIT Regulations, Art. 19.
63. New IIT Regulations, Art. 20.
64. New IIT Regulations, Art. 9.

© 1994 International Bureau of Fiscal Documentation

introduced Real Estate Value Added Tax ("REVAT").[65] REVAT is similar to a tax on excessive profits from land speculation, and was introduced to regulate the growing real estate market in China. It applies to all individuals and entities that realize gains from the transfer of real estate.[66] For the purposes of the REVAT, "real estate" includes land-use rights and buildings. Under the Chinese Constitution, land is publicly owned and land ownership cannot be transferred; the right to use land, however, can be transferred.

Gains realized from the transfer of real estate are taxed at rates of 20 to 60 percent.[67] The amount of gains is the proceeds of transfer less the cost of acquiring the property, development expenses, repair and maintenance expenses, relevant tax payment and other amounts that the Ministry of Finance considers to be deductible.[68] If the taxpayer has committed fraud or sold a property at a price below the reasonable price, REVAT is assessed on the estimated value of the property.

Taxpayers must complete tax registration with the local tax office within seven days of the date on which a real estate sales agreement is signed. Tax must be paid within the time limit specified by the local tax office. If a taxpayer fails to pay tax as required by the REVAT Law, the departments of land management and housing administration will not allow the transfer of the title to the property concerned.[69]

8. Incidental income and other income

Under the New IIT, incidental income (windfall gains) and "other income" are taxable. "Incidental income" is defined as income received by individuals from awards, lotteries and other incidental income.[70] The scope of "other income" is not defined under the New IIT Regulations.

The New IIT Regulations also provide that where the nature of an item is unclear, the tax authorities are authorized to determine under which category the item is taxable.[71] Where income is received in kind or in marketable securities, the amount of taxable income is generally the market value of the property or securities.[72] Where two or more individuals are jointly paid a lump sum, each individual is taxed on his or her share of the amount, net of the statutory deduction.[73]

C. Additional deductions in computing income from wages and salaries

Tax on employment income is calculated on a monthly basis. In calculating taxable income, a standard monthly deduction of 800 yuan (US$ 90) is allowed.[74] In addition, the New IIT Law provides that individuals without a domicile in China who earn wages and salaries from Chinese sources are allowed an additional deduction.[75] Similar deductions may be allowed for Chinese citizens who derive employment income from foreign countries.

The New IIT Regulations provide an additional deduction of 3,200 yuan. This amount is less than had been hoped for, and the New IIT Regulations do not offer the possibility of any further deductions. It is likely, however, that the amount of the additional deduction will be increased as the cost of living for foreigners increases in the future.

D. Foreign tax credit

As the final step in the calculation of a taxpayer's tax liability, the taxpayer may take a credit for income taxes paid abroad on income earned outside China. The credit cannot exceed the Chinese tax otherwise payable on the income earned abroad.[76] The "amount of Chinese tax otherwise payable" is defined as the amount of tax computed under the New IIT taking into account the following:

- the country in which the income is earned;
- the type of foreign source income;
- the amount of deductions allowed under the new IIT legislation in computing taxable income; and
- the applicable rates under the New IIT Law.[77]

The amount of foreign tax credit on income derived from a foreign country is the aggregate of the amount of foreign tax payable on each category of foreign-source income derived in that country.[78] A taxpayer must submit an original copy of the certificate evidencing the payment of taxes to a foreign government.[79]

Where the foreign income tax paid is less than the amount of Chinese tax otherwise payable, the taxpayer may deduct only the amount of foreign tax paid.[80] 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; it can, however, be carried forward for five years.[81]

---

65. Provisional Regulations of the People's Republic of China on Real Estate Value Added Tax adopted by the State Council on 26 November 1993 and promulgated on 13 December 1993 (hereafter "REVAT Law").
66. Tax is exempted where a taxpayer constructs standard accommodation buildings for sale and the amount of gains does not exceed 20% of the deductible costs and expenses, or the property is appropriated by the State. REVAT Law, Art. 8.
67. REVAT is imposed at progressive marginal rates based on four-brackets:
- 30% on the portion of the value-added not exceeding 50% of the deductible amounts;
- 40% on the portion of the value-added that exceeds 50% but not 100% of the deductible amounts;
- 50% on the portion of the value-added that exceeds 100% but not 200% of the deductible amounts;
- 60% on the portion of the value-added that exceeds 200% of the deductible amounts.

REVAT Law, Art. 7. These rates may be reduced as a result of the pressure from the business community.
68. REVAT Law, Arts. 5 and 6.
69. REVAT Law, Arts. 10 and 12.
70. New IIT Regulations, Art. 8(10).
71. New IIT Law, Art. 9.
72. New IIT Regulations, Art. 10.
73. New IIT Regulations, Art. 23.
74. New IIT Law, Art. 6(1). When the New IIT Law was introduced last year, the official exchange rate was US$ 1 = 5.8 yuan, while the market rate was about US$ 1 = 8.8 yuan. Since 1 January 1994, the official exchange rate has been hovering around US$ 1 = 8.7 yuan.
75. New IIT Law, Art. 6.
76. New IIT Law, Art. 7.
77. *Id.*
78. *Id.*
79. New IIT Regulations, Art. 33.
80. New IIT Regulations, Art. 32.
81. *Id.*

© 1994 International Bureau of Fiscal Documentation

III. CONCLUSIONS

The New IIT Regulations consolidate many of the rules for the implementation of the taxes that were replaced by the New IIT; they also provide some guidance with respect to the interpretation of the New IIT Law. However, there are some basic issues that require further clarification, such as the scope of income from wages and salaries and the determination of "residency".

From the taxpayer's perspective, the New IIT Regulations are disappointing in several aspects. First, the Regulations have eliminated the previous rule that exempted from tax foreign-source income derived by foreign individuals who stayed in China for more than five years. That change may increase the tax liability of foreigners whose home country does not have a tax treaty with China. Second, the Regulations fail to specify whether dividends paid by Chinese enterprises to foreign individuals are exempt from tax. Third, the additional monthly deduction of 3,200 yuan to foreign individuals working in China may be insufficient to offset the increase in cost of living in China. Finally, the Regulations make no attempt to achieve more horizontal equity. On the contrary, as a result of the provisions with respect to the computation of taxable income from business and management fees and the surtaxes on income from personal services, the regulations make the IIT regime less equitable.

© 1994 International Bureau of Fiscal Documentation

HONG KONG

BUDGET BONANZA

Ian Harris

Group Tax Adviser, HSBC Holdings plc.

I. INTRODUCTION

When the Financial Secretary of Hong Kong Sir Hamish Macleod rose to present his 1994/95 Budget on 1 March 1994, more correctly entitled the Appropriation Bill 1994, members of the Legislative Council and other commentators were hardly surprised when he announced that the estimated 1993/94 deficit of HK$ 3.4 billion was now expected to become a surplus of HK$ 15.1 billion. Unlike previous years when the under-estimate of Budget surpluses or over-estimates of deficits mainly arose through under-spending, the 1993/94 surplus arose from an under-estimate of revenue. Stamp duty from both stock market and property transactions and income from sales of land produced an additional HK$ 14 billion above the original estimate. It is against this background that the Financial Secretary was able to produce a Budget which not only cut taxes but also increased spending, a position which many other Ministers of Finance and their equivalents elsewhere in the world will surely be envious.

Despite the prophets of doom and gloom outside of South East Asia the economy of Hong Kong as with many other countries in the region continued to grow in 1993/94. Sir Hamish said that 1993 was the 27th successive year in which the Hong Kong economy had grown in real terms, and said that in real terms GDP per head had more than trebled since 1970. Reflecting that the current population of Hong Kong takes for granted that enterprise, education and personal endeavour brings improved personal incomes and a better quality of life year by year, the Financial Secretary said that GDP per head in 1993 reached US$ 18,500 and with a further growth of 5.5 percent expected in 1994, GDP per head is expected to reach US$ 20,600 by the end of the current year. This ranks Hong Kong among the major economies of the developed world.

Following the pattern of the previous year the Financial Secretary once again entered into extensive pre-Budget dialogue with not only members of the Legislative Council but professional bodies, commercial associations, labour and welfare groups in formulating his proposals. Out of this dialogue the Financial Secretary determined that the Hong Kong community expects the Government to meet four expectations in that:

- standards of Government services will continue to be raised;
- the social and physical infrastructure will continue to be improved;
- in a year of buoyant revenue the opportunity should be taken to leave money where it can do the most good, i.e. in the pockets of taxpayers;
- the Government should continue to battle inflation which while comfortably down from the double digit figures of previous years is still an unacceptable 8.5 percent.

II. INFLATION

In respect of inflation Sir Hamish said that he would like to set the record straight by saying that inflation is not imported but is home grown and in this connection import prices have only increased by an annual average of about 1 percent over the last five years. In no way was inflation the result of the Hong Kong dollar being linked to the US dollar and nor have wages not kept ahead of inflation. The two prime causes of inflation he said are the rapid increase in property prices which is due to two main factors. Firstly the natural shortage of land in a territory of only 400 square miles, and secondly the rise in standard of living which encourages people to own their own homes and at the same time to seek better accommodation. The other main cause for inflation is the rise in wages due to the shortage of labour in conjunction with the growing economy. Despite the loss of some 850,000 manufacturing jobs the increase in jobs in the service industry has more than offset this and despite a limited amount of labour being imported the shortages remain.

III. BUDGET STRATEGY

The Financial Secretary said in setting his Budget strategy it would be useful to restate the four principles fundamental to the economic success of Hong Kong:

- free trade and fair markets, which remain the best guarantees of economic efficiency;
- a stable currency and a sound financial system, both essential for business confidence;
- low and predictable taxes, to minimize the burdens on those who create wealth and encourage new investment; and
- prudent budgets, so that public spending does not outstrip the rate of economic growth.

Sir Hamish referred to his budget strategy that had been set out in his two previous Budgets and said that there were three points to be made in respect of 1994/95:

© 1994 International Bureau of Fiscal Documentation

- despite surpluses there must always be a constraint on Government spending and to ensure that it grows no faster than the economy as a whole. In Hong Kong as a percentage of GDP, public expenditure is typically half of that in other advanced economies;
- adequate reserves must be maintained to meet known commitments and to guard against future uncertainties;
- spending or concessions should not reverse the downward trend in inflation.

IV. PROSPECTS FOR 1994

The Financial Secretary said that the four major factors affecting the expected performance in 1994 were:

- the successful conclusion of the Uruguay Round which has boosted trade potential and blunted protectionist pressure;
- prospects in Hong Kong's major overseas markets have improved with the US and UK economies being set to grow by around 3 percent in the year ahead;
- the Chinese economy should have little difficulty in continuing to achieve an annual growth of about 10 percent in real terms;
- Hong Kong's other neighbours in East Asia are likely to maintain their dynamic growth, with trade within the region expanding by around 15 percent in 1994.

The key is of course the Chinese economy which is considered increasingly important to Hong Kong's future economic success and where China accounted for 35 percent of Hong Kong's external trade in 1993 Hong Kong in turn accounted for around two-thirds of the external investment in China. At the same time China is probably the largest external investor in Hong Kong. An indication of the closeness of the economic relationship and that it is not solely related to the passage of goods and services between Hong Kong and China is the enormous flow of people as indicated by the following statistics for 1993:

- Hong Kong residents made no less than 23 million visits to Chinese destinations;
- nearly two million foreign visitors used Hong Kong as their gateway to China;
- there were 7.4 million border crossings by cars and lorries;
- Hong Kong handled 34,000 flights to and from China.

In the spending measures announced the servicing of this flow is given priority.

V. REGULATORY ENVIRONMENT

Turning to the regulatory environment Sir Hamish Macleod said that the importance of integrity of Hong Kong's markets was essential. He said that he was determined to continue improving the regulatory environment and proposed to tackle both insider dealing and the management of risks relating from financial innovation. He also announced a major overhaul of the companies legislation as the existing legislation is based on a very old UK model.

VI. SPENDING PROPOSALS

The chief beneficiaries in the social area in respect of increases in recurrent expenditure and in real terms are:

Social welfare	8.4%
Health	6.9%
Education	6.5%

In addition, the major capital projects concerned with border links are:

- a new bridge to avoid congestion at the Cantonese port at a cost of HK$ 3.7 billion;
- an additional section of a new route to the border;
- a major expansion of the ranking status at the border.

VII. TAXATION PROPOSALS – SALARIES TAX

The Financial Secretary said that in his discussions with members of the Legislative Council he considered the highest priority should be given to concessions against Salaries Tax particularly for those who pay below the standard rate of 15 percent. These are largely the middle class employees who do not benefit from the protection of the public housing and yet are faced with the increased costs of private accommodation. In setting his concessions he said that half the workforce pays no direct personal tax of any kind and that the effective tax rate paid by those who do averages only 8 percent. This of course is only on salaries earned in Hong Kong as there is no comprehensive tax in Hong Kong let alone taxation of overseas income.[1]

The Financial Secretary said that as a result of the proposals a single income family of four would have to earn more than HK$ 184,000 before paying any tax and if they had two dependant parents or grandparents they would have to earn more than HK$ 224,000. This same family would have to earn at least HK$ 892,000 before paying tax at the standard

1. The proposed increase in allowances are as follows:

	1994/95	*1993/94*
Flat rate	15%	15%
Allowances:	HK$	HK$
Basic	72,000	56,000
Married Person	144,000	112,000
Child : 1st	20,000	17,000
2nd	20,000	17,000
Dependent Parent	20,000	17,000
Single Parent	32,000	27,000
Grandparent	32,000	Nil

Tax Bands:

1994/95	*1993/94*
HK$ 20,000 @ 2%	HK$ 20,000 @ 2%
HK$ 30,000 @ 9%	HK$ 30,000 @ 9%
HK$ 30,000 @ 17%	HK$ 30,000 @ 17%
Balance @ 20%	Balance @ 25%

© 1994 International Bureau of Fiscal Documentation

rate. The corresponding figure for the single taxpayer is now HK$ 444,000. As a result of the proposals there are the following consequences:

- about 420,000 taxpayers, or a quarter of the total, will drop out of the tax net entirely;
- a further 1.13 million taxpayers will pay less tax;
- the number of standard rate taxpayers will drop by 60 percent.

VIII. PROFITS TAX

The Financial Secretary proposes to cut the standard rate of profits tax from 17.5 to 16.5 percent at a cost of HK$ 1.6 billion in 1994/95. He considers that the reduction will enhance Hong Kong's competitiveness as a regional business centre. The proposal also complies with the Government policy that it only raises taxation to the extent that finances are required for agreed policies and programmes.

IX. OTHER TAXES

A. Estate duty

Various changes and reliefs have been proposed. The rates of charge will be:

Where the Principal Value of the Estates	Rate of Estate Duty
Does not exceed HK$ 5.5M	Nil
Exceeds HK$ 5.5M but does not exceed HK$ 6.5M	6%
Exceeds HK$ 6.5M but does not exceed HK$ 7.5M	12%
Exceeds HK$ 7.5M	18%

B. Stamp duty

Stamp duty rates on real property transfers have been revised to bring them back into line with the increase in property prices.[2]

C. Indirect taxes

An increase in duty on fuel of 8.5 percent in line with inflation is contrasted with a freeze on tobacco duty and a tax neutral rationalization of alcohol duty.

No increase in general rates on property was proposed but the recent revaluation exercise would have increased rates by some 30 percent. A phasing-in will be achieved by capping the increase in the first and second years to 20 percent.

X. TAX AVOIDANCE

The present Financial Secretary and his predecessor have both referred to unacceptable tax avoidance in recent Budget speeches and this year was no exception. The Government view is that Hong Kong has a low rate of taxation and therefore taxpayers should be prepared to pay their full dues without resort to artificial transactions or shams. Tax revenue in Hong Kong at only 11.25 percent of GDP is the lowest percentage out of a total of 36 economies surveyed in a recent study.

The target for this year is the service companies created by many professional firms and others to provide benefits which would normally be denied as a deduction to an individual or a partnership. Sir Hamish said that these devices are clearly wrong in equity and have little or no commercial justification and indeed are promoted by tax advisers who were quoted in a recent press headline "use service companies to unlock tax bonanza". He commented that he was not in the business of tolerating tax bonanzas! It is very clear that the Government is determined to wage a steady war against what they consider unacceptable tax avoidance even though the arrangements made by taxpayers are strictly within the letter of the law. Perhaps it is a way of creating level playing fields but what is certain is that where the spirit of the law is seen to be broken suitable legislation will be introduced.

XI. CONCLUSION

Despite tax cuts and real increases in expenditure the reserves of Hong Kong are expected to continue to increase in the period up to 30 June 1997 after which Hong Kong becomes a Special Administrative Region of China and are now expected to be HK$ 120 billion at 31 March 1997, a substantial improvement in the forecast of HK$ 78 billion made at the time of the 1993 Budget. In addition the land fund is expected to reach HK$ 125 billion by 1997.

In summary, despite the uncertainties of the future Hong Kong's finances are in excellent shape.

2. The new bands and rates are to be:

Property consideration	*Existing*	*Proposed*
Up to $ 250,000	$ 20	$ 100
$ 250,001 to $ 500,000	0.75%	$ 100
$ 500,002 to $ 1,000,000	1.50%	0.75%
$ 1,000,001 to $ 1,500,000	2.00%	1.50%
$ 1,500,001 to $ 2,000,000	2.75%	1.50%
$ 2,000,001 to $ 3,000,000	2.75%	2.00%
Over $ 3,000,000	2.75%	2.75%

© 1994 International Bureau of Fiscal Documentation

IFA NEWS

BELGIAN/LUXEMBOURG BRANCH

Prof. Ch.P.A. Geppaart discussed "Evasion in Dutch Tax Law" at the 27 April 1994 meeting.

DUTCH BRANCH

A joint meeting with the US branch is scheduled to take place at Niagara-on-the-Law, Canada, prior to the annual IFA Congress. Topics will include the new US/Netherlands tax treaty.

GREEK BRANCH

On 17 March 1994 a seminar was held in Athens on "VAT Harmonization in the EU and Greece". Among the distinguished speakers were Mr Peter Wilmott, Director General of the EC and Mr John Kallergis, Director, VAT Division of the Greek Ministry of Finance.

KOREAN BRANCH

On 7-8 April 1994 an informal OECD workshop was held on "Transfer Pricing: the Allocation of Income and Expenses, the Experience of the OECD and Dynamic Non-Member Economies".

SINGAPORE BRANCH

A branch meeting was held on 12 April 1994 to discuss the deductibility of interest, with Ms Teoh Lian Ee (Drew & Napier) and Ms Muthu Raman (Singapore Polytechnic) as speakers.

SWISS BRANCH

The annual general meeting will be held in Zurich on 2 June 1994, and an extraordinary meeting will convene in Bern on 3 November 1994.

UK BRANCH

The topic of the April meeting was "Recent Tax Cases", with Michael Flesch QC as speaker. The May meeting focused on two topics, "Privilege in Common Law Countries" and "Holding Companies in Different Trading Blocs".

US BRANCH

See Dutch Branch.

ANNUAL IFA CONGRESSES

The scientific programme for the Toronto Congress (28 August - 2 September 1994) is:
Subject I: Deductibility of interest and other financing charges in computing income
Subject II: National and international tax consequences of demergers

SEMINARS:

- Harmonization of tax under NAFTA
- Secondary adjustments and related aspects of transfer pricing corrections
- How domestic anti-avoidance rules affect double taxation conventions
- Recent international transactions of interest
- The OECD Model Treaty – 1994 and beyond.

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

ASIA & THE PACIFIC

Australia

AUSTRALIAN TAX REPORTS.
Volume 24. Court/AAT.
North Ryde, Butterworths. 1993, pp. 1245.
Reports of cases heard before the Administrative Appeal Tribunal for the year of decisions 1992-93
(B. 57.961)

THAMPAPILLAI, Dodo J.
Taxation and the environment. Papers presented at a conference organized by the Australian Tax Research Foundation at the Sheraton Sydney Airport Hotel on 17 February 1993. Sydney, Australian Tax Research Foundation. 1993. Conference Series, No. 14. pp. 130.
(B. 57.951)

ROSS, Stan.
Ethics for tax practitioners.
Sydney, Australian Tax Research Foundation. 1993. Research Study No. 18, pp. 106.
(B. 57.952)

Hong Kong

TAXATION IN HONG KONG.
Amsterdam, KPMG International Headquarters. 1993, pp. 78.
Information on property tax, salaries tax, profits tax, interest tax, personal assessment, estate duty, stamp duty, depreciation allowances and financial institutions in Hong Kong.
(B. 57.947)

Japan

ISHI, Hiromitsu.
The Japanese tax system. 2nd Edition.
Oxford, Oxford University Press. 1993, pp. 421.
Revised and updated edition on introduction to the Japanese tax system. The book covers individual income tax, corporate income tax, inheritance and gift taxes, local taxes, consumption tax and land tax.
(B. 57.953)

Malaysia

BUSINESS PROFILE SERIES: MALAYSIA.
7th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1993, pp. 56.
Introductory guide covering foreign investment, foreign exchange, social security, individual income tax, corporate income tax, customs duties, intellectual property and other taxes.
(B. 57.935)

Micronesia

INVESTMENT IN MICRONESIA.
Amsterdam, KPMG Peat Marwick. 1993, pp. 45.
General guide to the regulatory and tax aspects of investments and business activities within the five distinct jurisdictions of Micronesia (Northern Mariana Islands, Federated States of Micronesia, Marshall Islands, Republic of Palau, Territory of Guam). It reflects information available at 30 September 1992.
(B. 57.934)

Papua New Guinea

MCGAVIN, P.A.
Connections: the process of enhancing productivity change in Papua New Guinea.
Port Moresby, Institute of National Affairs. 1993. INA Discussion Paper No. 59, pp. 112.
Study describing the practical applications involved in making linkages or connections between productivity improvement and response to changing market conditions, and between productivity improvement and the welfare of employees.
(B. 57.928)

Philippines

BUSINESS PROFILE SERIES: PHILIPPINES.
7th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1993, pp. 48.
Information guide on the economic and investment climate in the Philippines, including taxation.
(B. 57.936)

Taiwan

GORDON, Richard; SUMMERS, Victoria.
Taxation of investment funds in emerging capital market: theory, problems and solutions in the case of Taiwan.
Cambridge, Harvard University. 1992. Taxation Research Series No. 2, pp. 27.
(B. 57.944)

Vietnam

JENKINS, Glenn P.; TERKPER, Seth E.
Vietnam's tax reforms: policies in transition economies.
Cambridge, Harvard University. 1992. Taxation Research Series, No. 7, pp. 33.
Tax reform considerations with respect to taxes imposed on state-owned enterprises as well as taxes on foreign entities and Vietnamese private enterprises. Tax unification is also covered.
(B. 57.945)

CARIBBEAN

THE CARIBBEAN HANDBOOK 1993/94.
Editor Lindsay Maxwell.
St. John's, FT Caribbean, P.O. Box 1037, St. John's, Antigua, West Indies. 1993, pp. 245.
US$ 75.-
The Caribbean Handbook offers country-by-country profiles of all the region's island states, together with the mainland states. As well as basic data on each state, it gives a tightly presented summary of the economic and political situation and the business climate in each country. It outlines everything from the most recent budget detail, trade data, investment policy and incentives, to government and private sector organizations. Specialist articles describe the major regional developments of the preceding year and analyse key sectors (such as tourism, aviation, trade and shipping). The book can also be obtained from the European Representative: FT Caribbean, 3A Sloane Ave. London, SW 3 JD, England at the price of 50.-
(B. 18.808)

EUROPE

MAITLAND-WALKER, Julian.
Guide to European company laws.
London, Sweet & Maxwell. 1993, pp. 499.
£ 48.
Short commentaries on the domestic company law of each of the EC and EFTA member states (except Iceland), together with an overview of developments in the EC company law harmonization programme. The guide will be of interest to anyone studying comparative commercial law.
(B. 113.345)

© 1994 International Bureau of Fiscal Documentation

Austria

MULLER, Eduard.
Steuersparbuch 93.
Vienna, Linde Verlag Wien AG. 1993, pp. 152.
Tax saving book 93. Short guide to wage tax and the possibilities of reducing the individual tax burden.
(B. 113.252)

KODEX DES ÖSTERREICHISCHEN
Rechts: Sozialversicherung. Stand 1.10.1993. Mit der Pensionsreform. 14. Auflage.
Bearbeitet von Franz Marhold.
Vienna, Linde Verlag Wien GmbH. 1993, pp. 700. 295.- S.
Sourcebook on Austrian social security laws effective as of 1 October 1993.
(B. 113.370)

Belgium

LIEVENS, Jozef; BROE, Luc de; MASELIS, Paul.
Fusies & Splitsingen. Juridisch, fiscaal, draaiboeken en modellen.
Gent, Mys & Breesch Uitgevers. 1993, pp. 200. 1950.- Bfrs.
Discussion of the new merger legislation, including legal and tax aspects, scenarios and models.
(B. 113.306)

CROMBRUGGE, S. van.
Beginselen van de vennootschapsbelasting. 2nd Edition.
Kalmthout, Biblo. 1993, pp. 165. 1590.- Bfrs.
Handbook on the principles of Belgian corporate income tax.
(B. 113.362)

1993 BELASTING EN
beleggingsgids.
Antwerp, De Financieel Ekonomische Tijd. 1993, pp. 430. 545.- Bfrs.
Practical tax guide for individuals and companies in filing their income tax returns.
(B. 113.174)

WETBOEK VAN DE
inkomstenbelastingen.
2nd Edition. Gecoordineerd tot en met de nieuwe fiscale regeling inzake fusie en splitsing van vennootschappen.
Kalmthout, Biblo. 1993, pp. 289.
Consolidated text of the 1993 income taxes (individual income tax, corporate income tax). Includes the new merger legislation.
(B. 113.361)

WETBOEK VAN DE
inkomstenbelastingen
1992 (Uitgave 1993.2).
Diegem, CED Samsom. 1993, pp. 724.
Consolidated text of the Income Tax Code implementing statutes, for purposes of the 1992 assessment year, updated as of 6 October 1993.
(B. 113.391)

SCHELFHAUT, Gonda; SPRUYT, Eric.
B.T.W. & successie-, registratie-, hypotheek-, griffie- en zegelrechten.
Diegem, CED Samsom. 1993, pp. 377.
860.-Bfrs.
"VAT and succession, registration, mortgage and stamp law". Part one is an outline of the basic VAT law and Part two deals with each of the specific types of law referred to above.
(B. 113.256)

ANNUAIRE FISCAL 1993.2.
Diegem, CED Samsom. 1993, pp. 697.
Quick annual tax reference manual summarizing relevant tax information (corporate and individual income taxes, VAT, similar taxes and death duties) from July 1993. Relevant addresses, names and telephone numbers of tax administration offices are appended.
(B. 113.368)

LIEVENS, Stefan.
Harmonisatie tussen boekhoudrecht en fiscaal recht ?
Deurne, Kluwer Rechtswetenschappen. 1993.
Fiscale Praktijkstudies, No. 15, pp. 248.
2858.- Bfrs.
Extensive monograph on the harmonization of tax law and accounting law in Belgium.
(B. 113.343)

HOFMANS, H.; SCHELFHAUT, G.; BRUEL, L. van den.
Fiscaal praktijkboek '92-'93. Indirecte belastingen. Editor: W. Maeckelbergh.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 448. 1850.- Bfrs.
Book containing several contributions on relevant indirect tax issues.
(B. 113.333)

ORSHOVEN, Paul van.
Fiscolex 1993. Regionale en provinciale belastingen. Impôts régionaux et provinciaux.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 640. 2350.- Bfrs.
Compilation of the regulatory legislation on local taxes in Belgium.
(B. 113.307)

Czech Republic

DOING BUSINESS IN THE CZECH AND
Slovak Republics.
Amsterdam, Price Waterhouse. 1993, pp. 161.
Information guide for those interested in doing business in the Czech and Slovak Republics. The material contained in this guide was assembled in March 1993. Chapters include: foreign investment and trade opportunities, investment incentives, banking and finance, exporting to the Czech and Slovak Republics, labour relations and social security, audit and accounting, taxation of corporations and individuals, taxation of foreign companies, partnerships and joint ventures, trusts and estates, VAT and other indirect taxes.
(B. 113.143)

EEC

LIER, A.P.; VLIET, D.G. van; HEERING, A.D.C.; ZEVENBOOM, G.H.
Tax and legal aspects of EC harmonisation.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 195. 105.- Dfl.
Complete overview of the tax aspects related to increasing economic and monetary integration within the EC. The harmonization of both direct and indirect taxes is discussed in depth and relevant historical developments are also highlighted.
(B. 113.404)

EASSON, A.J.
Taxation in the European Community.
London, The Athlone Press, 1 Park Drive, London NW11 7SG, England. 1993.
European Community Law Series, No. 5, pp. 322, £ 45.-.
Taxation is in important aspect of the financial operations of the European Community. Although there is not a Community tax system (as the Community does not have its own tax administration) the Community has its own budget and resources. VAT may be considered as a genuine "Community tax" and not simply as a share of national tax. The harmonization of direct taxation has already lead to a merger and parent-subsidiary directive. The harmonization of turnover taxes is extensively discussed, along with excise and other indirect taxes.
(B. 113.254)

TERRA, Ben; WATTEL, Peter.
European Tax Law.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 445. 100.- Dfl.
Survey of the tax implications of European integration and discussion of the Community tax rules in force and pending. Chapters include: taxes in the EC Treaty, harmonization bases; impact of general Community law on national tax law; European tax harmonization policy; Community Customs Code; VAT; excises; capital duty; the Parent-Subsidiary Directive; the Merger Directive; the Arbitration Convention; tax aspects of the European Economic Interest Grouping; proposed Direct Tax Directives and mutual assistance through exchange of information.
(B. 113.413)

INTERNATIONAL TRADE RESOURCES
from the California Chamber: European Community and Europe. A legal guide to business development.
London, California European Trade and Investment Office, 27 Dover Street, 2nd Fl., London W1X3PA, United Kingdom. 1993, pp. 376.
US tax considerations for accessing the EC Market. Articles by attorneys and accountants summarize important legal and financial considerations for companies doing business in the European Community and Europe. Includes overview of the creation of the EEC, mergers, joint ventures, distribution and franchising agreements, commercial law, tax considerations,finance, employment law,

© 1994 International Bureau of Fiscal Documentation

standards, exporting requirements and other business concerns. Also covers major sectors, including public procurement, high technology, environment, telecommunications, pharmaceuticals, energy and utilities. Country-specific chapters highlight requirements unique to individual nations in the EC and Europe.
(B. 113.363)

FIERSTRA, M.A.
Europees medèdingingsrecht. 2nd Edition.
Deventer, Kluwer; The Hague, Fenedex. 1993.
Fiscale en juridische documentatie voor internationaal zakendoen, No. 21, pp. 283.
Description of the various aspects of competition law in the European Single Market.
(B. 113.409)

INTERNE MARKT. STAND VAN ZAKEN op 1 januari 1993. Voorwaarden voor samenwerking tussen ondernemingen; Een gemeenschappelijke markt voor overheidsopdrachten; Interne markt voor energie.
Brussels, EGKS-EEG-EGA. 1993.
Voltooiing van de interne markt – Deel 3, pp. 116. 19.- ECU.
The situation as of 1 January 1993 with respect to the following subjects within the EC: the Internal Market; conditions for cooperation between companies; company law, intellectual property and company taxation; a collective market for governmental projects and an internal market for energy.
(B. 113.068)

Germany

FINANZGERICHTSORDNUNG MIT Nebengesetzen. 3. Auflage. Bearbeitet von R. von Groll, Hanns-Reimer Koch und Reinhild Ruban.
Munich, C.H. Beck'sche Verlagsbuchhandlung. 1993, pp. 1158.
188.- DM.
Tax procedure and organization of tax courts in Germany.
(B. 113.321)

KIRCHHOF, Paul; SÖHN, Hartmut.
Einkommensteuergesetz. Kommentar.
12 Volumes.
Cologne, C.F. Müller Juristischer Verlag, Postfach 102640, W-6900 Heidelberg 1, Germany. 1993, 398.- DM.
Loose-leaf service in 12 volumes. Price of basic work DM. 398, supplemented 6 times a year. Detailed analysis and practical article-by-article commentary on the German Individual Tax Act. Includes ministerial rulings, regulations, tax court decisions and bibliographic surveys of many articles. Contains an extensive keyword index.
(B. 107.286A)

RECHTSBEHELFSEMPFEHLUNGEN.
(Streck, Rainer, Mack, Schwedhelm).
Bonn, Stollfuss Verlag. 1992, pp. 111.
Suggestions for appeal procedures in fiscal matters.
(B. 113.339)

MAI, Thomas R.
Rechtsverhältnis zwischen Abschlussprüfer und prüfungspflichtiger Kapitalgesellschaft.
Düsseldorf, IDW Verlag GmbH. 1993, pp. 303. 98.- DM.
Explanation of the particular characteristics of the contract and the other legal relations between auditor and audited corporation and their responsibilities.
(B. 113.188)

WICHTIGE UMWELTGESETZE FÜR die Wirtschaft.
3. Auflage.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1991, pp. 454.
Important environment laws. A collection of legal texts including a short introduction by Rolf Stober. The texts refer to nuisance, waste, medicinal and chemical products, water, liability and criminal law.
(B. 113.340)

Greece

INVESTMENT IN GREECE.
Amsterdam, KPMG Peat Marwick Kyriacou. 1993, pp. 85.
An overview of matters to be considered by those contemplating investment in Greece. Information is given on opportunities for international investors, exporting to/from Greece, business entities, business taxation, taxation of individuals, labour and acquisition of property.
(B. 113.291)

Ireland

O'CALLAGHAN, J.M.
Taxation of estates. The law in Ireland.
Dublin, Butterworth (Ireland) Ltd. 1993, pp. 410. £ 39.50.
Detailed description of the taxation of personal representatives and beneficiaries. Topics covered include succession law, income tax, capital gains tax and capital acquisitions tax. Sets forth the law as of 31 December 1992.
(B. 113.243)

Netherlands

LEEUWEN, M. van.
Belastingrecht in hoofdzaken. Leidraad en examentraining voor MBA Belastingwetgeving.
Arnhem, Gouda Quint BV. 1993, pp. 123.
35.- Dfl.
Tax manual containing explanation of the tax laws, including questions and answers necessary for the MBA examination (business administration study).
(B. 113.292)

LENGKEEK, L.J.; SANDERS, J.T.
Subsidies en BTW.
Deventer, Fed. 1993. Fed Fiscale Brochures, pp. 144. 40.- Dfl.
Addresses the question of which subsidies are liable to VAT with reference to case law. An overview of the general rules governing VAT, subsidies and case law is also given.
(B. 113.419)

STEVENS, L.G.M.
Pensioen in de winstsfeer. 3rd Edition.
Deventer, Fed. 1993.
Fed Fiscale Brochures, pp. 210. 55.- Dfl.
Discussion of pension commitments made by businesses engaged in for-profit activities. Integrates the case law up to March 1993 and the bill concerning Brede Herwaardering II.
(B. 113.420)

NEDERLANDSE JURISPRUDENTIE inzake internationaal belastingrecht. Directe belastingen van internationaal opererende ondernemingen.
Groningen, Vereniging AIJB. 1993, 195 Dfl.
Loose-leaf publication based on a research project of the University of Groningen on Dutch case law regarding important international tax law topics, including: residence of companies, permanent establishments, permanent representatives and the fixed base, allocation of income to a permanent establishments, arm's length dealings between dometic and foreign group companies and procedural aspects. With regard to each subject, the case law is analysed and all cases are summarized.
(B. 113.336)

FISCAL JURIDISCH MEMO 1993.
Deventer, Kluwer. 1993, pp. 152.
Fiscal Legal Memo 1993 aims to provide summaries on a number of civil legal issues which are important in financial and tax advice practice, including contract law, company law and labour law.
(B. 113.172)

REUVERS, M.R.
Fiscale filosofie. Goed en kwaad van de burger en de overheid.
Duivendrecht, Reuvers & Co. 1993, pp. 68.
A personal view of the author on fiscal philosophy – the good and evil of citizens and the government. Included are comments on the administration of the state, the justification of the tax burden imposed on citizens within a state and how individuals experience fiscal matters.
(B. 113.314)

Poland

POLISH TAXATION 1993. PART II.
Deventer, Kluwer Law and Taxation Publishers. 1993.
The Polish Economic Law, pp. 141. 80.- Dfl.
This volume reflects the rapid transformation of the Polish economy and the modernization of the taxation system in its transitional period. Contains an English translation of the Goods and Services Tax Act; Natural Persons' Income Tax Act; Legal Persons' Income Tax

© 1994 International Bureau of Fiscal Documentation

Act; and Amending Act. The law is stated as of 1 August 1993.
(B. 113.405)

GTUCHOWSKI, Jan.
Polskie prawo podatkowe.
Warsaw, Wydawnictwo Naukowe PWN. 1993, pp. 170. Covers tax administration, individual income tax, corporate income tax, VAT, excise duty, death duties and taxation of hidden profits.
(B. 113.253)

Russia

ROMANOVSKY, M.V.; VANISTENDAEL, F.
Taxation policy and principles of taxation in Russia.
Leuven, Leuvens Instituut voor Centraal- en Oost Europa Studies, Europahuis, Blijde Inkomststraat 5, B-3000 Leuven, Belgium. 1992, pp. 44.
(B. 113.347)

Slovak Republic

DOING BUSINESS IN THE CZECH and Slovak Republics.
Amsterdam, Price Waterhouse. 1993, pp. 161. Information guide for those interested in doing business in the Czech and Slovak Republics. The material contained in this guide was assembled in March 1993. Chapters include: foreign investment and trade opportunities, investment incentives, banking and finance, exporting to the Czech and Slovak Republics, labour relations and social security, audit and accounting, taxation of corporations and individuals, taxation of foreign companies, partnerships and joint ventures, trusts and estates, VAT and other indirect taxes.
(B. 113.143)

Switzerland

BERNARDONI, Norberto; DUCHINI, Giorgio.
La fiscalité dell'azienda. Nel diritto federale e cantonale Ticinese.
Bioggio, Arti Grafiche Bernasconi S.A., Casella postale 168, 6934 Bioggio. 1993, pp. 768. 98.- Fr.
Federal and cantonal taxation in Ticino of private and corporate businesses.
(B. 113.389)

United Kingdom

TAX ASSESSMENT: TAXATION OF financial instruments.
London, Ernst & Young, Chartered Accountants, Rolls House, 7 Rolls Buildings, Fetter Lane, London EC4A 1NH. 1993, pp. 21.
(B. 113.089)

HOMER, Arnold; BURROWS, Rita; GRAVESTOCK, Peter.
Tolley's Taxwise I 1993-94. Income tax & national insurance, corporation tax, capital gains tax.
Croydon, Tolley Publishing Co. Ltd. 1993, pp. 850. £ 24.95.
100 examples covering income tax and national insurance, corporation tax and capital gains tax. Fully updated to include the relevant changes brought about by the Finance Act 1993.
(B. 113.385)

PRITCHARD, W.E.
Tolley's tax planning for new businesses. 4th Edition. A practical guide to the tax planning opportunities and pitfalls of starting a new business.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 130. £ 24.95.
Includes a discussion of the Finance Act 1993.
(B. 113.383)

BUDGET, AUTUMN 1993.
London, Touche Ross & Co. 1993, pp. 16.
(B. 113.313)

TAYLOR, Anthony; STEWARD, Clive.
The equitable life tax guide 1993. (formerly Smit's Taxation).
Oxford, Basil Blackwell Ltd. 1993, pp. 485. Comprehensive up-to-date guide to personal and business taxation covering existing law and practice relating to income tax, capital gains tax, corporation tax, VAT, council tax and other related subjects.
(B. 113.335)

ANDERSEN, ARTHUR.
Tolley's personal tax and investment planning.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 214. £ 29.95.
Clear and comprehensive guide to personal tax and investment, including provisions of the Finance Act 1993.
(B. 113.384)

RESIDENTS AND NON-RESIDENTS.
Liability to tax in the United Kingdom.
London, Inland Revenue. 1993, pp. 44. Explanation of what is meant by residence, ordinary residence and domicile, and how these factors affect how much income tax and capital gains tax must be paid in the United Kingdom. The booklet is only concerned with individuals.
(B. 113.395)

HOMER, Arnold; BURROWS, Rita; GRAVESTOCK, Peter.
Tolley's Taxwise II 1993-94. Value added tax, inheritance tax, taxation of trusts, tax planning.
Croydon, Tolley Publishing Co. Ltd. 1993, pp. 800. £ 23.95.
88 examples covering value added tax, inheritance tax, taxation of trusts and tax planning. Fully updated to include the relevant changes brought about by the Finance Act 1993.
(B. 113.386)

UNITED KINGDOM NATIONAL Accounts.
The CSO Blue Book, 1993 edition. Editor David Ruffles.
London, HMSO. 1993, p. 168.
(B. 113.150)

INTERNATIONAL

ESSAYS ON INTERNATIONAL taxation in honor of Sidney I. Roberts. Editors Herbert H. Alpert and Kees van Raad.
Deventer, Kluwer Law and Taxation Publishers. 1993. Series on International Taxation, No. 15, pp. 466. 185.- Dfl.
A compilation of essays dealing with aspects of international taxation, either from the perspective of a particular country's tax system or at a more general level.
(B. 113.428)

TOLLEYS TAX HAVENS. 2ND EDITION.
Croydon, Tolley Publishing Company Ltd. 1993, pp. 650. £ 50.-
A practitioner's guide to the leading tax havens of the world.
(B. 113.412)

Developing Countries

BIRD, Richard M.
Tax policy & economic development.
Baltimore/London, The Johns Hopkins University Press Ltd. 1992, pp. 270.
Evaluation of the unique conditions that apply to developing nations and an examination of their impact on both the kinds of taxes that may be raised and the effective administration of tax policy.
(B. 113.424)

OECD

THE TAX/BENEFIT POSITION OF production workers; la situation des ouvriers au regard de l'impôt et des transferts sociaux 1989-92.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 257. This report examines the income tax and social security contributions paid and family benefits received by taxpayers at the income level of a production worker for the years 1989-92. It also provides a standardized description of the personal income tax and social security systems in each OECD country. In this edition a special feature is included on Mexico.
(B. 113.400)

LATIN AMERICA

Brazil

Attila de SOUZA LEAO ANDRADE Jr.
Guidelines on Brazil's Foreign Investment Law. 2nd Edition.

© 1994 International Bureau of Fiscal Documentation

Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 110. 50.- Dfl.
Description, analysis and interpretation of the laws governing foreign investment in Brazil. Topics covered include: the legal concept of foreign capital pursuant to Brazilian law; principles and procedures of foreign capital registration with the Central Bank of Brazil; the registration of and tax law on the remittance of profits, dividends and royalties abroad; the registration of foreign loans; and Brazil's exchange control.
(B. 18.816)

OS NEGOCIOS E O DIREITO.
Sobrevivencia
legal no Brasil. Coordenadora: Vera Helena de Mello Franco.
Sao Paulo, Editora Maltese, Rua Augusta, 1122 Sobreloja, Sala 5, Sao Paulo, Brazil CEP 01304-001. 1992, pp. 210.
Business and law, legal survival in Brazil.
(B. 18.812)

Colombia

XVII JORNADAS COLOMBIANAS DE Derecho Tributario.
Bogota, Instituto Colombiano de Derecho Tributario. 1993, pp. 478.
Papers and discussions of the XVII Colombian Symposium on Tax Law held in Cali (Colombia), 24-27 February 1993.
(B. 18.813)

Guatemala

INVESTMENT IN GUATEMALA.
Amsterdam, KPMG – Klynveld Peat Marwick Goerdeler. 1993, pp. 74.
An overview of important issues to be considered by individuals who are contemplating investments in Guatemala. Topics include: registration of foreign companies, organization of Guatemalan companies, accounts, labour relations, income tax and other taxes.
(B. 18.811)

NORTH AMERICA

Canada

MCMECHAN, Robert; BOURGARD, Gordon.
Tax Court practice 1994.
Toronto, Carswell Thomson Professional Publishing. 1993, pp. 1200. $ 110.-
Current, up-to-date legislation and rules governing appeals, as well as guides to procedure in the Tax Court explaining the interplay between the Tax Court of Canada Act and the rules which apply to an appeal.
(B. 113.392)

CANADA TAX CASES. JUDGMENTS of the Supreme Court of Canada, Federal Court of Canada, Tax Court of Canada and provincial courts on taxation matters reported by Canada Tax Cases from January to June 1993 inclusive. 1993. Volume 1. Editor-in-Chief H. Heward Stikeman.
Scarborough, Carswell Thomson Professional Publishing. 1993, pp. 2270.
(B. 113.334)

PERSONAL TAX STRATEGY. 1994 Edition.
Amsterdam, Price Waterhouse. 1994, pp. 232.
Complete tax information and reference guide for 1993, as well as a planning guide for 1994 and beyond for individual taxpayers.
(B. 113.423)

TAXATION TO 2000 AND BEYOND.
Edited by Richard M. Bird and Jack M. Mintz.
Toronto, Canadian Tax Foundation. 1992.
Canadian Tax Paper No. 93, pp. 382.
In January 1991 the Canadian Tax Foundation convened a conference in Toronto dealing with issues to be considered in the formulation of Canadian tax policy for decades to come. The topics selected and written by various authors are: taxation and the environment, taxation and its impact on market structure, taxation in the service industry, tax policy in the 21st century, the source and residence principles of international taxation, and taxation and federalism in a changing world.
(B. 113.126)

USA

BOLES, Ernest.
Gesellschaften im US-Einkommensteuerrecht.
Munich, Verlag C.H. Beck. 1993. Muncher Schriften zum Internationalen Steuerrecht, Heft 16, pp. 178. 88.- DM.
Corporations under US tax law. A description of the taxation of companies in the USA.
(B. 113.132)

US MASTER TAX GUIDE 1994.
77th Edition. By
CCH Tax Law Editors.
Chicago, CCH Commerce Clearing House, Inc. 1993, pp. 660. $ 29.50.
Reflects all income tax law changes that affect 1993 tax returns, including legislative amendments made by the Revenue Reconciliation Act of 1993.
(B. 113.344)

1994 RIA FEDERAL TAX HANDBOOK.
New York, RIA Research Institute of America. 1993, pp. 762. $ 24.-
Handbook designed to answer tax questions and resolve tax problems that arise in everyday business and personal transactions. The book helps in preparing 1993 federal income tax returns and provides specific guidance to tax consequences of transactions occuring in 1994.
(B. 113.328)

BITTKER, Boris I.; EUSTICE, James S.; CUMMINGS, Jasper L.
Federal income taxation of corporations and shareholders. Sixth edition. Boston, Warren Gorham Lamont. 1993.
Textbook on the US federal income taxation of corporations and shareholders with reference to case law. Will be updated by future supplements.
(B. 113.390)

INTERNATIONAL TRADE RESOURCES from the California Chamber: European Community and Europe. A legal guide to business development.
London, California European Trade and Investment Office, 27 Dover Street, 2nd Fl., London W1X3PA, United Kingdom. 1993, pp. 376.
US tax considerations for accessing the EC Market. Articles by attorneys and accountants summarize important legal and financial considerations for companies doing business in the European Community and Europe. Includes overview of the creation of the EEC, mergers, joint ventures, distribution and franchising agreements, commercial law, tax considerations, finance, employment law, standards, exporting requirements and other business concerns. Also covers major sectors, including public procurement, high technology, environment, telecommunications, pharmaceuticals, energy and utilities. Country-specific chapters highlight requirements unique to individual nations in the EC and Europe.
(B. 113.363)

EXPORTING GUIDE FOR CALIFORNIA.
Sacramento, California Chamber of Commerce.
1993, pp. 139. $ 17.50
A step-by-step manual to help the California company wishing to become involved in exporting or to expand existing export volumes. Covers organizing for export, identifying markets and distribution avenues, pricing, documentation, shipping and financing.
(B. 113.365)

DOERNBERG, Richard L.
International taxation in a nutshell. 2nd Edition.
St. Paul, West Publishing Company, P.O. Box 64526, St. Paul, Minnesota 55164 0526, USA. 1993. West Nutshell Series, pp. 394.
Introduction to the US law of international taxation.
(B. 113.393)

INTERNATIONAL TRADE RESOURCES from the California Chamber: International trade resources guide.
Sacramento, California Chamber of Commerce, P.O. Box 1736, Sacramento, CA 95812 1736. USA. 1993, pp. 180.
A comprehensive guide to resources available to the California business community for conducting international trade, including domestic and international chambers of commerce; international trade associations; educational contacts; local, state and federal government officials; foreign trade zones; foreign government representatives; resource publications; glossaries; world holidays; metric conversion chart; international

© 1994 International Bureau of Fiscal Documentation

telephone calling codes; and world monetary units. The guide lists more than 1,600 resources in the public and private sectors.
(B. 113.364)

NORTH AMERICAN FREE TRADE
guide.
The emerging Mexican market and opportunities in Canada under NAFTA.
Sacramento, California Chamber of Commerce. 1993, pp. 134. $ 19.50.
A handbook to help businesses take advantage of the opportunities to be created by the North American Free Trade Agreement (NAFTA), linking the United States with Canada and Mexico, its first and third largest trading partners.
(B. 113.366)

Loose-leaf Services

Received between 1 and 28 February 1994

AFRICA

FIDAFRICA
release 12
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 1 and 2
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
– Legislation
  releases 71 and 72
Butterworth, North Ryde.

AUSTRALIAN INTERNATIONAL TAX AGREEMENTS
release 50
CCH Australia Ltd., North Ryde.

AUSTRALIAN STAMP DUTIES LAW
release 127
Butterworth Pty., Ltd., North Ryde.

BELGIUM

COMMENTAAR OP HET WETBOEK VAN DE INKOMSTENBELASTING
releases 5 and 6
Brussels, Ministry of Finance.

COMMENTAIRE DU CODE DES IMPOTS SUR LES REVENUS
releases 5 and 6
Brussels, Ministry of Finance.

FISCALE MODELLEN
release 36
CED Samsom, Diegem.

MODELES FISCAUX
release 37
CED Samsom, Diegem.

CANADA

GLOBAL INVESTMENT IN CANADA
release 101
Prentice Hall of Canada Ltd., Scarborough.

INCOME TAX REFERENCES/ REFERENCES A LA LOI DE L'IMPOT SUR LE REVENU
release 53
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 869, 871-874, 877
Prentice Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
– Skattenyt - Kronologisk
  releases 4 and 5
– Skattebestemmelser - Systematisk
  release 2
A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
– Verdragsteksten en aanverwante stukken
  release 340
Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – DROITS D'ENREGISTREMENTS ET DE TIMBRE
release 1
Editions Francis Lefebvre, Paris.

GERMANY

ABC FÜHRER LOHNSTEUER
release 37
Verlag Schäffer & Co., Stuttgart.

DEUTSCHE GESETZE
Schönfelder
release 82
Verlag C.H. Beck, Munich.

DOPPELBESTEUERUNG
Korn - Dietz - Debatin
release 62
Verlag C.H. Beck, Munich.

EINKOMMENSTEUERGESETZ.
Kommentar.
Kirchhof - Sohn
releases 49 and 50
Peter Deubner Verlag, Cologne.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBILIEN-KAPITALANLAGEN
release 64
Peter Deubner Verlag, Cologne.

KOMMENTAR ZUM ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
Hübschmann - Hepp - Spitaler
release 140
Verlag Otto Schmidt, Cologne.

INTERNATIONAL

INTERFISC TAX TREATY SERVICE
John Dewhurst
release 58
J.F. Chown, London.

STEUERN IN EUROPA, USA, KANADA und JAPAN
Mennel
release 26
Verlag Neue Wirtschafts Briefe GmbH., Herne.

NETHERLANDS

BELASTINGWETGEVING
– Loonbelasting
  releases 150 and 151
– Successiewet
  release 60
– Vennootschapsbelasting
  release 72
Noorduijn BV., Arnhem.

CURSUS BELASTINGRECHT
Mobach
release 211
Gouda Quint/D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING
– Gemeentelijke belastingen e.a.
  release 183
Kluwer, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
– Algemene wetgeving inzake douane
  releases 252 and 253
– Belastingheffing bij invoer
  releases 448-451
– Tarief van invoerrechten
  release 106
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 144-146
Kluwer, Deventer.

© 1994 International Bureau of Fiscal Documentation

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel, release 73

- AOW/AWW, release 65
- AWBZ, release 109

Kluwer, Deventer.

VAKSTUDIE - FISCALE ENCYCLOPEDIE
- Algemeen deel
  release 230
- Inkomstenbelasting 1964
  releases 888-893
- Investeringsregelingen
  release 161
- Invorderingswet
  releases 54 and 55
- Loonbelasting
  release 570
- Omzetbelasting
  releases 244-246
- Vennootschapsbelasting
  releases 317-320

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
B, release 20
Norsk Skattebetalerforening, Oslo.

SOUTH AFRICA

THE TAXPAYERS' PERMANENT VOLUME ON INCOME TAX IN SOUTH AFRICA
Meyerowitz - Spiro
release 19
The Taxpayer Publishing Co., Cape Town.

UNITED KINGDOM

SIMON'S TAX CASES
releases 4 and 5
Butterworth, London.

SIMON'S TAXES
release 196
Butterworth, London.

SIMON'S TAX INTELLIGENCE
releases 4,5,6
Butterworth, London.

VALUE ADDED TAX - DE VOIL
release 222
Butterworth, Sevenoaks.

USA

UNITED STATES TAX REPORTER
releases 4-7
RIA - Research Institute of America Inc., New York.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

MAY 1994

European/U.S. International Tax Planning, London, 23-24 May 1994 (English):

Corrine Simmers, International Tax Review, Nestor House, Playhouse Yard, London EC4V 5EX, England, Tel.: 44-71-779 8719, Fax: 44-71-779 8603.

7th East West Tax Conference, Sofia, 26-27 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Tax Treatment of Transfer Pricing, Amsterdam, 27-28 May 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Taxation Management Techniques, Brussels, 30-31 May 1994 (English):

Management Centre Europe, rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

JUNE 1994

Recent Developments in International Tax Law: the New OECD Model Treaty of 1992, Vienna, 1 June 1994 (German):

Institut für Finanzrecht, Althanstrasse 39-45, A-1090 Vienna, Tel.: 43-222-313 36, Fax: 43-222-313 36.

Corporate Finance Centres and Tax Havens, Geneva, 2-3 June 1994 (English):

IBC Legal Studies and Services Ltd., IBC House, Vickers Drive, Brooklands Industrial Park, Weybridge, Surrey KT13 0XS, England, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

International Tax Planning Association Meeting, Monte Carlo, 9-10 June 1994 (English):

Elizabeth Husband, ITPA Convention Bureau, PO Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732-762 910, Fax: 44-732-763 762.

Tax Avoidance and Tax Treaties, Amsterdam, 13-14 June 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1994

Leyden–Amsterdam–Columbia Summer Program in American Law, Leyden, 3-29 July 1994 (English):

Mrs B. Zaaijer, University of Leyden, Faculty of Law, Columbia Summer Program, Hugo de Grootstraat 27, 2311 XK Leyden, The Netherlands, Tel.: 31-71-277 632, Fax: 31-71-277 600.

Workshop on special economic zones in Asia (Asian Studies Association of Australia Biennial Conference), Perth, 13-16 July 1994 (English):

George Sanderson, Asian Studies, Griffith University, Nathan, Queensland 4111, Australia, Tel.: 61-7-209 8645, Fax: 61-7-875 5111.

AUGUST 1994

Principles of International Taxation, Amsterdam, 22 August-2 September 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Australia:
Ann O'Connel:
Capital Gains Tax Amendments 176

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Hong Kong:
Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shoma and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Israel:
Taxation of Corporations 141

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

New Zealand:
Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Qatar:
Finbarr Sexton:
Taxation regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

Switzerland
Wiliam Bush:
Low Tax Opportunities 183

United States:
Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41, 200

IV. CONFERENCE DIARY 55, 81, 137, 207

V. BIBLIOGRAPHY
– Books 45, 103, 150, 201
– Looseleaf services 49, 107, 154, 205
– List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 6/7 JUNE/JULY 1994

US IFA ANNUAL MEETING

This issue features nine of the papers presented during the Annual Meeting of the US IFA branch, which was held on 3-4 March 1994 in Atlanta, Georgia. Approximately 200 IFA members attended the meeting to listen to more than 35 speakers and panellists, which included acknowledged experts among practitioners, academics and government officials.

One of the more extensively covered topics during the meeting was the use of holding companies. Five of the papers deal with the use of holding companies in France, the Benelux, Switzerland, Germany and the United Kingdom. Experts from both sides of the Atlantic discussed and debated the pros and cons of locating holding companies in these countries.

Other subjects discussed during the meeting were recent treaty developments, the US IFA Report on demergers, use of special purpose entities in Latin America, joint venture and hybrid entity planning and issues, intercompany transactions and alternative dispute resolution of Section 482 cases.

USE OF HOLDING COMPANIES

These papers discuss the implications of setting up an international holding company in the respective countries. Certain features of the individual corporate tax systems are outlined, which are likely to affect the decision to locate.

BENELUX:	Paul Sleurink, Hans Decleir and Veronique Sway	271
FRANCE:	Olivier Delattre and Clotilde Fournier	281
GERMANY:	Dr Thomas Töben	285
SWITZERLAND:	Dr Nico H. Burki	292
UNITED KINGDOM:	Michael McGowan	296

LATIN AMERICA:
SELECTED TAX ASPECTS OF INVESTMENT 306
Ruben Diaz, Jr.

US businesses have long recognized the tremendous potential of Latin American economies and markets. For many years, however, the combination of state control of important economic sectors, complex regulations restricting foreign investment and unstable political systems had severely limited US investment in the region. Most Latin American countries have now opened their economies to foreign investment and embarked on a privatization programme, thus stimulating US investment.

UNITED STATES:
DEDUCTIBILITY OF INTEREST AND OTHER FINANCING CHARGES IN COMPUTING INCOME 310
David M. Benson and Matthew M. McKenna

The authors take a look at the Internal Revenue Code sections which deal with the deductibility of interest expense. Although the general principle starts out in a simple manner, several pages of the code then describe various limitations to the general rule, and other code sections prescribe additional limitations on the deductibility of interest expense.

UNITED STATES:
HYBRID ENTITIES 315
James J. Tobin and William R. Seto

The focus on hybrid entities by US multinationals has increased dramatically in recent years. Correspondingly, the level of ruling activity and IRS consideration of the area have increased as well. This article takes a look at the US tax treatment of hybrids, both inbound and outbound, as well as the advantages and disadvantages of using hybrids.

© 1994 International Bureau of Fiscal Documentation

UNITED STATES:
NEW IRS TRANSFER PRICING DOCUMENTATION REQUIREMENTS 321
Kenneth J. Krupsky, Esq.
This article reviews the new IRS transfer pricing documentation requirements, identifies key issues and unanswered questions and provides recommendations for compliance with the new rules.

INTERNATIONAL:
A PRIMER ON TAX EVASION 328
Vito Tanzi and Parthasarathi Shome
Tax evasion is universal. It depends on the economic and tax structures, types of income and social attitudes. The theory of tax evasion has limitations since it depends solely on the attitude toward risk with full information regarding the tax administration's behaviour. Methodologies for estimating tax evasion include predominantly estimating the underground economy, and comparing taxes declared with potential tax revenue calculated from national accounts. Actions in addressing tax evasion include use of withholding, presumptive and minimum taxes, selective auditing, penalties and cross-checks between taxes.

RUSSIA:
RESULTS OF INITIAL IMPLEMENTATION OF TAX REFORM 338
Dr Elena Markina
Transition to a free market economy required radical changes in the Russian tax system as the system used under the centrally planned economy discouraged the transformation process. A package of new laws, which abolished the former tax legislation, was adopted by the Russian Parliament in 1992. The article describes the basic characteristics of the new Russian tax system and analyses its advantages compared with the previous system. It then analyses the first results of the initial tax reform and subsequent amendments in tax legislation according to the present situation. Finally, the possibility of bringing the Russian tax system in line with the Western model is discussed.

SINGAPORE:
1994 BUDGET 347
Lee Fook Hong
This article highlights the proposals contained in the 1994 Budget.

INTERNATIONAL:
PUBLIC INTERNATIONAL LAW ASPECTS OF SOME TRANSFER PRICING ISSUES 351
Lynette V. Eastmond
Ms Eastmond examines from a public international law perspective certain aspects of transfer pricing which do not concern the determination of an arm's length price.

BIBLIOGRAPHY
– Books 358
– Loose-leaf services 366

CONFERENCE DIARY 327

CUMULATIVE INDEX 368

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

BENELUX

HOLDING COMPANIES

Paul Sleurink, Hans Decleir and Veronique Sway

The authors are all attorneys in the New York office of Loyens & Volkmaars.

This article highlights the characteristics of holding companies in Belgium, Luxembourg and the Netherlands.

BELGIUM

Belgian tax law does not provide for any special "holding company status" (such as, for example, the 1929 Luxembourg holding company). However, all Belgian resident companies that are subject to Belgian corporate income tax ("CIT") and all Belgian permanent establishments ("PEs") of foreign companies can benefit, under appropriate circumstances, from favourable tax treatment of dividends and capital gains. As in the Netherlands and Luxembourg, a Belgian company can combine a "holding" function with other activities.[1]

I. CORPORATE TAX SYSTEM

Belgian CIT is levied on the worldwide income of resident companies. Non-resident companies (i.e. foreign companies with their place of effective management outside Belgium) are taxed on certain Belgian-source income and on foreign-source income to the extent that the latter income is effectively connected with a Belgian PE of the non-resident company.

Taxable income is determined on the basis of the commercial accounts, unless specific tax rules provide otherwise. Generally, a Belgian company's taxable income is equal to the sum of:

- the increase in taxable reserves during the fiscal year concerned;
- the total amount of non-deductible expenses, such as the CIT, commissions and fees in certain circumstances, excessive interest charges, etc.; and
- dividends distributed.

This total is then reduced by certain deductions, such as profits attributable to foreign PEs located in countries which have concluded a tax treaty with Belgium, certain tax-allowed provisions, loss carry-forwards and most importantly the 95 percent deduction for dividend income (i.e. income falling within the participation exemption).[2]

CIT is presently levied at a general flat rate of 40.17 percent for Belgian resident companies, with lower progressive rates ranging from 28.8 to 42.2 percent for certain companies whose total taxable income does not exceed Bfrs. 13 million. Non-resident companies are generally taxed at a rate of 42.2 percent, although this rate is reduced under most tax treaties to the domestic rate of 40.17 percent on the basis of the non-discrimination principle.

Resident companies must withhold tax at 25.75 percent on dividends distributed to resident and non-resident shareholders, although most tax treaties reduce this withholding tax to 15 or 5 percent if paid to residents of treaty countries. Under the EC parent-subsidiary directive dividend distributions paid by a Belgian resident company to a qualifying EC company are exempt from dividend withholding tax. Under Belgian domestic tax rules, the proceeds distributed to the shareholders upon liquidation of a Belgian company, or proceeds distributed as a result of a repurchase of shares by a Belgian company, are not subject to Belgian withholding tax.

II. TAXATION OF DOMESTIC AND FOREIGN-SOURCE DIVIDENDS RECEIVED BY A BELGIAN HOLDING COMPANY

In general, the participation exemption for dividends received does not distinguish between the origin of the dividend income (domestic or foreign), or between dividends derived from EC or non-EC companies.

A. General rule

Dividends received by a Belgian parent company from a resident or non-resident subsidiary enjoy a 95 percent exemption from CIT, provided the conditions for application of the participation exemption are met.

1. A Belgian company (or a PE of a foreign company) can also benefit from the special "coordination centre" status if certain requirements are met. If a company qualifies as a coordination centre it can benefit from a very favourable tax regime. However, since a coordination centre cannot hold shares this regime will not be addressed in this article.
Belgian tax law also contains specific provisions for collective investment companies (SICAF/Vs, comparable to the Luxembourg SICAV/F or the Dutch "investment institution"). Due to the comprehensive requirements that need to be met (publicly traded, specific investment pattern, etc.), the tax regime applicable to such institutions will not be discussed.
2. As explained below, the Belgian participation exemption system operates as a deduction system, i.e. intercorporate dividends are first included in a company's total taxable income and are later deducted.

© 1994 International Bureau of Fiscal Documentation

B. Method of exemption

The participation exemption exempts 95 percent of the dividend income; the remaining 5 percent is subject to CIT. The exemption of intercompany dividends is granted as follows. Dividends received or accrued[3] are included in full in the taxable income and then 95 percent is deducted from the calculated base in order to determine the amount of income on which the tax rate is applied, but only if the initial computation results in a positive amount. Therefore, if the net result of the Belgian company's other activities in the current year (i.e. not including qualifying dividends) is a loss, all or part of the qualifying dividends cannot be deducted. The reason for this is that dividends received are only included in the taxable base after the net result of the company's other activities in the current year. Since loss carry-forwards from previous years are deducted after the deduction for dividends received, the loss carry-forwards cannot have an adverse effect on the deductible amount of dividends received. It should be noted that the dividends (or part thereof) which cannot be deducted are not available for carry-forward, and therefore are permanently lost.[4]

C. Conditions for application of the participation exemption

The participation exemption applies to dividends, i.e. all income (as opposed to capital gains) derived from shares or profit certificates from companies. As a result, dividends in kind, stock dividends, bonus shares,[5] interim dividends, etc. qualify for the participation exemption. Under Belgian tax law, the proceeds from the liquidation or redemption[6] of shares of a company are taxed as a dividend, so the participation exemption for dividends received may apply to such distributions.[7]

At the moment the dividend is paid or becomes payable, the Belgian company must own at least 5 percent of the capital of the subsidiary, or the participation must have an acquisition price for the Belgian company of at least Bfrs. 50 million.

No minimum holding period for the participation is required for application of the participation exemption.

It is not necessary to hold the participation in full ownership, so dividends received from "derivative ownership rights" of shares, such as usufruct, may qualify for the participation exemption.

A participation will only qualify for the participation exemption when the subject-to-tax requirement is met, i.e. the subsidiary must be subject to Belgian CIT or a similar foreign tax (see below). An advance ruling may be obtained from the tax authorities as to whether the subject-to-tax requirement is fulfilled.

D. Anti-avoidance provision

The participation exemption does not apply to dividends derived from shares in the following companies:[8]

(1) companies established in a jurisdiction where the tax system is not similar to the Belgian CIT system;[9]
(2) companies established in a jurisdiction where the tax system, although similar to the Belgium CIT, is significantly more advantageous than in Belgium;[10]
(3) holding or finance companies which are established in a jurisdiction where all or certain types of such companies are subject to a corporate tax which differs from the normal tax regime;[11]
(4) investment companies;[12]
(5) foreign companies distributing dividends out of (dividend) income which does not fulfil the subject-to-tax requirement.

Dividends distributed by companies described under (3) and (4) may nevertheless qualify for the participation exemption if it is demonstrated that the dividends received by those companies fulfil the subject-to-tax requirement (i.e. the dividend income would qualify for the participation exemption if it were paid directly to a Belgian company). However, this look-through rule does not apply if the excluded holding, finance or investment company is established in jurisdictions described under (1) and (2).

The scope of the anti-abuse provision described under (5), which applies only to foreign intermediate companies, may be limited because it conflicts with the equal treatment clause contained in several of Belgium's tax treaties.[13] This clause requires that Belgium treat dividends derived from a company resident in the other contracting state in the same manner as dividends derived from a similar Belgian company.[14]

The fact that dividends distributed by a Belgian intermediate company to its Belgian parent out of "non-qualifying divi-

3. I.e. the net dividend received (gross dividend minus e.g. foreign withholding tax). The dividend is included in the tax base of the Belgian company at the time the dividend is at the disposal of the shareholder or made payable, whichever comes first.
4. However, this adverse effect will not arise if the company is a pure "holding company" with no other activities that may give rise to losses.
5. Insofar as bonus shares constitute taxable income, which is usually not the case.
6. With respect to liquidation proceeds and proceeds of a redemption of shares of foreign companies, Belgian tax law requires that the liquidation/redemption be "treated likewise" in the foreign jurisdiction (i.e. as a "distribution" to the shareholder).
7. Assuming that the foreign jurisdiction would treat the liquidation/redemption as a capital gain (e.g. United States), then the (100%) exemption for capital gains should in principle apply. This point of view is not clear, however, under Belgian tax law.
8. Belgian Income Tax Code ("ITC") Art. 203.
9. The Belgian tax authorities have published an official non-exhaustive list of these jurisdictions (e.g. Bahamas, Bermuda).
10. These jurisdictions also appear on the list (e.g. Aruba, British Virgin Islands, etc.).
11. According to the list, such jurisdictions include Jersey, Liechtenstein, Luxembourg, the Netherlands Antilles and Uruguay.
12. Since this concept is not explicitly defined in the ITC, other legislation, such as the Law on Financial Transactions and Financial Markets of 4 December 1990, may provide guidance as to which companies are specifically excluded. The above-mentioned law applies to collective investment institutions which invest funds obtained from the general public (such as SICAVs and SICAFs). According to Parliamentary documents this provision also applies to similar foreign collective investment vehicles (e.g. Irish UCIT's, Luxembourg SICAV/Fs).
13. Each provision of the relevant tax treaty must be carefully examined in this respect (e.g. only applicable to certain types of companies).
14. Such a clause can be found in the treaties with *inter alia*, Austria, Canada, Germany, Greece, Ireland, Luxembourg, Malta, the Netherlands, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

© 1994 International Bureau of Fiscal Documentation

dend income" qualify for the participation exemption, while such dividends distributed by a foreign intermediate company would not qualify, is not compatible with the equal treatment clause.

III. WITHHOLDING TAX ON DIVIDENDS PAID TO THE UNITED STATES

Under the Belgium–US income tax treaty, the dividend withholding tax is reduced to 5 percent if the beneficial owner of the dividend is a company which owns directly at least 10 percent of the voting stock of the company paying the dividends, or to 15 percent in all other cases. The treaty contains a limitation on benefits provision (Article 12A), which is far less comprehensive than Article 26 of the US–Netherlands tax treaty.

IV. TAXATION OF CAPITAL GAINS/LOSSES ON SHAREHOLDINGS

A. Realized capital gains

In principle, gains realized on the disposal of a company's assets are considered profits and therefore subject to CIT.

Under the participation exemption, capital gains realized by a Belgian company in respect of shares in a Belgian or a foreign subsidiary company are fully exempt from CIT provided the dividends on the shares would qualify for the participation exemption for dividends.[15]

Unlike the participation exemption for dividends,[16] no minimum participation (or acquisition value) is required for the capital gains exemption. However, the exemption applies only to the extent that the capital gains realized on the shares exceed the net amount of the previous write-downs on the book value of these shares to the extent deducted, and the previous capital gains to the extent taxed.

The capital gains exemption is granted by a direct elimination of the gains from taxable income, so that the limitation connected with the method used for granting the deduction (maximum 95 percent) of intercompany dividends does not come into play.

B. Unrealized capital gains

Unrealized capital gains are not taxable if the capital gain is not expressed in the accounts. If the capital gain would be expressed in the accounts, said gain is not taxable to the extent it is booked and remains booked on a blocked reserve account.[17]

C. Losses

Capital losses on both realized and unrealized shares are not tax deductible (regardless of whether the underlying shares qualify for the participation exemption). However, if a loss is incurred in connection with the liquidation of a subsidiary company, i.e. the liquidation distribution is less than the purchase price of the shares, such loss is deductible, but only to the extent that the liquidation distribution is less than the amount of the paid-up share capital on the shares.

V. DEDUCTIBILITY OF INTEREST EXPENSE

Arm's length expenses (i.e. financial or other) incurred with respect to a participation are fully deductible. Belgian tax law does not contain any formal thin capitalization rules,[18] so a Belgian company can be leveraged to a very high extent, whereby the deductible interest expense can be used to offset the 5 percent taxable portion of a dividend received, as well as any taxable profits from other activities. Furthermore, if properly structured[19] the deductible interest expense can substantially reduce a future dividend withholding tax claim upon redistribution of the profit of the Belgian holding company.

VI. ANTI-DEFERRAL REGIME RELATING TO CFCS

In general, there are no such rules under Belgian tax law. However, under ITC Article 344, the Belgian tax authorities can disregard certain transfers of assets, contributions of stock, etc. by a Belgian company to a tax haven company unless the Belgian company demonstrates that the transaction has legitimate business purposes, or that the taxpayer received a countervalue which gave rise to income subject to a normal effective tax burden in Belgium comparable to the tax burden which would have applied in the absence of said transaction.

VII. CAPITAL TAX

In general all contributions to the capital of a Belgian company are subject to a 0.5 percent capital tax. The taxable base is the nominal value of the shares issued in consideration for the contribution, or the fair market value of the contribution, whichever is higher.

15. Realized capital gains also include gains realized in Bfrs. as a result of the appreciation of the currency of the country where the foreign subsidiary is resident.
16. For dividends received, a 5% participation or acquisition value of Bfrs. 50 million applies.
17. This rule also applies to unrealized capital gains resulting from appreciation of the currency of the country where the foreign subsidiary is resident.
18. Apart from certain rules which, under specific circumstances, recharacterize interest payments as dividends if a director or partner of a Belgian company grants a loan to that company.
19. Interest payments are in principle subject to a 13.75% interest withholding tax. Therefore, the leveraging must be structured via an entity resident in a treaty country, so that the withholding tax can be reduced to zero (e.g. the Netherlands, Luxembourg).

© 1994 International Bureau of Fiscal Documentation

An exemption from capital tax is granted, *inter alia*, in the following cases:

- a contribution by an EC-company of all its assets and liabilities to a Belgian company in consideration solely for shares in the Belgian company, or in consideration for both shares and cash so long as the cash payment does not exceed 10 percent of the par value of the shares received;
- a contribution by an EC-company to a Belgian company of an independent part[20] of its enterprise where the compensation received by the contributing EC company consists solely of shares in the Belgian company, or in consideration for both shares and cash so long as the cash payment does not exceed 10 percent of the par value of the shares received.

VIII. SUBSTANCE REQUIREMENTS

According to ITC Article 2 paragraph 2(2), a resident company is a company incorporated under Belgian law or a company that has its statutory seat, its principal establishment or place of effective management in Belgium. Authoritative sources[21] agree that a company with only its statutory seat in Belgium, but with its place of effective management outside Belgium, cannot be taxed as a Belgian resident company. As in the Netherlands and Luxembourg, Belgian holding companies have a variable amount of substance (management by trust office, etc.). The same caveat applies as in the Netherlands with respect to the declaration of residence in the case of a dual resident receiving income from a third country (see below).

IX. TREATMENT OF EXCHANGE GAINS AND LOSSES ON ACQUISITION DEBT

Such gains and losses are not treated as forming part of the shareholding, so they will be included in or deducted from the tax base of the Belgian holding company. It is advisable to fund the holding company with a Belgian franc-denominated debt.

X. INTEGRATION SYSTEM

Such a system is not known under Belgian tax law.

XI. OTHER TAX CONSIDERATIONS – FUTURE DEVELOPMENTS

For certain structures, the Belgian holding company regime, with its peculiarities, offers a very interesting alternative to the traditional Dutch and Luxembourg holding company regimes because:

- interest and other costs to acquire the participation are fully deductible;
- there are no debt-to-equity ratios;
- there is no compartmentalization theory, i.e. fulfilment of the requirements for the participation exemption is determined only at the time dividends are distributed or capital gains realized.

In addition, the exit possibilities via liquidation or repurchase of shares (which do not result in dividend withholding tax) may create interesting tax planning possibilities. As noted above, the tax authorities can issue an advance ruling with respect to the subject-to-tax requirement. Whether this ruling practice provides sufficient flexibility for the taxpayer remains unclear.

NETHERLANDS

For many years, Dutch resident holding companies have been among the standard tools of the international tax practitioner.

It should be noted at the outset that the Netherlands does not have a special "holding company regime", i.e. a Dutch company acting as a holding company is subject to CIT in the same manner as any other company, and dividends distributed by its subsidiaries and capital gains derived from the disposal of subsidiaries may be exempt from CIT in the hands of any Dutch corporate taxpayer by virtue of the participation exemption (see below). Therefore, a Dutch company may very well combine a 'holding-function' with other activities, such as for example (but not limited to), financing, licensing and commercial and industrial activities.

I. CORPORATE TAX SYSTEM

The Netherlands imposes an annual CIT on both resident and non-resident corporate entities. Resident corporate entities are subject to CIT on their worldwide income, while non-resident corporate entities are subject to CIT only with respect to certain Dutch-source profits. The 1969 Corporate Income Tax Act ("CITA") does not distinguish between ordinary income and capital gains/losses, i.e. both are included in taxable profits. CIT is levied on taxable profits, as adjusted by loss carry-forward (eight years) and carry-back (three years). The standard rate of tax is 35 percent; the rate of CIT on the first Dfl. 250,000 of profit is 40 percent (the Dfl. 250,000 may be reduced to Dfl.100,000 in July 1994).

II. TAXATION OF DOMESTIC AND FOREIGN-SOURCE DIVIDENDS RECEIVED BY A DUTCH HOLDING COMPANY

A. Domestic dividends

In principle, dividends derived by a Dutch (holding) company from a shareholding in a Dutch resident company are

20. Under certain circumstances, a 100% shareholding can qualify as an independent part of an enterprise.

21. The Belgian tax authorities consider a company with its statutory seat in Belgium to always be subject to CIT as a Belgian resident company, unless a tiebreaker rule in a treaty provides otherwise. There is case law to the contrary.

© 1994 International Bureau of Fiscal Documentation

included in the recipient's taxable profit. In general, dividends paid by a resident company to residents are subject to a withholding tax of 25 percent. This withholding tax may be credited by resident recipients against their income tax liability; in the case of non-residents the withholding tax is final.

If a company owns substantial shares in another company it may be eligible for application of the participation exemption (or "affiliation privilege"). The participation exemption exempts from tax all intercompany dividends or other profit distributions (and capital gains on the disposal of all or part of the shares; see below). If the participation exemption applies the dividends are also exempt from the dividend withholding tax. To qualify for the participation exemption the following conditions must be fulfilled:

- the taxpayer must hold at least 5 percent of the nominal paid-up capital of the distributing company;[22]
- the shareholding may not be held as inventory;[23]
- the distributing company must not have elected to be taxed as an investment institution under CITA Article 28.

B. Foreign dividends

As a result of the implementation of the EC parent-subsidiary directive, a distinction has to be made between dividends received from EC resident companies and dividends received from non-EC resident companies.

Dividends received from non-EC resident companies will be exempt from CIT only if in addition to the conditions set forth above, the following two conditions are also met:

- the shares in the distributing company are not held as a portfolio investment but rather as a business investment; and
- the non-resident company is subject to a tax on its profits in its country of residence.

Under the parent-subsidiary directive dividends received from EC resident companies will be exempt from CIT only if all conditions mentioned above are fulfilled. However, the non-portfolio investment criterion will not be applied if the Dutch company:

- has an interest of at least 25 percent of the paid-up capital of the distributing company resident in another member state;[24]
- both companies take one of the legal forms as listed in the Annex to the directive;
- neither the parent nor the subsidiary are resident for tax purposes outside the EU under a tax treaty with a third country; and
- the company in which the participation is held has no possibility in its country of residence to opt for taxation or being exempt.

As is well known it is possible to request an advance ruling from the Dutch tax authorities regarding the tax treatment of a particular transaction. In particular, such a ruling will confirm that the shareholding by the Dutch company in a foreign subsidiary cannot be considered a portfolio investment, so that if all other requirements are met, eligibility for the participation exemption will be binding on the Dutch tax authorities.

III. WITHHOLDING TAX ON DIVIDENDS PAID TO THE UNITED STATES

Under the 1992 Netherlands–US double tax treaty, the statutory Dutch dividend withholding tax rate of 25 percent is generally reduced to 15 percent; a further reduction to 5 percent is granted if the beneficial owner of the dividends is a company which holds directly at least 10 percent of the voting power of the company paying the dividends. Dividends paid by a Dutch company which is an investment institution always are subject to a withholding tax rate of 15 or 25 percent. The reduction will apply only to the extent that the US recipient is a "qualified" resident under Article 26 of the treaty.

IV. TAXATION OF CAPITAL GAINS/LOSSES REALIZED ON SHAREHOLDINGS

Capital gains derived from disposals of qualifying shareholdings in both domestic and foreign companies are exempt from Dutch CIT under the participation exemption rules as summarized above.[25]

Capital losses sustained on the disposal of a qualifying participation are not deductible unless the subsidiary is formally liquidated, and CITA contains a number of provisions restricting the deduction of liquidation losses in the case of abusive practices.

V. DEDUCTIBILITY OF INTEREST EXPENSE

Expenses related to a participation are not deductible unless they contribute directly or indirectly to taxable income in the Netherlands. Therefore, interest incurred by a Dutch holding company to acquire a participation in a non-resident subsidiary (where the participation exemption applies), or interest incurred by a Dutch subsidiary which in turn carries on its business through a PE outside the Netherlands, is not deductible. Since taxpayers have attempted to confuse the allocation between the interest expense and investment, CITA Article 13(1) provides that interest incurred on loans made in the six months preceding the acquisition of a participation is deemed to be made in connection with that participation unless the taxpayer proves otherwise.

Other than the above rules, there are no statutory thin capitalization rules in the Netherlands. Under the advance ruling practice, however, it is customary for the tax authorities to

22. A smaller participation may qualify in certain circumstances.
23. This provision is limited to cases where the distributing company has exclusively liquid assets, i.e. cash companies.
24. The 25% ownership of the paid-up capital in the EC distributing company is replaced by a requirement to own at least 25% of the voting shares under treaties where this criterion is used, i.e. see the treaties with Germany (by election), Ireland, Italy and the United Kingdom.
25. Capital gains include gains realized as a result of the appreciation of the currency of the country in which the foreign company is resident.

© 1994 International Bureau of Fiscal Documentation

require a maximum 85/15 debt-to-equity ratio. While the legality of this requirement is debatable, it has been standard practice for many years.

Finally, the Dutch Ministry of Finance has announced that it is considering measures against the virtually unrestricted base erosion that takes place when a Dutch target company is acquired by a highly leveraged Dutch acquisition company, followed by tax consolidation of the two Dutch companies.

VI. ANTI-DEFERRAL REGIMES RELATING TO CFCS

The Dutch corporate anti-deferral regime is limited to a single provision. Under CITA Article 28b, a Dutch company which owns alone, or together with its related entities, an interest of at least 25 percent in a non-resident entity, must value that interest annually at the fair market value if the assets of the non-resident entity consist of at least 90 percent (directly or indirectly) of portfolio investments. This provision must be applied in conjunction with the participation exemption. While an increase in the fair market value of the interest held by a Dutch company in principle will currently result in taxable profit, such deemed gain may very well be exempt from CIT if the conditions discussed above for the participation exemption are fulfilled.

VII. CAPITAL TAX ON FORMATION

In general, any contribution of equity to a Dutch company in exchange for shares is subject to capital duty at the rate of 1 percent, based on the higher of the fair market value of the contribution or the nominal value of shares issued. A contribution of equity may take place on the issuance of shares, as nominal capital plus possibly share premium, or as informal capital.

Three exemptions are important in connection with the formation of a Dutch holding company, i.e. an exemption from capital duty is available in respect of shares issued on the occasion of a share merger, an enterprise merger or a group reorganization.

A. Share merger exemption

In principle, when a Dutch company receives by way of capital contribution at least 75 percent of the shares of an EC resident company or, alternatively, an existing participation of 75 percent or more is increased, the capital contribution is exempt from the 1 percent capital duty. The residence of the contributing entities/persons is not relevant for purposes of this exemption.

B. Enterprise merger exemption

If an EC resident company contributes to a Dutch company all of its assets and liabilities, or its entire enterprise or an independent part of its enterprise, in return for the issue of shares, the contribution is exempt from capital duty.[26]

C. Group reorganization exemption

Where a Dutch company which belongs to a group acquires all of the business assets of a similar kind from the other group companies in return for the issue of shares, the contribution is exempt to the extent that the assets were received from EC resident members of the corporate group.[27]

VIII. SUBSTANCE REQUIREMENTS

Dutch tax law does not contain any specific substance requirements that need to be met in order to benefit from the participation exemption. In practice, many Dutch resident holding companies have very little substance and are managed locally by a trust company without having substantial assets and/or activities in the Netherlands. The CITA provides that any company incorporated in the Netherlands is deemed to be a Dutch resident company regardless of where the place of its effective management (which otherwise is the decisive factor) is located. This deeming provision can be overridden by a tiebreaker rule in a tax treaty.

Substance in the Netherlands should nevertheless be a point of consideration. Modern tax treaties generally contain a provision identical to Article 4, paragraph 1, second sentence of the 1992 OECD model treaty. With respect to the interpretation of this provision, the Dutch Ministry of Finance has publicly announced that whenever such a provision is included in a treaty between the Netherlands and the source state of foreign income, and the Dutch company is deemed to be a resident of a third state as a result of a tiebreaker provision, the issuance of a declaration of residence, necessary to obtain a reduction of withholding taxes in the source state, may be denied. While this position is widely attacked, it should still be considered whenever the substance of a Dutch company is at issue.

IX. TREATMENT OF EXCHANGE GAINS AND LOSSES ON ACQUISITION DEBT

Unlike the rules relating to current expenses incurred on foreign participations, capital gains and losses on acquisition debt form part of the taxable profit of a Dutch holding company, so it is generally recommended to fund a Dutch holding company with a (notional) Dutch guilder-denominated debt.

26. This exemption is of particular interest since in some circumstances a 100% subsidiary can qualify as an independent part of an enterprise, so that for example, the contribution by a UK company of a Japanese company to a Dutch company may be exempt from capital duty.

27. The Dutch Supreme Court recently ruled that capital tax incurred by a Dutch company in relation to an equity investment in a non-resident subsidiary is deductible when the participation exemption applies. The Revenue argued that based on such ruling, the same rule would apply to interest. The Supreme Court based its decision on the fact that the capital tax was a cost of the company as such, regardless of the use of the proceeds.

© 1994 International Bureau of Fiscal Documentation

X. INTEGRATION SYSTEM

The Netherlands does not provide for any form of integration between taxation at the level of a company and its shareholders.

XI. OTHER TAX CONSIDERATIONS – FUTURE DEVELOPMENTS

On 16 July 1993 the Dutch Ministry of Finance released a draft bill (the "Bill") which contained new anti-tax haven measures and certain other amendments to the CITA.

The Bill addressed the following issues:
- a limited deduction on interest paid to a subsidiary resident in a low-tax jurisdiction;
- non-applicability of the participation exemption with respect to income and capital gains derived from certain companies resident in low-tax jurisdictions (the Bill introduced an indirect foreign tax credit for dividends which did not qualify for the participation exemption); and
- a limitation of the deemed residence rule for corporations organized under Dutch law.

The Bill was released in the form of a draft because its main purpose was apparently to generate discussion, in particular from the business and legal community. After ferocious attacks from almost all sides, the Ministry of Finance withdrew the Bill to further study the various proposals. The Under-minister of Finance also announced that the form of the Dutch participation exemption will not be the subject of a new bill, but that implementation by the Dutch tax authorities may be reconsidered. This vague remark has not been further explained.

Although the Bill has been withdrawn, the following overview of the proposals regarding the participation exemption are important because they provide an insight into the policy and thinking of the Dutch tax authorities in this area.

Under existing law, a non-resident subsidiary merely needs to be subject to a tax on its profits in its country of residence – the rate of tax is irrelevant. Under the Bill, a non-resident company would be considered subject to a tax on its profits in its country of residence only if one of the following conditions is met:
- the non-resident company is subject to a tax on its profits at a (in principle, statutory) rate of at least 15 percent without the possibility of opting for exemption or of being subject to a special regime, under which tax is levied at an (effective) rate of less than 15 percent; or
- the non-resident company is subject to tax in its state of residence and it is engaged mainly in activities other than the following:
  - the non-resident company is a credit institution; or
  - the non-resident company is primarily (i.e. more than 50 percent) engaged in activities other than lending to related companies, portfolio investments or similar activities, or activities generating royalty income.

Benefits (both dividends and capital gains) from shares in non-resident companies that do not meet one or more of the above requirements would not qualify for the participation exemption and would therefore be subject to Dutch CIT. As a result of the Bill, the participation exemption no longer applies to group financing and licensing companies that are subject to a special tax regime or to a tax at a rate of less than 15 percent, or that have the option to choose whether or not to be taxed at a rate of at least 15 percent.

The Bill introduced a two-tier indirect foreign tax credit with respect to benefits that do not qualify for the participation exemption under the new requirements. No refund is granted for an excess foreign tax credit in any taxable year.

The foreign tax credit is in principle fixed at 20 percent of the benefits derived from shares in the non-resident company minus attributable expenses. Upon request, the credit is increased to the CIT due by the non-resident company (first-tier subsidiary) attributable to the benefits derived from the shares *plus* the attributable tax due by second-tier subsidiaries. However, the credit may never exceed 35 percent of the benefits derived minus attributable expenses (the 35 percent limitation does not fully take into account the fact that the Dutch CIT rate structure is degressive, i.e. 40 percent on the first Dfl. 250,000 of taxable profit and 35 percent on the excess). Foreign tax that cannot be credited due to the 35 percent limitation may be credited against CIT payable in one or more of the succeeding eight taxable years.

LUXEMBOURG

A Luxembourg holding company (often referred to as "SOPARFI"), is a company subject to normal Luxembourg CIT, and it is eligible to benefit from the Luxembourg participation exemption.[28] As is the case in Belgium and the Netherlands, a Luxembourg holding company can combine a holding function with other activities.

I. CORPORATE TAX SYSTEM

Corporate income taxpayers are subject to national CIT at a general rate of 33 percent (increased by a 1 percent surcharge for the unemployment fund) and a municipal business tax on income at a rate of 10 percent. The municipal business tax is deductible from the taxable base for purposes of both the municipal tax and the national CIT. As a result, the general effective CIT rate, which applies to taxable profits exceeding approximately Lfrs. 1.3 million, is 39.39 percent.

CIT is imposed on all entities which have a capital divided into shares and which have income that cannot immediately be taxed in the hands of the beneficial owners. For purposes of this article, the most important corporate income taxpayers are the corporation ("SA"), the limited liability company ("SARL") and the partnership limited by shares ("SCA").

28. The "1929 holding company", which is granted a special status whereby it is not subject to Luxembourg CIT, will not be addressed in this article.

© 1994 International Bureau of Fiscal Documentation

Corporate income taxpayers are hereafter referred to as "companies".

Luxembourg operates a classical system of taxation, i.e. CIT is levied at the level of companies and distributed profits are fully taxed again in the hands of the shareholders. Distributions such as dividends are not deductible in computing taxable income.

A resident company, i.e. a company incorporated under Luxembourg law or a company having its principal place of management in Luxembourg, is subject to CIT on its worldwide income, which includes capital gains and other benefits. A non-resident company is only subject to Luxembourg CIT if it has received certain Luxembourg-source income. Taxable income is computed according to the "net asset value comparison". Generally, all expenses that relate to the business activities of the company are deductible for CIT purposes with the exception of certain expenses, such as CIT, net worth tax and most fines and penalties. The deductibility of financing expenses connected with a participation is discussed below.

In order to mitigate the double taxation resulting from the classical system, dividends received and capital gains realized by a company with respect to (qualifying) shareholdings in other (resident or non-resident) companies are exempt from Luxembourg CIT (both national and municipal). This exemption is subject to certain conditions, discussed below. Most tax treaties contain less stringent conditions for the exemption of dividends.

Losses (incurred after 1 January 1991) may be carried forward indefinitely, but no carry-back of losses is allowed.

Dividend distributions by a Luxembourg company are in principle subject to a dividend withholding tax at a rate of 25 percent; the rate may be reduced in certain cases under Luxembourg domestic law or by tax treaties.

II. TAXATION OF DOMESTIC AND FOREIGN DIVIDENDS

According to CITA Article 166, as amended by the Grand Ducal Decrees of 22 April 1986 and 27 May 1988, dividends (including liquidation dividends) received by a SOPARFI are exempt from Luxembourg CIT if the following requirements are met:

- the SOPARFI is fully subject to Luxembourg tax, i.e. it is not an exempt holding company under the law of 31 July 1929;
- the SOPARFI holds at least 10 percent of the issued capital of the subsidiary (resident or non-resident), or the participation has an acquisition price for the SOPARFI of at least Lfrs. 50 million;
- the subsidiary is either a resident of Luxembourg and fully subject to Luxembourg CIT, or in the case of a non-resident subsidiary, is subject to an income tax comparable to the Luxembourg CIT in its country of residence; and
- the SOPARFI continuously held the shares from the beginning of the accounting year in which the dividends were received, and continuously during at least 12 months immediately preceding the end of the taxable year in which the dividends were received.

As mentioned above, in order to qualify for the participation exemption, a non-resident subsidiary must be subject to a comparable tax in its country of residence. The Luxembourg tax authorities generally consider a foreign tax to be comparable to the Luxembourg CIT if it is levied at a rate of at least 15 percent. For subsidiaries established in treaty countries, the 15 percent requirement is generally deemed to have been automatically fulfilled.

One of the requirements of the participation exemption is that the shares must have been held for a certain period of time, which differs for dividends and capital gains (see below for capital gains). As a general rule, the minimum holding period must be met with respect to each individual share. Consequently, in the case of an acquisition of additional shares or an issue of new shares, the holding period commences with respect to the new shares. The new minimum holding period does not apply if shares are issued to a 100 percent parent company, or if shares are issued to existing shareholders in proportion to their shareholdings before the new issue.

III. WITHHOLDING TAX ON DIVIDENDS PAID TO THE UNITED STATES

Under the US–Luxembourg tax treaty, dividends distributed by a Luxembourg holding company to a US shareholder are subject to 7.5 percent dividend withholding tax, which is further reduced to 5 percent if the recipient is a corporation and:

- during the part of the payer corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year, at least 50 percent of the voting stock of the payer corporation was owned by the recipient corporation either alone or in association with no more than three other corporations of the other state, and at least 10 percent of the voting stock of the payer corporation was owned by each such corporation of the other state; and
- not more than 25 percent of the gross income of the payer corporation (other than a corporation whose principal business is the making of loans) for such prior taxable year was derived from interest and dividends other than interest and dividends received from its subsidiary corporations.

Note that liquidation proceeds and the proceeds derived from a repurchase of shares may not be subject to dividend withholding tax (see below).

IV. TAXATION OF CAPITAL GAINS/LOSSES REALIZED ON SHAREHOLDINGS

On 24 December 1990, a Grand Ducal Decree extended the participation exemption to capital gains realized on the dis-

© 1994 International Bureau of Fiscal Documentation

position of shares in a qualifying subsidiary, if the following requirements are met:

- the SOPARFI is fully subject to Luxembourg CIT (i.e. it is not an exempt holding company under the Law of 31 July 1929);
- the subsidiary is a resident of Luxembourg and fully subject to Luxembourg tax or, in the case of a non-resident subsidiary, it is subject in its country of residence to an income tax which is comparable to the Luxembourg CIT;
- the SOPARFI holds 25 percent or more of the issued capital of the subsidiary or the participation has an acquisition price of at least Lfrs. 250 million; and
- the shares must have been held directly and continuously for a period of at least 12 months immediately preceding the beginning of the accounting year in which the shares were alienated.

If the value of a participation is written down, a tax-deductible reserve may be created, but this reserve is to be offset against any exempt capital gain arising on a subsequent alienation of the shares (so-called "recapture" rule). The same applies to the writing down of a receivable on the subsidiary and negative income from the subsidiary that has been deducted from taxable income from other sources.

It should be noted that Luxembourg does not have a non-portfolio requirement, although an active participation in the subsidiary is required, at least for the exemption of capital gains. The Luxembourg legislature has decided that a participation of at least 25 percent or Lfrs. 250 million is by definition active.

Capital gains also include gains realized in Lfrs. as a result of the appreciation of the currency of the country in which the foreign company is resident.

V. DEDUCTIBILITY OF INTEREST EXPENSE

Financing expenses connected with a participation are tax deductible insofar as they exceed revenue from the participation in a given year. After the expiration of a tax year, the expenses lose their link to a participation. Expenses are allocated to the extent possible on a historical link basis and otherwise on a *pro rata* basis (e.g. divided over the number or the value of the participations). The above implies that the expenses may create or increase a tax loss, which may be carried forward indefinitely.

In general, there are no prescribed debt/equity ratios. Based on discussions with the Luxembourg tax authorities, a debt/equity ratio in excess of 85:15 should be avoided, in general. If a higher ratio is maintained, then part of the interest payments may be considered a constructive dividend, resulting in such part not being deductible for Luxembourg tax purposes and, depending on the case, Luxembourg dividend tax becoming due.

Currency gains and losses on loans to finance the acquisition of a subsidiary or operating loans are taxable/deductible. Therefore, currency exposure should be avoided, preferably by denominating such loans in Lfrs. Hedging agreements are accepted. Currency gains and losses on the investment itself are exempt by virtue of the participation exemption.

VI. ANTI-DEFERRAL RULES RELATING TO CFCS

Luxembourg legislation does not contain any such rules.

VII. CAPITAL TAX ON FORMATION

A non-recurrent capital duty of 1 percent is levied on any contribution to the capital of a company in exchange for shares of stock. The taxable base is either the par value of the shares received or the fair market value of the contribution, whichever is greater. Conversion of retained earnings to formal capital is not subject to capital tax.

An exemption (based on the EC directive) from capital tax applies where:

- a Luxembourg company acquires all of the assets and liabilities or one or more branches of activities from another EC-company in exchange for shares;
- a Luxembourg company acquires at least 75 percent of another EC company in exchange for its newly issued shares. This exemption is granted to the extent (i) the acquired shares are not transferred within five years, unless the Luxembourg company or the contributed company[29] is liquidated, or unless the disposal of the shares occurs in connection with a transaction for which an exemption from capital tax applies; and (ii) the Luxembourg company holds all of the shares it acquired upon the share merger continuously during this five year period.

VIII. SUBSTANCE REQUIREMENTS

The same requirements and caveat as in the Netherlands and Belgium apply.

IX. TREATMENT OF EXCHANGE GAINS AND LOSSES ON ACQUISITION DEBT

The same treatment as in the Netherlands and Belgium applies.

X. INTEGRATION SYSTEM

Luxembourg does not have any such system.

29. In case of liquidation of the contributed company, the exemption nevertheless remains applicable, provided that as a result of the liquidation, the Luxembourg company receives a percentage of the assets of the contributed company, which equals at least the percentage that the Luxembourg company previously had in the contributed company prior to the liquidation.

© 1994 International Bureau of Fiscal Documentation

XI. OTHER TAX CONSIDERATIONS – FUTURE DEVELOPMENTS

Under Luxembourg law, a liquidation dividend is not subject to dividend withholding tax; however, such a distribution will in principle be subject to Luxembourg income tax if paid to a holder of a substantial interest. The same applies to a repurchase by the company of shares from one or more shareholders who thereby cease to be a shareholder. Other capital reductions may give rise to Luxembourg dividend withholding tax. In very broad terms, a substantial interest exists if a shareholder, either alone or together with certain related parties, has held a shareholding of more than 25 percent in a Luxembourg company at any time during the five-year period preceding the liquidation/repurchase of shares. However, non-resident holders of a substantial interest are subject to Luxembourg income tax on such liquidation dividend repurchase proceeds only in case they were a Luxembourg resident taxpayer for more than 15 years and have become a non-Luxembourg taxpayer less than five years before the liquidation dividends/repurchase proceeds are paid. As a result, in most cases liquidation proceeds/repurchases will not be subject to any Luxembourg tax implications by liquidating the SOPARFI.

Note that the current US–Luxembourg tax treaty does not contain a limitation on benefits clause. At present, the current treaty is under renegotiation. It is very likely that the new treaty will contain a (comprehensive?) limitation on benefits provision.

The Taxation of Patent Royalties, Dividends, Interest in Europe

Guide I of IBFD's 'Guides to European Taxation'

A systematic guide to withholding tax payments on corporate cross-border payments. The 12 EC countries, Austria, Finland, Liechtenstein, Norway, Sweden and Switzerland are each covered in separate chapters dealing with transactions with the other countries in the book, plus some information on the USA and Canada.

- Taxation of Resident Companies: a brief description of taxes applicable to patent royalties, dividends or interest
- Taxation of Foreign-Source Income: unilateral provisions for the avoidance of double taxation, in particular on patent royalties, dividends and interest. Tables show the treatment of income from each country (plus the USA and Canada)
- Taxation of Non-Resident Companies: with particular reference to patent royalties, dividends and interest
- Taxation of Patent Royalties, Dividends and Interest received by Non-Resident Companies: detailed information on bilateral tax situations. Tables show withholding and other taxes applicable on income received from the taxing country by companies in each of the other countries in the guide, plus the USA and Canada
- Holding Companies: an outline of the taxation of international holding companies and other companies receiving and distributing foreign-source income

New subscription 1994: NLG 900

Loose-leaf, 1 binder, updated 3 times a year

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

FRANCE

TAX REGIME OF HOLDING CORPORATIONS

Olivier Delattre and Clotilde Fournier

Olivier Delattre is a tax partner at Bureau Francis Lefebvre, the Paris-based law firm. Mr Delattre holds a Diplôme d'Etudes Supérieures de Fiscalité from the Université de Paris. He furthered his studies of international tax law at the Boston University Law School for one year after which he joined the New York law firm, Davis Polk & Wardwell. In 1983, Olivier joined the international tax department at Bureau Francis Lefebvre in Paris, and in 1987 established their New York branch. He holds membership in the International Bar Association, the French branch of IFA and the American Tax Institute.

Clotilde Fournier, a member of the New York bar, has been a tax associate at the New York office of Bureau Francis Lefebvre since 1991, and was a tax associate at the New York law firm of Davis Polk & Wardwell for two years. Clotilde received a Diplôme d'Etudes Approfondies from the University of Paris, an LL M from the London School of Economics and Political Science and an LL M from Cornell University Law School.

I. CORPORATE TAX RATES

Effective for 1993, there is a single corporation tax rate, i.e. 33 1/3 percent, on ordinary income. Long-term capital gains, however, benefit from a reduced rate, as discussed below.

II. TAXATION OF DOMESTIC AND FOREIGN-SOURCE DIVIDENDS RECEIVED BY A FRENCH HOLDING CORPORATION

Dividends from any source received by a French corporation are taxable in France at the standard corporation tax rate but with the following adjustments.

Under French Tax Code ("CGI") Section 145 a French parent company may be exempt from corporation tax on dividends received from a qualifying French or foreign subsidiary. This tax regime, which is optional, is available upon satisfaction of the following requirements:

- the parent corporation must be subject to corporation tax at the standard rate;
- the shares of the subsidiary must be in registered form or deposited with one of the financial establishments listed by the tax authorities;
- the parent corporation must own at least 10 percent of the voting stock of the subsidiary or must have acquired the participation for at least FF 150 million; and
- the parent corporation must commit to keep the shares for at least two years unless the shares were acquired upon issuance.

If the parent/subsidiary regime of Section 145 is not available, the French parent corporation may obtain the same result through the *avoir fiscal* (a tax credit in the amount of half the dividend received), although only with respect to its French-source dividends. The combination of the avoir fiscal and the 33 1/3 percent corporation tax rate results in a total neutralization of the corporation tax that is due upon receipt of the French dividends.

III. WITHHOLDING TAX ON DIVIDENDS PAID TO THE UNITED STATES

The 25 percent rate of withholding tax that is normally levied on French-source dividends paid to non-residents of France is reduced under Article 9 of the France–US tax treaty to (i) 5 percent when the recipient is a US corporation that holds at least 10 percent of the voting stock of the French distributing corporation, or (ii) 15 percent otherwise (i.e. individuals and less-than-10 percent corporate shareholders).

In addition to the reduced rates of withholding tax, Article 9 of the treaty grants either the payment from the French Treasury of the avoir fiscal[1] or the reimbursement of the *précompte*[2] less the French withholding tax, to a resident of the United States who is not entitled to the avoir fiscal (because it is a corporation which holds at least 10 percent of the French distributing corporation). The avoir fiscal is designed to alleviate the fact that taxation is imposed at the level of the distributing corporation and at the level of the shareholder. When corporation tax has been imposed on profits which are distributed as dividends, there is no other imposition and the avoir fiscal will be available to the resident French shareholder, and possibly to a non-resident of France as well if the provisions of the applicable tax treaty provide for such benefit. If corporation tax has not been levied on the distributed profits (e.g. the parent-subsidiary regime of dividend exemption applies), the avoir fiscal will still be available under the above conditions, but the précompte will then be due by the distributing corporation.

The impact of the précompte, which even when refunded is a cash flow burden, can be lessened by two mechanisms:

1. For individuals, residents of the United States and US corporations with a less-than-10% stock ownership in the distributing corporation.
2. The précompte is an equalization tax in the amount of half of the dividend distributed. The précompte is levied when a dividend is paid out of profits which have not borne corporation tax at the standard rate (e.g. the distributing corporation was exempt under the parent-subsidiary regime) or out of profits that were realized more than five years prior to distribution of the dividends.

© 1994 International Bureau of Fiscal Documentation

- an exemption from the précompte is available when the French parent corporation qualifies for the foreign participation regime. Upon satisfaction of certain requirements,[3] dividends received by the French holding company from its foreign subsidiaries are not subject to the précompte on redistribution and any foreign tax credit attached to the dividend redistributed is passed through to the shareholders of the French holding. Correspondingly, the shareholders are not entitled to the avoir fiscal or any refund under the applicable tax treaty; and
- under CGI Section 146, the French distributing corporation is entitled to deduct from the précompte any tax credits for foreign withholding taxes levied on the distributed dividends by tax treaty countries.

Finally, an interesting possibility regarding dividend redistribution resides in the fact that when the French company redistributes foreign-source dividends to a non-resident of France, the foreign withholding tax that had been imposed on these dividends can be used as a tax credit to offset the French withholding tax that is imposed upon redistribution. This tax credit can only be used with respect to the same dividends to which it is attached.

IV. TREATY NETWORK WITH OTHER EUROPEAN AND EASTERN EUROPEAN COUNTRIES

France has an extensive tax treaty network (about 84 tax treaties), in particular with European (EC or non-EC) countries. The tax treaty of 4 October 1984 with the then USSR remains in force as to Russia and the other Republics but not with respect to the Baltic Republics.

Tax treaties with Eastern European countries (except for Romania and ex-Czechoslovakia) provide usually for an alternative reduced rate of withholding tax on dividends, i.e. 5 and 15 percent according to the shareholder, and a refund of the précompte (except for the tax treaty with Russia) but not for the avoir fiscal.

In addition to the tax treaty benefits, the EC directive of 23 July 1990, regarding the taxation of dividend distributions between parent and subsidiary companies located in different EC states, has now been implemented by member states. As a result, instead of the reduced rate of withholding tax provided by the applicable tax treaty, a dividend distribution by a qualifying company located in one member state to a French holding is subject to a zero percent withholding tax. On the French side, the zero percent withholding tax rate on a dividend distribution by the French holding to another EC company is available under the provisions of CGI Section 119 ter.[4]

V. TREATMENT OF CAPITAL GAINS AND LOSSES ON DISPOSAL OF SHARES OF OPERATING COMPANIES

The transfer of the stock of a subsidiary does not give rise to any specific exemption from tax of the resulting capital gains (unless the transfer is part of a qualifying exempt reorganization in France or within the EC).

However, as a general rule long-term capital gains, i.e. capital gains realized by corporations on assets such as stock,[5] held for at least two years prior to disposition, benefit from a reduced rate of taxation, i.e. 18 percent, provided the balance of the gain is set aside in a special reserve. Amounts subsequently distributed from the special reserve are subject to an additional tax to raise the level of effective taxation up to the standard corporation tax rate. Capital gains that do not meet one of these criteria, i.e. short-term capital gains, are taxable at the standard corporation tax rate.

Long-term capital losses are deductible from other long-term capital gains realized over the next ten years or from the special reserve. Short-term capital gains are deductible from ordinary income of the current taxable year, and if such income is not sufficient it can be carried forward over the next five years or carried back over the preceding three years.

VI. DEDUCTIBIILITY OF INTEREST EXPENSES

Interest paid on a debt owed to third parties is deductible on an accrued basis, provided the loan has been incurred in the interest of the borrowing corporation and is accounted for in its balance sheet.

However, when the lenders of the corporation are its shareholders, some limitations apply under CGI Sections 39-1-3º and 212, as follows:

(i) the share capital must be fully paid up;
(ii) interest is deductible only up to the average annual rate of private bond issues in France (e.g. 7.19 percent for 1993); and
(iii) if the lender[6] is de jure or de facto managing the company or holds more than 50 percent of the stock in terms of financial rights or voting stock of the borrowing corporation, interest relating to that part of the shareholder loan exceeding 1.5 times the share capital of the corporation is not deductible.[7]

3. The distributing corporation must satisfy the following conditions both on the day of distribution and at the end of the taxable year during which the distribution occurs: (i) at least two-thirds of its assets must consist of interests in companies located outside France which are covered by the parent-subsidiary system of dividend exemption, (ii) at least two-thirds of its income (excluding capital gains) must come from the foreign subsidiaries, and (iii) its sole activity must be the administration of its interests.
4. The French holding must be subject to corporation tax without exemption and be organized as a "société anonyme", a "société à responsabilité" or a "société en commandite par actions". The EC receiving corporation must (i) have its actual head office in one of the EC member states; (ii) be organized under one of the specified forms listed in the Annex to the directive; (iii) be subject to corporation tax in the state where its actual head office is located; (iv) own at least 25% of the French subsidiary; and (v) not be entitled to an avoir fiscal under an applicable tax treaty in an amount that exceeds the withholding tax specified by the tax treaty.
5. Gains from portfolio investments are excluded from the long-term capital gains regime, and hence are subject to the standard corporation tax rate.
6. Unless the lender is a parent company that meets the requirements for the parent-subsidiary regime of CGI Sec. 145, i.e. a French parent company with a 10% stock holding in the borrowing corporation.
7. Interest which is not deductible because of these limitations may not be deducted in the future and is considered a deemed dividend.

© 1994 International Bureau of Fiscal Documentation

On the other hand, there are interesting opportunities for interest deductions when the acquisition of a subsidiary is debt financed. A French parent company that acquires a foreign subsidiary through indebtedness is entitled to deduct from its income the interest on such loan even though it also benefits from the parent-subsidiary regime of dividend exemption. In addition, if the French parent company is controlling other French subsidiaries and these French corporations are part of the same tax consolidated group, interest on loans incurred to acquire a French or foreign target from a non-member will be deductible from the group's taxable profits. On the other hand, under the so-called "Charasse amendment", debt financing should not be used when acquiring the stock of a corporation that will become a member of the consolidated group from (i) individuals or corporations that control directly or indirectly the purchasing corporation, or (ii) from corporations controlled directly or indirectly by the shareholders in "(i)". In such a case CGI Section 223 B provides that part of the financial expenses incurred by the group must be added back to the overall income of the group by fractions over a 15-year period.

VII. ANTI-DEFERRAL REGIMES RELATING TO CONTROLLED FOREIGN COMPANIES

The French equivalent to the US controlled foreign corporation rules are contained in CGI Section 209 B. Section 209 B has been the focus of important changes in 1993 which have given rise to new Section 209 B-I bis.

Effective for structures established as of 30 September 1992,[8] a French corporation subject to corporation tax will fall within the scope of new Section 209 B-I bis if (i) it has a foreign establishment[9] or holds directly or indirectly at least 10 percent[10] of the stock, shares, financial rights or voting rights of a corporation or association established outside France or holds a participation in such corporation or association valued at least FF 150 million, and (ii) such foreign permanent establishment, corporation or association is subject to a privileged tax regime.[11] As a practical rule, the French tax administration presumes that the tax regime is privileged when the rate of tax levied in the foreign country is at least one-third less than the rate of tax that would be imposed in France.

If the ownership and privileged regime requirements are met, the French corporation is taxed in France on the profits of the foreign structure, which must be determined separately from its other profits and according to French tax rules. To avoid this immediate taxation, the French corporation must demonstrate that the foreign structure is primarily engaged in an effective industrial or commercial activity and that this activity is exercised primarily on the local market.

VIII. CAPITAL TAX ON FORMATION

At the time a corporation is constituted, the contribution by a foreign corporation of cash or shares to a new corporation in exchange for its stock is in principle subject only to a fixed registration duty of FF 500.

Reorganizations (merger, division and transfer of assets) realized since 15 October 1993 are subject to a fixed payment of FF 1,220,[12] while increases of capital realized on or after that date through an incorporation of reserves, profits or provisions are subject to a fixed payment of FF 500.[13]

IX. SUBSTANCE REQUIREMENTS

A French holding company can take various forms such as a "société anonyme", a "société en commandite par actions" or more recently, a "société par actions simplifiée". For that purpose, the corporate requirements relating, among other things, to meetings or accounting must be respected.

From a tax point of view, a corporation that is organized under French corporation law is treated as a resident of France, and as such subject to French taxation. The French tax administration would not challenge the existence of the corporation unless it is fictitious and its existence gives rise to a favourable tax treatment which is abnormal. In such a case, the tax administration would recharacterize the structure on the basis of abuse of law under Section L 64 of the Code of Fiscal Procedure.

X. TREATMENT OF EXCHANGES GAIN/LOSS ON ACQUISITION DEBT

Mark-to-market rules have progressively been introduced into French law over the past years.

Under CGI Section 38-6º-1, French or foreign term instruments that are listed on a market are in principle subject to the mark-to-market rule. These term instruments include contracts, options and other financial instruments. Pursuant to the mark-to-market rule, the gain or the loss realized at the end of every taxable year is immediately recognized.

When these term instruments are involved in symmetrical positions, however, recognition of losses on one position is limited to the amount which exceeds the non-taxed portion of the gain realized on the other position. For that purpose, positions are symmetrical if they are affected by variations in value or return which are related and inverse.

8. That is, (i) the creation on or after that date of a foreign establishment, (ii) the acquisition or issuance on or after that date of stock, shares, financial rights or voting rights, resulting in the 10% ownership threshold being reached or otherwise maintained or increased, and (iii) the acquisition or issuance on or after that date of a participation resulting in the FF 150 million participation threshold being reached or increased.
9. In contrast, foreign establishments do not fall within the scope of Sec. 209 B.
10. 25% under Sec. 209 B.
11. Currently, Sec. 209 B focuses on whether the country's overall tax regime is privileged.
12. Before that date, it is imposed at the rate of 1.2% computed on the excess of the merged corporation's net assets over its paid-in capital.
13. 3% before that date.

© 1994 International Bureau of Fiscal Documentation

XI. EFFECT OF CONSOLIDATION SYSTEM ON DISTRIBUTION OF FOREIGN PROFITS TO THE UNITED STATES

The French consolidation tax regime does not entail specific tax consequences for foreign-source dividends.

A. Receipt of foreign-source dividends by a French consolidated corporation

As a general rule, earnings that have been included in the overall profits of the consolidated group are exempt from the précompte when they are distributed within the consolidated group, and hence do not give rise to the avoir fiscal. This exemption also applies to distributions out of earnings realized outside France.

B. Distribution of dividends to a resident of the United States

Upon redistribution by the parent corporation, dividends paid out of the net (after corporation tax at the standard rate) overall profits of the affiliated group will be subject to the 5 percent withholding tax (15 percent for individuals, residents of the United States but with the benefit of the avoir fiscal) but will not be subject to the précompte. The précompte will be due when the dividends are distributed out of untaxed profits. In such a case, the parent corporation is entitled to deduct from the gross amount of the précompte the aggregate of all avoir fiscal and tax credits normally attached to the dividends received by the group.

XII. OTHER TAX CONSIDERATIONS

With respect to the liquidated corporation, distributions out of the special reserve for capital gains (see *supra* V) do give rise to the additional taxation that would normally be due and long-term capital gains that may be realized in the course of the liquidation do not have to be set aside in the special reserve. However, the effective distribution of the long-term capital gains realized in the course of the liquidation will normally entail the imposition of the précompte, refundable under the France–US tax treaty when the distribution is made to a resident of the United States not entitled to the avoir fiscal.

Regarding the shareholders of the liquidated corporation, the liquidation of the French holding corporation is a taxable event to the extent of the difference between the amount distributed in liquidation and the amount contributed by the shareholder (*boni de liquidation*).

The boni de liquidation is considered a dividend distribution by the tax administration that may give rise to the imposition of the précompte at the level of the distributing corporation. When received by a non-resident of France, it is subject to French withholding tax with the eventual benefit of the avoir fiscal under the applicable tax treaty.[14] For a corporate shareholder, a liquidation can also give rise to a capital gain or a capital loss in the amount of, respectively, the excess of the accounting value of the liquidated shares over the amount contributed or the excess of the accounting value of these shares over the amount received in liquidation. In such a case, the non-resident of France would in principle be taxable in the state of its residence under the applicable tax treaty (such as under the France–US tax treaty).

The French Parliament recently enacted a law that introduces a new type of company, the "société par actions simplifiée" ("SAS"). It purports to bring some needed flexibility to French corporate law, and to induce multinational groups to establish their holding in France rather than in traditionally more flexible EC countries. The main characteristic of the SAS is the contractual freedom that the parties will have to tailor the by-laws to their needs.

From a legal point of view, such corporation can be constituted with a capital of as low as FF 250,000 and with only two shareholders, but which must be French or foreign corporations with a capital of at least FF 1.5 million. The shareholders will have limited liability. They will be able to determine freely the conditions for meeting and voting. A more significant departure from general principles is that the by-laws may (i) suspend the right of shareholders to sell their stock for a period not exceeding ten years, (ii) subject all transfers of stock to the prior agreement of the parties, (iii) provide for the suspension of a shareholder's right to vote in case of a change of ownership affecting that shareholder, and (iv) provide for the exclusion of shareholders under certain conditions.

From a French tax point of view, this new entity will be treated as a corporation subject to corporation tax. The Technical Correction Law for 1993 expressly provides that the SAS must be assimilated to a "société anonyme" for purposes of applying the provisions of the CGI. Regarding the zero percent withholding tax pursuant to the EC directive (see *supra*), however, it will apply to distributions by the SAS but not to distributions from other EC subsidiairies since the actual language of the list of categories of corporations that fall within the scope of this exemption does not permit an implied inclusion of the SAS.

XIII. OTHER LEGAL AND COMMERCIAL CONSIDERATIONS

The exchange control rules that until recently were restricting foreign investments by residents of France have been lifted. Thus, such investments can generally be made without any requirements for prior administrative authorization. The only formalities may take the form of an information return in cases of investments by foreign persons in France or by residents of France outside France, and in cases of liquidation of these investments.

14. The tax administration's position is not without criticism as regards the treatment of the *boni de liquidation* as a dividend rather than capital gain. In this sense, a decision of the Conseil d'Etat on the treatment of redemptions may provide some grounds to challenge the dividend treatment (CE 7/8/92, nº 88734, "Gardet").

© 1994 International Bureau of Fiscal Documentation

GERMANY

HOLDING COMPANIES

Dr Thomas Töben

Rädler Raupach Bezzenberger, Berlin/New York

Two major tax laws were enacted in 1993, i.e. the 1994 Tax Reform Act (the Business Location Improvement Act, "BLA") on 17 September 1993,[1] and the Anti-Abuse and Technical Corrections Tax Act on 30 December 1993.[2] Some of the new provisions affect German international tax law, in particular the tax treatment of German holding companies. For the most part, the changes are applicable as of 1 January 1994 or for fiscal years which commenced or ended after 31 December 1993.[3]

I. CORPORATE INCOME TAX

A. General

Resident companies, i.e. companies with their legal seat or principal place of management in Germany, are subject to corporate income tax ("CIT") on their worldwide income. Non-resident companies are only subject to CIT if they receive income from German sources.

The German corporate tax system is a full imputation system which completely eliminates the economic double taxation of distributed profits for resident shareholders. Under the imputation system, which was introduced in 1977, different CIT rates apply for retained and distributed profits, i.e. a flat rate of 45 percent is imposed on retained profits and distributed profits are taxed at a rate of 30 percent (as from 1994).[4] In addition, a 25 percent dividend withholding tax is also levied, although this tax is frequently reduced under tax treaty provisions.

For German shareholders (both individuals and corporations) the imputation system is basically neutral with respect to its effect on financing, legal form and profit distribution. Dividend income distributed by German corporations is grossed up at the level of the German shareholders in order to determine the tax base, and the grossed up amount is subject to tax at the shareholder level. The tax rate depends on the rate to be applied (i.e. 45 percent as from 1994 for corporate taxpayers, progressive rates up to 53 percent for individuals),[5] although the shareholder's tax burden will be reduced by a tax credit equalling the distribution tax already paid by the corporation.

In the international context, however, the system is not neutral. In particular, the imputation credit mechanism is not available to non-resident shareholders. Compared to other locations, Germany has been rather unattractive as a holding location for multinational enterprises. This was especially true to the extent that German holding companies earned tax-exempt foreign-source income (e.g. income exempt under a tax treaty). When such income was redistributed by the German company the distribution tax of 36 percent was applied until the end of 1993 (in addition to the dividend withholding tax of 25 percent). Although non-resident recipients of tax-exempt foreign-source income redistributed by a German company had the right to a refund of the German tax (36 percent), the refund procedure was cumbersome, and the dividends were subject to German withholding tax (between zero and 25 percent, depending on the applicable tax treaty).

Furthermore, capital gains realized from the disposition of shares in foreign subsidiaries were subject to German CIT at general rates (50 percent or 36 percent with no tax credit or tax refund).

B. Tax reform

The BLA is designed to promote economic growth by facilitating investment activities, maintaining the international competitiveness of the German economy and ensuring the attractiveness of Germany as a business location for foreign investors.

The most important measures of the new law include the following:

- CIT rates have been lowered:
  - from 50 to 45 percent on retained profits;
  - from 36 to 30 percent on distributed profits;
  - from 46 to 42 percent on the profits of a German branch of a foreign corporation.
- The top personal income tax rate on income from business activities is reduced from 53 to 47 percent.
- An exemption from CIT on the distribution of foreign-source treaty-exempt income if such income is redistributed to a German corporate shareholder or to a non-resident corporate/individual shareholder.[6]

1. Bundesgesetzblatt ("BGBl.") 1993 I, at 1569.
2. *Id.*, at 2310.
3. For further details see Blumenberg, "Recent Developments in German International Taxation", *The International Tax Journal* (forthcoming).
4. The rates were previously 50% for retained profits and 36% for distributed profits. For resident corporations the reduced rate of 30% applies to dividends paid after 31 December 1993.
5. Beginning in 1995 a solidarity surcharge will be re-introduced at a rate of 7.5% of the income tax liability.
6. Corporate Income Tax Act ("CTA") Sec. 8b(1).

© 1994 International Bureau of Fiscal Documentation

- The dividend participation exemption under tax treaties has been extended to capital gains derived from the disposition of shares in a foreign subsidiary.
- German PEs of non-resident corporations are entitled to the latter two exemptions if shares in foreign subsidiaries are attributable to the German branch.[7]

II. TAXATION OF DOMESTIC AND FOREIGN-SOURCE DIVIDENDS RECEIVED BY A GERMAN HOLDING COMPANY

A. General

The taxation of dividends received and redistributed by a German holding company depends on a number of factors, including whether:
- dividends are received from a foreign or domestic source;
- treaty provisions apply;
- the applicable tax treaty contains an "activity clause";
- the parent company has a substantial shareholding of at least 10 percent;
- the shareholding is held for at least 12 months prior to distribution;
- redistribution by the German holding company is made to a resident corporate shareholder, a resident individual shareholder or a non-resident shareholder.

B. Dividends received from non-resident companies

In principle, dividends received from a non-resident company by a German holding company must in general be included in taxable income. However, many treaties provide that if the German company owns a substantial interest in the non-resident payor company, then such dividends are exempt from German tax. A substantial interest is generally set at 25 percent of the capital of the foreign company (although this is reduced to 10 percent under German corporate tax law). In case of a treaty exemption, no credit is available for any foreign dividend withholding tax.

The benefit of the participation exemption may be denied under a tax treaty if the income is not earned by an active business.

Foreign-source dividend income is subject to German tax if there is no treaty. The foreign tax, including the underlying foreign CIT attributable to the German holding company, is creditable if certain requirements are met (e.g. 12-month holding period, active business of the foreign subsidiary, etc.). Foreign-source dividends, which are tax-exempt or deemed to be so (after taking into account the tax credit), are attributed to the EK 01 basket (see below).

C. Dividends received from resident companies

Dividends received by a resident holding company from another resident company are treated as taxable income of the recipient (except see below). The net dividend, grossed up by the 30 percent imputation tax credit for the underlying CIT on the distribution of profits and the withholding tax of 25 percent, constitute taxable income of the recipient holding company. Both the imputed tax credit and the withholding tax may be credited against the recipient's final CIT liability.

D. Redistribution of income

Prior to the BLA when a German corporation redistributed income, a 36 percent (30 percent since 1994) distribution tax was imposed regardless of whether the redistributed income had been earned in Germany or abroad. Distribution tax levied on non-taxed foreign-source income redistributed by a German corporation out of the EK 01 basket to its non-resident shareholder was refunded according to a burdensome refund procedure. (To the extent that a German company receives tax-exempt foreign-source income or that foreign-source income is deemed to be tax-exempt, that income must be allocated to the EK 01 basket).[8] Although German withholding tax was levied not only on the cash dividend paid but also on the tax refund, ultimately the tax-exempt foreign-source income earned by a German holding company was only subject to German dividend withholding tax (between zero and 25 percent depending on whether a tax treaty applied).

The BLA has eliminated the requirement to pay equalization tax on the redistribution of tax-exempt foreign-source income, i.e. no CIT is levied on distributions out of the EK 01 basket.[9]

If the recipient is a German corporation or non-resident corporation/individual, the tax exemption applies to each redistribution of tax-exempt dividend income.[10] As a result, a 100 percent exemption privilege is granted for intercompany dividends financed out of tax-exempt foreign-source income (e.g. tax-exempt foreign-source dividends). The refund procedure for dividend payments to foreign shareholders out of foreign-source income (EK 01) has been abolished.

However, such redistributions of tax-exempt dividend income are still subject to German withholding tax at the rate of 25 percent, subject to a reduced rate under EC law[11] or tax treaty law.[12] For resident corporations, withholding tax is treated as dividend income within the meaning of ITC Section 20(1) No. 1 and is therefore tax-exempt under CTA Section 8b(1); the withholding tax is credited against German income tax on other taxable income, or refunded.[13] However, for foreign parent companies and individuals the withholding

7. CTA Sec. 8b(4).
8. A thorough discussion of the equity basket system is beyond the scope of this article. It is sufficient to say that net equity available for distribution is divided into several classes, which are prioritized for purposes of dividend distributions. The EK 01 basket is comprised of foreign-source income bearing no German CIT, e.g. either as a result of the participation exemption or of the indirect tax credit.
9. CTA Sec. 40 sentence 1 no. 1.
10. CTA Sec. 8b(1) sentence 1.
11. ITC Sec. 44d.
12. ITC Sec. 43(1) No. 1.
13. ITC Sec. 36(2) No. 2.

© 1994 International Bureau of Fiscal Documentation

tax (up to 25 percent, 5 percent under the parent-subsidiary directive until mid-1996) represents an effective tax burden.

If the recipient is a German individual the net amount of the dividend received, including a tax credit for the dividend withholding tax on tax-exempt foreign-source dividends received and redistributed by the holding company, is subject to German personal income tax at the individual's marginal rate. However, no imputation tax credit is granted for the foreign tax paid on the foreign-source income, so the tax burden remains the same as before – it has merely been fully shifted from the corporate level to the level of the resident individual shareholder.

III. TREATY NETWORK WITH OTHER EUROPEAN COUNTRIES AND EASTERN EUROPEAN COUNTRIES

Germany has an extensive tax treaty network, including more than 60 income tax treaties, five treaties on inheritance tax and seven treaties concerning income from shipping and aircraft transportation. Negotiations are underway to conclude income tax treaties with new Eastern European states, such as Estonia, Latvia and Lithuania, or to renegotiate or amend existing treaties.[14]

A. Treaties with EC and other Western European countries

Following implementation of the parent-subsidiary directive in the various EC countries, dividend withholding tax on qualifying shareholdings has generally been abolished with a few exceptions. One of these exceptions is that Germany may levy a reduced dividend withholding tax of 5 percent until mid-1996; thereafter dividends distributed by a German resident company to a qualified EC parent company will not be subject to any German withholding tax.

The following rates apply to portfolio dividend distributions/intercompany dividends in other western European countries:

Austria:	5/15%
Switzerland:	5/15%
Finland:	10/15%
Norway:	0/15%
Sweden:	5/15%

B. Treaties with Eastern European countries

The German government has reached agreement with most of the tax treaty partners of the former GDR to the effect that the old GDR treaties are applicable only until the end of 1990.[15] Following the political changes in the former Soviet Union, Yugoslavia and the former CSFR, Germany has reached agreement regarding the application of old treaties concluded by (West) Germany with the following results.

The 24 November 1981 treaty concluded between Germany and the USSR applies to the Russian Republic and the republics of Georgia, Kyrghystan, Kazakhstan, Armenia and Uzbekistan. The 26 March 1987 treaty concluded between Germany and the former Yugoslavia applies to the Republics of Bosnia-Herzegovina, Croatia and Slovenia. The treaty of 19 December 1980 between Germany and the CFSR applies to the Czech and Slovak Republics. Germany has also concluded income tax treaties with Hungary, Poland and Romania.

All of these treaties (except the treaty with the USSR) contain a participation exemption for dividends received by a German corporate shareholder holding a qualifying interest. Most of the treaties also contain an "activity clause", i.e. the participation exemption will only be granted if the dividends are paid by subsidiaries with an active business. Distributions made by a Russian corporation are only eligible for a tax credit (including an indirect tax credit).

Having a German (as opposed to a foreign based) corporation as the shareholder in an East European corporation (subsidiary) may offer some advantages in respect of host-country losses (subsidiary's losses). For example, if the German parent company, as shareholder in a Russian corporation, can establish a "non-typical silent partnership" together with the Russian corporation (subsidiary), the subsidiary's losses attributable to the German parent company as the silent partner may be covered by a special provision in the ITC, according to which the German-based silent partner may deduct foreign-source losses from other German (source) taxable income.[16]

IV. TREATMENT OF CAPITAL GAINS/LOSSES ON DISPOSITION OF SHARES IN OPERATING COMPANIES

A. Capital gains

The tax treatment depends on whether the German holding company holds shares in a resident or a non-resident corporation.

1. Shares in a German resident subsidiary

Capital gains resulting from the disposition of shares in a German corporation increase the taxable income of the German parent company. There is no preferential tax rate, i.e. the normal CIT rates apply.

2. Shares in a non-resident subsidiary

Until the end of 1993, capital gains realized by a German company on the disposition of shares in a foreign subsidiary were subject to full German tax.[17] Under the BLA, capital gains realized by a German corporation on the disposition of

14. See *Federal Tax Gazette* (1994) I, at 7.
15. See Ministry Ruling of 4 January 1993, *Federal Tax Gazette* (1993) I, at 4.
16. ITC Sec. 2a.
17. According to Art. 7(1), 13(4) OECD Model Convention the country of residence of a seller has the right to tax.

© 1994 International Bureau of Fiscal Documentation

its shares in a foreign subsidiary (or on the liquidation or reduction in the nominal share capital of such a corporation) are exempt from tax under certain conditions.[18]

The capital gains exemption is designed to remove the disadvantages of German holding companies and make Germany more competitive with other EC countries which offer similar benefits, such as Austria, Belgium, Luxembourg and the Netherlands.

To be eligible for the capital gains exemption the dividend distribution of the foreign corporation must qualify for the intercorporate participation exemption under the relevant treaty, i.e. the German corporation must own least 10 percent of the capital of the foreign company (even if the treaty provides for a higher percentage), and if the treaty contains an activity clause, the requirements of that clause must also be met.

If there is no treaty between Germany and the source country, such capital gains are exempt if the requirements for the indirect tax credit under German domestic law are met,[19] i.e. the income of the foreign subsidiary must be derived exclusively, or almost exclusively, from active sources and the German company must have a participation of at least 10 percent in the nominal share capital of the foreign subsidiary for an uninterrupted 12-month period before the end of the fiscal year.

The tax-exempt income (i.e. capital gains) will be allocated to the equity EK 01 basket,[20] and in case of redistribution, no equalization tax is levied on this income. If the recipient is a German corporation, the tax exemption for intercompany dividends applies. Thus, the same treatment applies as for intercompany dividends paid out of tax exempt foreign-source dividends.

Specific anti-tax-abuse provisions have been included to prevent participations in a German corporation or branch from being sold in a tax-free share exchange transaction under the German provisions of the EC merger directive.

B. Losses on shares in foreign corporations

1. Participation write-down

Losses resulting from a write-down to a lower market value of a participation in a foreign corporation may be set off against taxable income, unless the write-down is directly connected to previous tax-exempt dividend distributions. Consequently, capital gains exemption will be denied to the extent that there has been a tax-effective write-down of shares in a foreign subsidiary.

Losses resulting from the disposal of shares in a foreign subsidiary lead to a reduction in taxable income, unless such losses are directly connected to prior tax-exempt distributions. The main idea is that losses resulting from the disposal of shares in a foreign subsidiary are to be treated as participation write-downs which may be reflected tax-effectively. This rule also applied when dividends and/or capital gains are or would have been tax exempt.

V. DEDUCTIBILITY OF INTEREST EXPENSES

A discussion has been ongoing since the early 1970s about whether interest expense is deductible for tax purposes if the interest is effectively connected with the acquisition of shares in a foreign subsidiary, the dividends of which are tax-exempt under a treaty and/or according to national rules.

This dispute may be summarized as follows:

(1) According to several Federal Tax Court decisions, interest expenses have been held non-deductible to the extent that the German corporation receives tax-exempt foreign-source dividend income. If there has been no tax-exempt foreign-source dividend income (no distribution by the foreign subsidiary), and/or to the extent interest expenses exceed the tax-exempt foreign-source dividend in a year, this interest (or a portion of it) was considered deductible.

(2) Some Ministry of Finance officials argued in literature in the early 1970s that the tax exemption under a treaty does not include gross dividend income but rather only net income, i.e. gross dividend income reduced by effectively connected expenses. As a result, all interest was considered non-deductible for German tax purposes regardless of whether there was a dividend and/or whether the interest exceeded tax-exempt foreign-source dividends received.

(3) A 1992 decision by the Tax Court of Baden-Württemberg supported the line of reasoning mentioned under (2). That decision also held that participation write-downs regarding shares in foreign subsidiaries, the dividends of which were tax-exempt, could not lead to a reduction in the German tax base.

(4) Following the new capital gains exemption, the argument was put forward that in future interest, and probably participation write-downs and losses from the disposal of the shares, may no longer be deductible.

However, as stated above a participation write-down and losses are deductible based on the wording of the capital gains exemption provision. Interest expenses should be deductible for German tax purposes, provided there is no dividend income, or to the extent that interest expense exceeds tax-exempt foreign-source dividends received. This is the view now also expressed by the Ministry of Finance in a draft ruling which is still under discussion. If the draft ruling should be confirmed (which is not yet clear), Germany will be one of the most attractive locations for holding companies taking into account not only the capital gains exemption and the interest deduction, but also the advantages described below (in particular no capital tax and the 9:1 debt/equity ratio for holding companies.

18. CTA Sec. 8b(2). Capital gains on the disposition of foreign shares attributable to a German branch of a foreign corporation are similarly exempt from German tax, so a German branch will be treated the same as a German corporation. CTA Sec. 8b(4).
19. CTA Sec. 26(2) or (3).
20. CTA Sec. 30(2) No. 1.

© 1994 International Bureau of Fiscal Documentation

VI. CAPITAL TAX ON FORMATION

The 1 percent capital tax on formation was abolished in 1992, so no capital tax is levied on shareholder equity contributions.

VII. SUBSTANCE REQUIREMENTS

As mentioned above, preferential tax treatment is only granted where the requirements for the participation exemption are met under a tax treaty, or if there is no treaty between Germany and the source state, where the requirements to obtain the indirect tax credit are fulfilled. In other words, the German holding company must either have a qualifying interest (more than 10 percent) in the foreign company, and if required by a treaty, the foreign subsidiary must have an active business; if there is no treaty the German holding company must have held the shares (at least 10 percent) for more than 12 months and the foreign subsidiary must have an active business.

Substance requirements (with respect to a foreign shareholder company) may have an impact on the reduction of the German dividend withholding rate in respect of redistributions made by a German holding company to a foreign shareholder. A 1993 provision, i.e. ITC Section 50d, denies treaty benefits (in this case, a reduced rate of dividend withholding tax) where the shareholders of the foreign company would not have been entitled to treaty benefits if they had received the income directly rather than through the foreign company.[21]

The wording of ITC Section 50d is broad enough to deny a reduction of dividend withholding tax as well as other treaty benefits, such as the tax exemption of capital gains realized by a foreign shareholder company as a result of a disposal of shares in a German corporation.[22]

VIII. TREATMENT OF EXCHANGE GAINS/LOSSES ON ACQUISITION DEBT

Under current law there is in general no restriction. Exchange gain/losses are recognized in determining German taxable income regardless of whether the participation in a foreign subsidiary would lead to tax-exempt foreign-source dividend income or tax-exempt capital gains in case of a share disposition.[23]

For example, a German holding company may write down the participation held in a foreign subsidiary if the going concern value has decreased as a result of a currency change or other reasons. If a currency change led to a loss regarding acquisition debt, this loss, under special circumstances, may be reflected in the German tax books, even if not actually realized.

Non-realized gains as a result of a currency change may not be reflected immediately, but only when actually realized.

21. For example, a non-treaty-protected investor holds shares in a Dutch company which itself holds a substantial interest in a German holding company. Under the Dutch/German tax treaty the withholding tax on dividend distributions by a German corporation to a qualifying Dutch shareholder is 5%. However, if the shareholder of the Dutch company is not eligible for treaty benefits, the German withholding tax should not be reduced if there are no business or other justifiable reasons for the interposition of the foreign company, and if this company does not conduct business activities of its own. This would probably also be the case if the shareholder of the Dutch company was treaty protected had he earned the income directly. For example, if the shareholder of the Dutch company is based in Japan, the rate under the Japan/Germany treaty may be 15%, but under Sec. 50d, the German tax rate would be 25%.
22. Generally, these capital gains are tax exempt, but if the shareholder of the Dutch company in note 21 is not treaty-protected this exemption may be denied.
23. See Schmidt/Glanegger, *Commentary on German Income Tax Act*, Sec. 6, annotation 90e (foreign currency debt), annotation 62 (participation in foreign subsidiaries) and annotation 86a (receivables to be repaid in foreign currency).
24. See Hundt, *Der Betrieb* 1993, S. 2048 ff.

IX. COMPARISON OF EC HOLDING LOCATIONS[24]

	Netherlands	*Luxembourg*	*Belgium*	*France*	*Germany*
Treaty protection	yes	yes(1)	yes	yes	yes
Participation exemption	yes	yes	95%	yes	yes
Tax-exempt redistribution of tax-exempt foreign-source income (except DWT)	yes	yes	yes	yes(2)	yes
Deductibility of interest, etc.	none	partly	yes	yes	yes
Capital gains tax exemption	yes	yes	yes	none(3)	yes
Participation write-down	none	none	none	yes (18%)	yes
Losses from share disposal	none	none (except for liquidation)	none	yes(3) (except for liquidation)	yes
Capital tax	1%	1%	0.5%	none	none

(1) So-called "1990" holding.
(2) Précompte (33 ⅓%) refundable, not due if 100% of assets are foreign subsidiaries.
(3) After two-year holding reduced rate of 18% (rather than 33 ⅓%) and net capital gain stays with the holding company.

© 1994 International Bureau of Fiscal Documentation

X. OTHER TAX CONSIDERATIONS

A. Debt/equity rules

At the end of 1993, Germany finally enacted a thin capitalization rule in the CTA.[25] The rule is contained in new Section 8a, and it allows interest expenses on loans to be recharacterized as constructive dividends under certain circumstances. The main elements of the thin capitalization rule are as follows:

- New thin capitalization rules are applicable to shareholders not entitled to the imputation tax credit, including non-resident shareholders as well as German-based tax-exempt organizations and public institutions. These shareholders must have a substantial (direct or indirect, including through an interposed partnership) shareholding in the German subsidiary's stated capital, or if less, this shareholder, either alone or in conjunction with others in effect exercises controlling influence over the debtor corporation.
- Debt includes all debt obtained from the above-mentioned affiliates or third parties having recourse to the shareholder/ affiliates. Equity includes all equity pursuant to the German commercial balance sheet of the borrower, including 50 percent of the special accounts with a reserve portion at the end of the preceding fiscal year allocable to the shareholder on the basis of the shareholder's proportionate interest in the company. According to a draft ruling, so-called "Genussrechte" should be treated as debt, even if shown as equity in the commercial balance sheet.
- Safe harbour amounts permit loans up to certain percentages of equity without adverse consequences:
  - A 3:1 debt/equity ratio generally applies for fixed interest loans. Shareholder debt exceeding three times the equity will be treated as a constructive dividend unless it is shown to be at arm's length, i.e. that the loan would have also been granted by an unrelated third party on the same terms, or if the loan is used to finance ordinary banking business.
  - A 0.5:1 debt/equity ratio applies to profit-participating loans (i.e. hybrid instruments), i.e. loans related to a share in the borrower's profit and/or sales which do not exceed 0.5 times the equity are not recharacterized as a dividend. Any excess is reclassified (regardless of whether it would have also been granted by an unrelated third party or that the loan was used to finance ordinary banking business).
  - Combined fixed interest and hybrid debt financing: in this case it must first be determined whether the safe harbour for hybrid debt (i.e. 0.5:1) has been exceeded (i.e. whether the hybrid debt capital is less than 50 percent of the prorated shareholder's equity); if not then the shareholder may use the safe harbour for fixed interest loans according to a specific formula.
  - A special safe harbour of 9:1 applies to German holding companies.
- Third-party loans: Interest may also be reclassified as a constructive dividend if the loan is granted by a third party, and that third party (regardless of residence) has recourse to the shareholder or a person related to the shareholder.
- The thin capitalization rule does not affect net worth tax/trade tax on income/capital, i.e. if an amount is recharacterized as a constructive dividend it will only be subject to German CIT and dividend withholding tax, not net worth or trade tax.
- Section 8a also applies to situations where foreign shareholders try to circumvent the rules by using certain intermediate non-corporate holding entities, i.e. certain branch and partnership structures.
- As noted above the new rule applies to accounting periods which begin after 31 December 1993. Transitional rules, however, apply to long-term hybrid agreements, i.e. to hybrid debt that was injected before 9 December 1992 (the date on which the federal government announced the new legislation). Under the transitional rules, the debt/equity ratio for hybrid debt for business years ending before 31 December 1997 is 1:1 rather than 0.5:1. In addition, the book value of investments in subsidiaries need not be deducted when determining the equity. The transitional rules are restricted to hybrid debt, because in the case of fixed interest loans the taxpayer has the option of rebutting the presumption that shareholder debt financing in excess of the stated ratios is abusive by establishing that the loan could have been obtained from a third party on the same terms.

As a result of the new rule, foreign shareholders must evaluate the financing of their German subsidiaries (corporations). Strategies to avoid the adverse impact of the debt/equity rules include:

- all measures aimed to achieve an increase, or at least avoid a decrease, in the commercial balance sheet equity, which is the basis for determining the relevant safe harbours, such as dividend policy, avoiding write-downs of assets, avoiding long-term (book) losses reducing equity, etc.;
- restructuring measures to increase the German corporation's commercial balance equity and the relevant basis for determining the safe harbour, such as the tax-neutral drop-down of assets into a 100 percent partnership and/or corporation or the tax-neutral realization of unrealized appreciation of participations in foreign subsidiaries;
- restructuring to qualify for the holding company safe harbour of 9:1;
- interposing German "holding partnerships" which itself may be debt-financed via foreign-based affiliates and/or third-party bank loans;
- financing the German subsidiary through lease arrangements rather than debt cash financing because the thin capitalization rules only apply to shareholder debt (cash) finance structures;

25. CTA Sec. 8a.

© 1994 International Bureau of Fiscal Documentation

- reducing to 25 percent the foreign shareholder participation in the subsidiary's stated capital combined with voting shares/preferred shares the rights of which differ from the participation in the German sub's stated capital.

B. Branch vs. subsidiary

As a result of the reduction of the tax on distributed profits from 36 to 30 percent, and the reduction of the withholding tax on intercompany dividends within the EC to nil in Germany as from mid-1996, the overall CIT burden on German-source income is substantially lower for a German subsidiary as compared to a German branch/permanent establishment. Therefore, foreign investors should evaluate whether transferring their German branch activities to a German subsidiary would offer more advantages in the long run, whereby the German taxation of unrealized appreciation of branch assets (to be transferred to a German corporation) must be taken into account and compared to the reduced overall German taxation of subsidiaries.

DATABASE ON CORPORATE TAXATION AND CROSS-BORDER PAYMENTS IN OECD COUNTRIES

DATABASE ON DISKETTE

Easy to install and easy to use, IBFD's database is the most convenient way to keep up to date with corporate taxation and cross-border payments in the major countries of the world. Contents include:

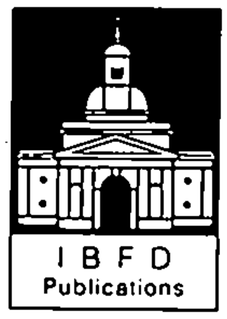
- Taxation of Resident Companies
- Taxation of Foreign-Source Income
- Taxation of Patent Royalties, Dividends and Interest Received by Non-Resident Companies
- Withholding Tax Rates Chart: showing withholding tax rates for patent royalty, dividend and interest payments from a specific OECD country to all other OECD countries, and to a specific OECD country from all other OECD countries
- Holding Companies

Updates three times a year ensure that the information is current.

The core of the information in IBFD's 'Database on Corporate Taxation and Cross-Border Payments in OECD Countries' is derived from and expands on Volume I of IBFD's 'Guides to European Taxation', 'The Taxation of Patent Royalties, Dividends, Interest in Europe'. Subscribers to the guide qualify for a 20% discount on the annual licence fee for the database.

Countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States and one non-OECD country, Liechtenstein.

Annual licence fee: NLG 550
(includes updates three times a year)
Once-only software licence fee: NLG 350
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item



IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

SWITZERLAND

HOLDING COMPANIES

Dr Nico H. Burki

Dr Burki is a partner at the law firm of Bär & Karrer in Zurich, Switzerland. He graduated from the University of St. Gallen for Business Administration, the University of Basel and was admitted to the Zurich bar in 1979.

I. GENERAL RULES APPLYING TO THE INCOME AND CAPITAL TAXATION OF A CORPORATION

A. Introduction

Swiss resident corporations are liable to federal, cantonal and municipal taxes[1] on their worldwide income, except for income attributable to a foreign permanent establishment or foreign immovable property which is exempt from Swiss taxes (however, this income is taken into account in determining the tax rate). A corporation is considered resident in Switzerland if it is incorporated in Switzerland or if its place of effective management is in Switzerland.

The income tax is calculated based on the profit as shown in the statutory financial statements of Swiss corporations. Group consolidation for tax purposes is not permitted. Profits are taxed at progressive rates under both the federal and cantonal systems; federal taxes amount to approximately one-third, and the combined cantonal and communal taxes amount to approximately two-thirds of the total tax burden, depending on the corporation's canton of residence. For federal tax purposes all direct and indirect taxes are deductible. Under the cantonal tax systems, the deductibility of taxes varies.

In addition to income tax, an annual capital tax is levied at the federal level at a rate of 0.0825 percent of a corporation's equity (as of 1 January 1995: 0.08 percent). Each canton also levies an annual capital tax, the rate of which (depending on the canton) is based on the paid-in share capital or total equity. Cantonal rates range from 0.05 to 1 percent.

B. Federal income taxes

A revised Federal Direct Tax Law ("FDTL") dated 20 December 1990 will enter into force as from 1 January 1995. The following comments on federal taxation will therefore focus on the rules under the FDTL rather than on the Federal Direct Taxes Decree of 9 December 1940, which is still in force in 1994.

The FDTL has retained the classical system of taxation providing for economic double taxation of a corporation and its shareholders. A dividend distributed by a corporation is first subject to corporate income tax, and subsequent to its distribution, also subject to income tax at the level of the shareholder. Relief is only granted to corporate shareholders holding substantial participations (see below).

Corporate income tax is levied at progressive rates ranging from 3.63 to 9.8 percent of a corporation's after-tax income. Losses may be carried forward seven years, but they may not be carried back.

C. Cantonal income taxes

At present, the 26 Swiss cantons each have their own tax laws, which differ considerably from each other, and which differ substantially from the FDTL. With a view to harmonizing the federal and cantonal direct tax systems, the Federal Law on the Harmonization of the Direct Taxes of the Cantons and Communes ("FLH") of 14 December 1990 was approved by Parliament after about 30 years of preparation. The FLH came into force on 1 January 1993. All cantons must adapt their laws to conform to the provisions of the FLH within eight years, i.e. by the year 2001.[2] After 2001, the FLH will directly apply to cantonal taxation whenever the respective provisions of the cantonal tax laws are not in conformity with the FLH.

Cantonal income tax rates currently range between approximately 12 and 35 percent, and as stated above taxes may or may not be deductible depending on the canton. Cantonal taxes are normally calculated on the same basis as the federal tax, i.e. the rate is determined by reference to profits expressed as a percentage of net worth. However, cantonal laws provide for maximum and minimum tax rates. If the calculation based on the above formula results in a higher or lower tax rate than the minimum or maximum rate provided for in the law, the minimum or maximum rate will apply rather than a rate resulting from the above calculation.

1. There are approximately 3,000 municipalities in Switzerland, many of which may levy taxes based on delegated powers from the cantons. A discussion of these taxes, however, is beyond the scope of this article.
2. The cantons are still competent to set their own tax rates, tax tariffs and tax exemptions. However, the principles of taxation, taxable objects, tax periods and procedural provisions of cantonal tax laws must conform to the FLH in the future. As the FLH has been promulgated with the FDTL, care has been taken to harmonize the two laws as much as possible.

© 1994 International Bureau of Fiscal Documentation

II. TAXATION OF THE INCOME OF A SWISS HOLDING COMPANY

A. Federal income tax

No special tax status is conferred on Swiss holding companies for federal tax purposes, i.e. all resident companies are subject to federal income tax at progressive rates ranging from 3.63 to 9.8 percent depending on the company's earning capacity.

1. Dividend income from Swiss and foreign sources

Dividends received by a resident corporation from Swiss and foreign sources are considered normal income and are therefore included in the recipient's taxable income. However, a special rule applies to dividends received from a qualifying participation, which is defined as a participation in a company which amounts to at least 20 percent of the capital of a participation or a participation whose value equals at least Sfrs. 2 million. Such dividends must be included in taxable income, but the company can benefit from a reduction in income tax. This reduction is computed based on the ratio that the net dividend income from a substantial participation bears to the total net profits of the recipient corporation.

For purposes of this formula, net dividend income from a substantial participation is defined as the dividend received after deduction of costs related to financing the participation, and 5 percent of the dividend received to cover presumed administrative costs incurred in managing the holding company. The total net profit of the corporation corresponds to the net profits as per the statutory financial statements.

The dividend income only qualifies for the reduction to the extent that no write-offs have been made on the participation in connection with the dividend. Repayments of capital, capital gains, appreciation gains and income qualifying as a deductible expense at the level of the payor do not constitute dividend income, so they do not benefit from the reduction – these types of income are subject to ordinary federal taxes.

2. Other income

All other income of a Swiss corporation, including capital gains, interest, realized exchange gains and royalty income, is subject to ordinary federal income tax. Unrealized exchange gains, as well as any other unrealized income, is not subject to Swiss income tax, as unrealized income must not be accounted for under Swiss corporate law principles.

Capital losses and interest expenses, as well as realized and unrealized exchange losses, are deductible for federal income tax purposes.

B. Federal capital tax

A tax of 0.0825 percent is levied at the federal level on the net worth (i.e. paid-up capital and reserves) of Swiss resident corporations.

C. Cantonal income tax

As mentioned above, Swiss resident companies are subject to cantonal tax in addition to federal tax.

1. Holding company privilege

A special holding company regime applies for cantonal tax purposes. Pure holding companies are generally defined as companies whose primary or exclusive purpose is to acquire and hold a certain percentage of shares in the capital of other companies on a permanent basis, although the requisite holding varies from one canton to another. Generally speaking, the income from a holding company's participations in other corporations must constitute a major part (50 to 75 percent) of its total income and/or the fair market value of the holding company's investments in the capital of other corporations must represent the major part of its total assets (50 to 75 percent).

Like the FDTL, the FLH and most of the cantonal tax laws currently in force impose a substantial participation requirement, i.e. dividends received from substantial investments representing at least 20 percent of the capital or stock the value of which equals at least Sfrs. 2 million are subject to income tax, but may benefit from the reduction in income tax. This provision is of relevance in cases where the cantonal holding privilege is not available. Companies qualifying for the holding company regime are also exempt from cantonal income tax on any other income, such as interest from bonds, government securities, royalties and management fees.

The FLH mandates harmonization of the special holding company regime, i.e. the cantons must grant the holding privilege if the total income of a holding company or the fair market value of the holding company's investments in the capital of other corporations represents at least two-thirds of the total income or the total assets of the holding company, respectively; the company may not be actively engaged in business; and the company's primary purpose must be the holding of shares of other companies. As mentioned above, cantonal law must conform to the FLH by the year 2001. Many cantons, however, already apply the above-mentioned holding company test in accordance with the FLH.

D. Cantonal capital tax

In addition to exemption from income tax, holding companies also usually benefit from preferential rates for capital tax purposes, i.e. they only pay capital taxes in the range of 0.05–.2 percent of the paid-in capital or total equity, depending on the applicable cantonal tax law.

III. WITHHOLDING TAXES

A. Swiss Unilateral Tax Law

Switzerland levies a withholding tax of 35 percent on:

© 1994 International Bureau of Fiscal Documentation

- dividends, including constructive and liquidation dividends, distributed by a Swiss corporation to its shareholders (or related parties);[3]
- interest paid on publicly-offered bonds, debentures and other instruments of indebtedness issued by a Swiss resident borrower;
- distributions by a Swiss investment fund; and
- interest on customers' bank deposits.

Tax must be withheld by the payor of the dividend or interest, as the case may be, and charged to the recipient of income. It should be noted, however, that there is no Swiss withholding tax on interest paid in connection with straight loans as well as on rents, royalties, licence, management and technical assistance fees, etc.

Swiss residents receiving such dividends and interest from Swiss sources are entitled to a full refund of the withholding tax. Non-residents are entitled to a (full or partial) refund of the Swiss withholding tax in accordance with a tax treaty provision.[4]

B. US–Switzerland double taxation treaty

Article VI(1) of the US–Switzerland treaty provides that the withholding tax on dividends distributed by a resident of one contracting state to a recipient in the other contracting state may not exceed 15 percent. Article VI(2) provides that the tax rate may not exceed 5 percent if the shareholder is a corporation controlling directly or indirectly at least 95 percent of the voting power of the payor corporation, and if not more than 25 percent of the gross income of the payor corporation is derived from dividends and interest, other than dividends and interest received from its own subsidiary corporations. The treaty further provides that the reduced rate of 5 percent will not apply if the relationship between the two corporations has been arranged or is maintained primarily with the intention of securing the reduced rate.

Article VII provides that the withholding tax on interest may not exceed 5 percent, whereas Article VIII provides for a total exemption of royalties from withholding taxes.

C. Treaties with European countries, including Eastern European countries

Switzerland has concluded comprehensive double taxation treaties with all the EC countries (see chart). As Switzerland is not part of the EC, it is important for Switzerland that the treaties with the Netherlands and, as of 1 January 1994, with Luxembourg provide for a total relief from withholding taxes on dividends from substantial participations, thus bringing the withholding tax in line with the parent/subsidiary. It is expected that the Germany–Switzerland treaty will be amended in 1996 to provide for a zero percent withholding tax rate on dividends from substantial participations.

Switzerland has not concluded many double taxation treaties with Eastern European countries, but this situation should change in the next few years, as negotiations are currently taking place with most of the Eastern European countries.

D. Swiss decree against treaty abuse[5]

In response to some international pressure and to prevent abuse of the extensive Swiss tax treaty network (particularly the reduction or exemption of withholding tax on dividends, interest and royalties) Switzerland enacted the anti-abuse decree in 1962. The decree basically attacks the practice whereby non-residents who would ordinarily not be entitled to treaty benefits would channel payments through Switzerland or accumulate income in Switzerland.

Foreign controlled Swiss holding companies are entitled to benefit from double taxation treaties in the same manner as other Swiss companies. However, they can only obtain treaty benefits if they conform to the decree against treaty abuse and meet the following requirements:

- not more than 50 percent of the treaty-benefited income is paid out in the form of charges such as interest or royalty payments to non-qualified persons (non-residents);
- at least 25 percent of the treaty-benefited income is distributed by the Swiss company to shareholders in the form of a dividend;
- the total interest-bearing debt of the company does not bear more than an arm's length interest rate and does not exceed six times its equity capital, i.e. the Swiss company is properly capitalized;
- expenses related to income other than treaty-benefited income are covered by other income.

A company which fails to meet these requirements will be regarded as being in "abuse" of a treaty, and therefore will be denied treaty benefits in the form of reduced or exempted withholding taxes. A number of Switzerland's tax treaties have incorporated (some form of) the decree, i.e. see the treaties with Belgium, France, Germany and Italy.

IV. STAMP DUTIES

A. Securities issuance tax

The issuance of shares, participation certificates and profit sharing certificates by corporations and similar entities in connection with the incorporation or increase of capital is subject to the securities issuance tax at a rate of 3 percent of the par value of the shares or the fair market value of the actual contribution, whichever is higher.

Participation rights created or increased pursuant to resolutions regarding mergers, merger-like reorganizations, transformations and spin-offs of corporations, however, are exempt from the securities issuance tax. No securities issuance tax is levied if the seat of a foreign corporation is transferred to Switzerland without liquidation.

3. No withholding tax is levied by the cantons on dividend distributions.
4. Thus the withholding tax is levied even if there is a treaty between Switzerland and the non-resident's country of residence. In order to obtain the refund, the non-resident must make a claim to the Swiss tax authorities.
5. Decree of 14 December 1962.

© 1994 International Bureau of Fiscal Documentation

B. Securities transfer tax

A securities transfer tax is levied on the transfer of title to debentures, shares, similar instruments and investment fund certificates issued by a Swiss or foreign entity if one of the parties to the transaction or one of the intermediaries is a Swiss securities dealer under the Swiss Stamp Tax Law.[6] The securities transfer tax is levied at rates of 0.15 percent for Swiss securities, and 0.3 percent for foreign securities.

6. The term "securities dealer" comprises:
- Swiss banks and bank-like financial institutions;
- traders of securities for the account of third parties and investment advisors acting as intermediaries in the purchase and sale of taxable securities;
- boards of investment funds;
- corporate entities whose assets, as per the last balance sheet, consist of taxable securities in excess of 10 million Sfrs.

The provision qualifying all corporate entities holding a securities portfolio exceeding Sfrs. 10 million as securities dealers has the effect that most of the larger Swiss holding companies and other corporations qualify as securities dealers, and are therefore subject to the securities transfer tax.

DOUBLE TAXATION TREATIES

(Europe, including former Eastern Bloc Countries)

Source Country	Dividends (%)			Interest (%)	Royalties (%)
	Rate	Subsidiaries			
		Rate	Shareholding (%)		
Austria	5	5		5	5
Belgium	15	10	25	10	0
Bulgaria	15	5	25	10	0
CIS[1]	–	–		–	0
Denmark	0	0		0	0
Finland	5	0	20	0	0
France	15	5	20	10	5
Germany	10	5	20	0	0
Great Britain	0[2]	5[2][3]	10	0	0
Greece	0[2]	0[2]		10	5
Hungary	0[2]	0[2]		0[2]	0
Ireland	0[2]	0[2]	25	0	0
Italy	15	15		12,5	5
Luxemburg	15	0[4]	25	0	0
Netherlands	15	0	25	5	0
Norway	15	5	25	0	0
Poland	15	5	25	10	0
Portugal	15	10	25	10	5
Spain	15	10	25	10	5
Sweden	15	0	25	0[2]	0

1) Not applicable with respect to the Baltic countries (Estonia, Latvia, Lithuania).
2) No withholding tax based on unilateral tax laws.
3) Treaty gives a half tax credit to non-resident companies possessing 10% or more of the voting power of the company paying the dividend, subject to a 5% withholding on the total of the dividend and the tax credit.
4) Permanent shareholding for 2 years.

© 1994 International Bureau of Fiscal Documentation

UNITED KINGDOM

SETTING UP A UK INTERNATIONAL HOLDING COMPANY

Michael McGowan
Solicitor, Linklaters & Paines, New York

The author wishes to thank Guy Brannan and Neal Todd (Linklaters & Paines, London) and Stef van Weeghel (Stibbe Simont Monahan Duhot, New York) for their comments and assistance.

This article discusses the implications of setting up an international holding or headquarters company in the United Kingdom. It is divided into two main parts. Part I outlines certain features of the UK tax system which are likely to affect a UK-resident international holding or headquarters company, especially if that UK company is controlled from the United States. Part II discusses the maturity of the United Kingdom as a holding company jurisdiction by comparing it with the Netherlands, the best-known European jurisdiction for setting up an international holding company.

I. FEATURES OF THE UK TAX SYSTEM

A. Corporate tax rate

Companies resident in the United Kingdom pay corporation tax at 33 percent on their worldwide income and gains. The company's basis in capital assets is indexed by reference to movements in the UK retail prices index. However, anti-avoidance rules may limit indexation relief where one company holds shares and debt in an affiliated company.[1] Furthermore, once the UK Finance Bill 1994 comes into force, indexation relief will generally only be available to reduce capital gains, not to create or increase capital losses.

UK-resident companies with relatively small profits are eligible for a reduced corporation tax rate of 25 percent.

B. Taxation of domestic and foreign-source dividends received by a UK resident holding company

1. UK-source "distributions"

A UK-resident company is not subject to corporation tax on dividends and other income "distributions" received from another UK-resident company.[2] "Distributions"[3] include dividends as well as a range of payments and transfers of value by a UK-resident company all of which are taxed as if they were dividends (see C.1). These include interest payments on certain forms of "hybrid" debt.

2. Foreign-source dividends

Foreign-source dividends are subject to corporation tax, but this is usually reduced by UK double taxation relief in the form of foreign tax credits. The foreign tax credit rules are outlined below.

The United Kingdom will generally grant a foreign tax credit for foreign dividend withholding tax which is otherwise irrecoverable.[4] Several features of the UK foreign tax credit rules should be noted:

- "Excess" foreign tax credits are automatically lost – they cannot be carried forward or backward.
- It is only possible to credit foreign tax against income from the same "source". Therefore, "excess" credits from one source cannot be cross-credited against income from another foreign source. This can lead to "excess" credits. In order to sidestep these limitation rules, UK companies have often streamed foreign-source taxed income through a Netherlands "mixer" company owned by the UK company. Because of the Dutch "participation exemption", and reduced or nil rates of Dutch withholding tax on dividend payments from the Netherlands to the United Kingdom, there is usually little extra tax cost in streaming foreign-source taxed income through such a company. This is particularly true since the EC parent-subsidiary directive was implemented in the Netherlands, thereby eliminating Dutch withholding on dividends paid in respect of major share participations in Dutch companies which are owned by taxpaying companies in other EC jurisdictions. The UK company receives a single blended dividend stream from the Dutch "mixer" company. Income from this single source should carry a UK foreign tax credit for the entire underlying foreign tax borne on the Dutch company's income. The net effect is that cross-crediting is achieved, and "excess" UK foreign tax credits reduced, by "mixing" income in the Dutch company.
- Subject to certain fairly restricted anti-avoidance rules, a UK-resident company may allocate its deductible expenses as it pleases between UK-source and foreign-source income. Therefore, if a UK-resident company has fully taxable UK-source income (e.g. interest), as well as foreign-source dividend income carrying tax credits, it

1. Secs. 182-184 Taxation of Chargeable Gains Act 1992 ("TCGA 1992").
2. Sec. 208 Income and Corporation Taxes Act 1988 ("Taxes Act 1988").
3. Secs. 209 and 418 Taxes Act 1988.
4. Part XVIII Taxes Act 1988.

© 1994 International Bureau of Fiscal Documentation

will usually seek to allocate its deductible expenses (notably, interest and management expenses) against the fully-taxable income.[5] This enables it to maximize the benefit of its deductible expenses and foreign tax credits.

- The United Kingdom has relatively generous rules for granting credits in respect of underlying foreign taxes where dividends are paid to a UK-resident company from its foreign affiliates.[6] Generally, a credit for underlying tax is available if the UK company controls directly or indirectly, or is a subsidiary of a company which controls directly or indirectly, not less than 10 percent of the voting power of the foreign company paying the dividend. Broadly speaking, credit for underlying tax is available regardless of how many corporate tiers separate the UK-resident company from the non-UK affiliate whose taxable profits ultimately fund the dividend.[7]

The availability of UK credits for underlying foreign tax is the primary cause of "surplus ACT" (see K. below).

C. Treatment of dividends paid from the United Kingdom to the United States

1. ACT and tax credits

There is no UK domestic withholding tax on UK-source dividends. However, dividends paid by a UK-resident company are non-deductible and they also give rise to "advance corporation tax" ("ACT"). ACT is a liability of *the paying company*.[8] With effect from 6 April 1994, the rate of ACT is 25 percent of the dividend. For example, a dividend of £ 80 will give rise to ACT of £ 20. ACT is in theory only a cash-flow cost because it can be offset against "mainstream" corporation tax of the paying company and/or certain UK-resident affiliates. However, there are complications (see K.1. below). ACT is a key feature of the UK "imputation" system of corporation tax. In particular, it provides the Inland Revenue with the resources to fund a "tax credit" to UK-residents who are entitled to the dividend which gives rise to the ACT.[9] From 6 April 1994 this "tax credit" equals 25 percent of the dividend received (£ 20 in the case of a dividend of £ 80). A UK person grosses up his dividend income by the amount of the credit, but can set the credit against UK income tax on this grossed-up amount. Where the credit exceeds tax payable by the UK person (e.g. where the recipient is a UK tax-exempt), the credit is refundable in full (although there are restrictions on the ability of UK-resident companies to obtain a cash refund of the tax credit).

2. Availability of UK tax credits to non-UK residents

Generally, refundable "tax credits" are only available to UK-residents (subject to limited exceptions, e.g. for Commonwealth and Irish citizens). However, certain UK tax treaties (notably the UK–US treaty) make available a limited cash refund to treaty-protected non-UK residents. This refund is a proportion of the credit available to a UK-resident individual in respect of an equivalent distribution.[10]

A treaty-protected US "portfolio" investor is entitled to a refund which is equal to a UK-resident individual's tax credit *less* a "withholding". This withholding is 15 percent of the aggregate of the cash dividend and the credit to which a UK-resident individual would have been entitled. In short, a dividend of £ 80 paid to a US "portfolio" investor will give rise to a refund of £ 5 (£ 20 minus 15 percent of £ 100).

Where the US investor is a corporation which, either alone or together with one or more associated companies, controls at least 10 percent of the voting stock of a UK-resident company, the refund is calculated differently. It is half of the credit to which a UK-resident individual would have been entitled, *less* a withholding of 5 percent of the aggregate of the cash dividend and that half-credit. Therefore, in the case of a dividend of £ 80, the cash refund is £ 5.50 (i.e. £ 10 minus 5 percent of £90).

These treaty-based refunds reduce the effective rate of underlying UK tax on the profits distributed to the US investor. This is an important consideration for US tax-exempts and US investors with "excess" US foreign tax credits.

The United Kingdom has set up procedures for refunds to be made available at source.[11] These procedures vary. For example, the "H" Arrangement applies to dividends paid on American Depositary Shares issued by UK companies and held by "portfolio" investors. The "P" Arrangement applies to dividends paid to a non-UK corporate investor which controls at least 10 percent of the voting stock of the UK company.

However, the Inland Revenue consider that no refund can ever be available under a UK tax treaty where a treaty-protected non-UK resident receives a "foreign income dividend" (see K.2.).

3. US–UK treaty Article 16

No refund of ACT will be available to US corporations which fall within Article 16 of the US–UK treaty. This article is targeted at certain companies which enjoy preferential tax treatment, and which are potentially vehicles for "treaty shopping". However, Article 16 is much narrower in scope than equivalent provisions in more recent US treaties (e.g. those with Germany and the Netherlands). Therefore, although it must be considered, it is unlikely to affect a US company which controls a UK holding company. Article 16 is also relevant where UK companies invest in the Unites States, and is referred to further in Part II.

In practice, it has proved relatively easy to structure transactions so as to avoid Article 16. The same cannot be said of the UK retaliatory legislation regarding "unitary taxation".[12] If invoked, this could deny US corporate investors the treaty-based refund for investors which control 10 percent of the

5. Secs. 797(3) Taxes Act 1988.
6. Secs. 800 and 801 Taxes Act 1988.
7. In this respect, the UK rules are more generous than Sec. 902 Internal Revenue Code.
8. Sec. 14 Taxes Act 1988.
9. Sec. 231 Taxes Act 1988.
10. Art. 10(2) UK–US treaty.
11. Double Taxation Relief (Taxes on Income) (General) (Dividend) Regulations 1973.
12. Secs. 812-815 Taxes Act 1988.

© 1994 International Bureau of Fiscal Documentation

voting stock of a UK company. This legislation was enacted in retaliation for what the United Kingdom regarded as the unfair treatment of foreign multinationals under the California worldwide "unitary taxation" system. In the summer of 1993, the United Kingdom threatened to invoke this legislation. However, following changes in California law, the United Kingdom announced, in September 1993, that it would defer implementing this legislation indefinitely. The debate in the United States on the constitutionality of the California system of "unitary taxation" is of course very much in the news. The US Supreme Court is expected to deliver judgment this month in the long-running litigation between Barclays Bank, Colgate-Palmolive and the California Franchise Tax Board.

D. UK tax treaty network

1. Treaties with EC member states

The United Kingdom has income tax treaties with all of its EC partners. Many of these treaties have been renegotiated fairly recently and enable non-UK investors to obtain partial refunds of ACT (see for example, the treaties with the Netherlands, Belgium, Luxembourg, Denmark and Italy). The treaties with France and Ireland only provide refunds to "portfolio" investors. The treaty with Germany provides for no refund at all, but is being renegotiated, as is the treaty with France.

Those treaties which provide for a partial refund of ACT usually contain anti-"treaty shopping" provisions. However, UK tax treaties (apart from the UK–US treaty) tend to be based on the 1977 OECD model tax treaty and therefore do not contain extensive US-style "limitation of benefits" provisions.

The UK's tax treaties with France, Ireland and Italy (but *not* Germany) entitle UK residents to refunds of tax under those countries' integration systems. However, under the treaties with France and Ireland, refunds are only available to UK-resident "portfolio" investors. In particular, no refund will be available to a UK-resident company which controls directly or indirectly at least 10 percent of the voting power in the French/Irish company.

The EC parent-subsidiary directive eliminates intra-EC withholding taxes on dividend payments between taxpaying "parent" and "subsidiary" companies in different EC states. Broadly speaking, the "parent" must hold directly at least 25 percent of the capital of the "subsidiary". The directive eliminates any Dutch withholding tax on dividend payments to the United Kingdom from a Dutch "mixer" company. However, it has no impact on dividend payments from the United Kingdom because such payments do not suffer any UK domestic withholding tax.

Furthermore, the directive does not improve existing entitlements to treaty-based tax refunds where dividends are paid to non-residents from the United Kingdom or from those other EC jurisdictions (e.g. France, Germany, Italy and Ireland) which operate an integration system of corporation tax. In other words, the directive only affects dividend withholding taxes.

The parent-subsidiary directive is an extensive topic in its own right and is not discussed in detail in this article. However, if a UK holding company seeks to rely on the directive to avoid dividend withholding in respect of shares held in a European company, it is essential to consider carefully the manner in which the investee member state has implemented the directive. Member states are allowed some latitude by the directive, especially regarding anti-abuse provisions. In particular, France has introduced a provision which denies exemption from French dividend withholding tax under the directive where an EC company controlled from outside the EC is set up in order to take advantage of the directive.

2. Treaties with Eastern European countries

The United Kingdom has concluded a number of treaties with former members of the Eastern Bloc. The former East Germany now benefits from the existing UK treaty with Germany. There are treaties with Czechoslovakia, Hungary, Poland, Rumania, Bulgaria and (most recently) the Ukraine and Uzbekistan. The United Kingdom aims to conclude ongoing negotiations with Belarus (Belorussia) and the Baltic States, and is conducting negotiations with the Russian Federation. The Inland Revenue will apply the old UK treaty with the Soviet Union to the constituent republics of the former Soviet Union until such time as new agreements take effect with particular countries which belonged to the former Soviet Union.

Following the dissolution of Czechoslovakia, the treaty with Czechoslovakia remains in force between the United Kingdom and the Czech and Slovak Republics. Currently, the UK tax treaty with Yugoslavia is only in effect as regards Croatia and Slovenia.

These treaties are normally less generous than the UK's treaties with the United States and EC member states. In particular, it is fairly unusual for partial refunds of ACT to be made available (although there are exceptions; see the treaties with Poland, Rumania and Yugoslavia). Furthermore, residual rates of withholding tax on interest and royalties tend to be higher.

E. Capital gains/losses on disposal of shares of operating companies

Subject to indexation relief, UK corporation tax is chargeable in full on any capital gain realized on such a disposal. A foreign tax credit will normally be available for any overseas tax charged on the gain. Capital losses are allowable, but can only be offset against capital gains of the accounting period of the company in which the disposal arises, or of a subsequent accounting period.

F. Deductibility of interest expenses

1. General rules

Generally, a UK-resident company which is not a bank or financial trader can only deduct interest when it is *paid*, rather than when it accrues (although the Inland Revenue

© 1994 International Bureau of Fiscal Documentation

announced in November 1993 a major review of the taxation of interest in the United Kingdom). Furthermore, the United Kingdom draws a fairly firm distinction between "interest" and original issue discount ("discount"). Discount is generally not deductible by a UK-resident company which is neither a bank nor a financial trader. There is an important exception for "deep discount securities", which are non-convertible debt securities which are issued at a "deep" discount and which provide a fixed yield to redemption. The issuer can usually deduct this "deep" discount as it accrues. Normally, investors who hold "deep discount securities" as capital assets will only pay tax on their discount income when they dispose of the bonds (e.g. at redemption).

The UK approach to characterizing debt and equity is more formalistic than the US approach. Therefore, undated heavily-subordinated debentures will usually be regarded as "debt". However, in some cases, interest will be recharacterized by statute as a non-deductible "distribution", which will give rise to ACT. This is generally true of profit-related interest, interest in excess of a "reasonable commercial return", interest on some kinds of convertible debt and interest on long-dated or undated "equity notes". It is also true in respect of interest on debt owed to certain non-UK resident companies affiliated with the UK borrowing company.[13]

2. Withholding tax

There is no UK domestic withholding tax on payments of discount. By contrast, UK-source interest payable on debt which is likely to be outstanding for at least a year is generally subject to 25 percent withholding tax. An interest deduction will be denied if the appropriate amount of tax is not withheld. Apart from tax treaties, there are two principal domestic exemptions from withholding on UK-source interest:

- an exemption for interest paid on an advance made by a bank "recognized" in the United Kingdom.[14] A bank will not be "recognized" unless it is carrying on a bona fide banking business in the United Kingdom. Even if the bank is "recognized", the exemption will not be available unless the interest is brought into account in calculating the bank's UK taxable profits;
- the "quoted Eurobond" exemption.[15] This applies to interest-bearing securities issued by a company in bearer form, which are quoted on a stock exchange "recognized" by the Inland Revenue. A number of stock exchanges worldwide are "recognized" by the Inland Revenue (notably London, Luxembourg, Paris and New York). In practice, if the exemption is to be available, interest must either be paid through a non-UK paying agent or the securities must be held in a "recognized clearing system" (notably Euroclear or Cedel, but *not* DTC).

3. Thin capitalization

The United Kingdom does not have comprehensive "thin capitalization" or "earnings stripping" rules. However, there are various techniques available to the Inland Revenue for combating thin capitalization:

- Interest paid to a non-UK-resident company which is 75 percent affiliated with a UK-resident corporate borrower is automatically recharacterized as a non-deductible "distribution". This "distribution" also gives rise to ACT.[16] In many UK tax treaties (notably the UK–US treaty), this recharacterization is overridden and the interest is deductible in the normal way. However, the override is only effective to the extent that the amount of interest paid by the UK borrower does not exceed the amount which would have been paid if there had been no "special relationship" between the borrower and the non-UK affiliate, nor between both of them and a third party. This proviso is interpreted not only as a curb on excessive interest rates but also on thin capitalization.

  The proviso will also deny treaty relief from UK withholding tax, to the extent that "excess" interest is paid because of a "special relationship".

  The proviso usually only applies where the amount of interest paid is excessive "owing to a special relationship between the payer and the person deriving the interest or between *both of them* and some other person". This language seems to be too narrow to affect automatically any interest paid by a UK company to a non-UK lender in respect of debt guaranteed by the borrower's non-UK parent.
- The UK's "transfer pricing" legislation (see L.1.) is probably not drafted sufficiently widely to provide the basis for a thin capitalization attack (although the Inland Revenue may disagree!).
- The UK's thin capitalization rules are therefore of primary importance where interest is paid to a non-UK affiliate and/or the lender seeks treaty relief from UK interest withholding. These rules should not affect debt issues by UK companies to third parties in the capital markets, where the "quoted Eurobond" exemption is normally relied upon to avoid UK interest withholding.
- Where the Inland Revenue mount a successful thin capitalization attack, there are no statutory debt:equity ratios. However, the Inland Revenue generally require a debt:equity ratio of no more than 1:1 and interest cover of at least 3:1.

G. Anti-deferral regimes relating to controlled foreign corporations ("CFCs")

1. CFC rules

The UK CFC rules are of particular relevance to a UK-resident holding company. They enable non-UK profits to be attributed to UK-resident *companies* which have an "interest" in a non-UK company which is "controlled" from the United Kingdom.[17] "Control" is widely defined but essential-

13. Secs. 209(2)(d) and (e), and 212 Taxes Act 1988.
14. Sec. 349(3)(a) Taxes Act 1988.
15. Sec. 124 Taxes Act 1988.
16. Sec. 209(2)(e)(iv) Taxes Act 1988.
17. Secs. 747-756 and Schedules 24-26 Taxes Act 1988. As in the United States, there are other sets of rules (notably, the "offshore fund" rules and Secs. 739-745 Taxes Act 1988) which also deal with tax deferral through offshore vehicles. These other regimes are of less immediate relevance to a UK holding company and are not discussed further.

© 1994 International Bureau of Fiscal Documentation

ly means that UK-resident persons and related parties (whether UK-resident or not) hold or can acquire the greater part of the voting power, income or assets of the non-UK company. It is important to note that the non-UK profits which can be taxed under the CFC rules do *not* include capital gains of the non-UK company which would be taxable if it were UK-resident.

A non-UK company is only a CFC if the effective rate of tax on its income profits is less than 75 percent of the effective UK rate which it would suffer on those profits if it were UK-resident. When calculating the non-UK company's hypothetical UK tax for the purposes of this comparison, one ignores UK foreign tax credits which would have been available for foreign tax suffered by the non-UK company in the jurisdiction where it is resident.

If a non-UK company is a CFC, the Inland Revenue can make a direction apportioning an appropriate amount of its income profits to UK-resident *companies* which have an "interest" in it. Apportionment is made on a "just and reasonable" basis. Profits apportioned to UK-resident companies are then taxed at the normal corporation tax rate, but there is a credit for UK and foreign tax already suffered by the CFC on the apportioned profits.

2. Defences to a CFC assessment

There are a number of defences to a CFC assessment.

Firstly, a UK-resident company cannot be assessed under the CFC rules unless at least 10 percent of the profits of the CFC for the relevant accounting period can be attributed to that UK company or persons related to it.

Secondly, no CFC direction may be made where the income profits of the CFC for the relevant accounting period do not exceed £ 20,000 or (if that period is less than 12 months) a proportionately reduced amount. UK tax rules are used to calculate income profits for this purpose.

Thirdly, no CFC direction may be made if, throughout the relevant CFC accounting period, the "public" beneficially owns shares or stock (other than fixed-rate dividend shares) which carry at least 35 percent of the CFC's voting power. Those shares or stock must be quoted during that period in the official list of a Revenue-recognized stock exchange in the territory where the CFC is resident, and must also be dealt in on such an exchange. There are further rules which prevent this exemption being available where, in substance, the shares, stock or voting power of the CFC are not widely held.

Fourthly, there will be no CFC direction if the CFC pursues an "acceptable distribution policy" for the relevant accounting period. If the CFC is a trading company, its distribution policy will be "acceptable" if, within 18 months of the relevant accounting period ending, at least 50 percent of its *accounting* profits for that period (ignoring capital gains and losses) are dividended (directly or indirectly) to UK-resident persons. However, if the company is not a trading company, the rules are more stringent. In particular, the UK Finance Bill 1994 imposes further restrictions (with effect in relation to CFC accounting periods ending on or after 30 November 1993). Once the Bill is in force, a non-trading CFC will only meet the "acceptable distribution" test if not less than 90 percent of its profits (calculated *according to UK tax principles*) are distributed to UK-resident persons within 18 months of the end of the relevant accounting period of the CFC. In ascertaining whether there is a 90 percent distribution, profits are reduced by UK and foreign tax actually suffered by the CFC in respect of the distributed profits. By basing the distribution test for non-trading companies on profits computed according to UK tax principles, the 1994 changes counteract various techniques for making minimal "acceptable distributions" by manipulating accounting profits.

Fifthly, there will be no CFC direction if the CFC carries on "exempt activities" in the relevant accounting period. Leaving aside holding companies (which are discussed below), a CFC will only be engaged in "exempt activities" if:

(i) its affairs are "effectively managed" from a "business establishment" in the territory in which it is resident;
(ii) its principal activity does *not* consist of leasing; dealing in securities (other than as a broker); holding securities or intellectual property; certain kinds of fund investment; or dealing in goods for delivery to or from the UK or to or from related parties; and
(iii) if the CFC is mainly engaged in "wholesale, distributive or financial business" (e.g. shipping, air transport, banking, insurance, commodities and futures dealing), most of that business is conducted with unrelated parties.

There are special rules for exempting CFCs which are holding companies. Such CFCs must comply with (i) above. They must also invest, in essence, in other companies carrying on "exempt activities". The protection offered to certain holding companies is highly relevant to Dutch mixer companies which are owned by UK companies, especially given the changes to the rules regarding an "acceptable distribution policy". A Dutch mixer company should be regarded as carrying on "exempt activities" if at least 90 percent of its *gross* income in the relevant accounting period is derived *directly* from non-Dutch companies which it controls, and which themselves carry on "exempt activities". A company controlled by the mixer company may itself be a holding company (a "local holding company") without prejudicing the exempt status of the mixer's activities for UK CFC purposes. However, if the mixer is to remain protected from the UK CFC rules, at least 90 percent of that local holding company's gross income must in turn be derived directly from companies which the local holding company controls, which are resident in the same territory as the local holding company, and which (without being holding companies themselves) carry on "exempt activities".

H. Capital tax on formation and transfer of securities

Apart from company registration fees, there is currently no capital tax on company formation in the United Kingdom. There are no UK net worth taxes.

UK stamp duty or stamp duty reserve tax ("SDRT") is usually payable (at ½ percent) where shares of a UK company are transferred on sale. Special 1 percent stamp duty/SDRT charges can apply if the shares of a UK company are issued

© 1994 International Bureau of Fiscal Documentation

or transferred into a clearing system or a depositary receipt facility.

Generally, stamp duty and SDRT do not affect the issue or transfer of corporate debt securities (although there are some notable exceptions).

Stamp duty and SDRT on securities transactions have been scheduled for abolition since 1990, but the abolition date has been repeatedly postponed.

I. Substance requirements

A composite transaction is to be taxed in the United Kingdom by reference to its end result, if it contains steps which have been artificially inserted for purposes of tax avoidance.[18] This doctrine is still evolving.[19] However, in the international context, its impact to date has been fairly limited. Except in fairly extreme circumstances, it is doubtful whether an English court would rely on this doctrine to disregard a "conduit" company used for "treaty-shopping" into the United Kingdom: compare the US approach in *Aiken Industries Inc. v. Commissioner* (1971) TC 925. The Inland Revenue are much more likely to invoke anti-treaty shopping rules in particular tax treaties.

Similarly, although the concept of "beneficial ownership" is known to UK law, it is fairly narrowly defined. Therefore, an English court is currently fairly unlikely to rule that a "conduit" company investing into the United Kingdom lacks beneficial ownership of the income which it receives (although the Inland Revenue have attempted such arguments). Specific UK treaties should be checked for anti-treaty shopping rules (e.g. language which denies refunds of ACT).

On a more mundane level, a UK holding company may require a substantial presence in the United Kingdom if its non-resident shareholders are to enjoy treaty benefits. For example, if a US investor in a UK-resident company is to obtain a refund of ACT (see C.1.), that company must be "managed and controlled" in the United Kingdom. Incorporation is not enough, even though incorporation makes the company UK-resident under domestic law. A dual-resident company resident in the United Kingdom is also likely to be subject to restrictions. For example, a company resident in both the United States and the United Kingdom can only claim very limited benefits under the UK–US treaty (see Article 1(2)).

Of course, if a UK holding company is set up to invest in other jurisdictions, "substance" issues in those jurisdictions must also be considered carefully. This is particularly true of the United States, where "conduit" companies have been attacked in the *Aiken Industries* decision referred to above, and also in a series of IRS rulings in the 1980s. This US offensive against conduit entities looks likely to continue, following the entry into force of the new US–Netherlands tax treaty (with its extensive "limitation of benefit" provisions) and the 1993 enactment of Section 7701(l) Internal Revenue Code. Section 7701(1) is a rule-making provision which authorizes the IRS to write regulations preventing avoidance of US tax by means of "multiple-party financing transactions". These include not only back-to-back loans but also multiple-party transactions involving debt guarantees or equity investments. Section 7701(l) is designed to reinforce the IRS campaign against conduit entities.

J. Treatment of exchange gains and losses on acquisition debt

Historically, the UK tax rules regarding foreign exchange gains and losses have been defective. In particular, post-tax mismatches were likely to arise as a result of foreign exchange fluctuations where a UK-resident company incurred non-Sterling debt in order to acquire non-Sterling assets.

The UK Finance Act 1993 contains new rules to cure these anomalies. These rules are not expected to come into force until late 1994/early 1995. Key features of the new rules are as follows:

(a) Exchange gains and losses on "qualifying assets" and "qualifying liabilities", and on forward contracts to buy or sell currency, are recognized as they accrue between one "translation time" and the next. "Qualifying liabilities" include debts. Generally, shares are not "qualifying assets".

(b) Exchange gains arising on such periodic translation are to be taxed as income. Exchange losses arising on translation are offsetable against income. Exchange gains on "qualifying assets" are no longer taxable as capital gain.

(c) There is scope for "matching" exchange differences on borrowings and forward currency contracts with exchange differences on certain non-"qualifying assets". This should help, for example, to prevent translation mismatches arising where non-Sterling debt finance is used to acquire assets (e.g. most shareholdings) which are not "qualifying assets" under the new rules.

The new rules should make it easier to run international treasury operations from the United Kingdom, especially as the United Kingdom is also reforming the tax treatment of instruments for managing interest rate and exchange rate risk. The new tax regime for such instruments is expected to come into force at the same time as the new rules regarding exchange gains and losses.

K. UK integration system and the distribution by UK companies of foreign-source profits

1. Surplus ACT

Dividends paid by a UK-resident company give rise to ACT (see C. above). Foreign-source income of a UK-resident

18. *W.T. Ramsay Ltd. v. IRC* [1981] STC 174; *Furniss v. Dawson* [1984] STC 153; *Craven v. White* [1988] STC 476.
19. *Ensign Tankers (Leasing) Ltd. v. Stokes* [1992] STC 226; *Countess Fitzwilliam v. IRC* [1993] STC 502; and the speech of Lord Templeman in *Matrix Securities Ltd. v. IRC* [1994] STC 272.

© 1994 International Bureau of Fiscal Documentation

company is subject to UK corporation tax, but is likely to attract UK foreign tax credits. In particular, foreign-source dividend income may give rise to UK credits for underlying taxes which largely eliminate any UK "mainstream" tax liability on that income. When foreign-source income is distributed by the UK company, ACT remains payable even if that income gives rise to UK foreign tax credits. This ACT is technically offsetable against any "mainstream" corporation tax liability of the distributing company or certain of its affiliates. In practice, the scope for offsetting this ACT may well be minimal if little or no "mainstream" corporation tax is payable by the distributing company because of foreign tax credits. "Surplus" ACT therefore arises where no offset is possible. Surplus ACT is often in effect an "alternative minimum tax" on distributed foreign-source profits. Historically, surplus ACT has been a major drawback to setting up international holding companies in the United Kingdom (although there have been other drawbacks as well, such as the lack of a UK exemption from tax on capital gains when a share participation in a non-UK company is disposed of).

2. Foreign income dividends and international headquarters companies

The UK Finance Bill 1994 contains detailed legislation which aims to alleviate the problem of surplus ACT[20] where a UK-resident company pays dividends out of taxed non-UK source profits. The new rules are capable of applying to dividends paid on or after 1 July 1994, provided they are paid out of non-UK-source profits for accounting periods beginning on or after 1 July 1993.

Under the new rules, any UK-resident company can elect to pay in cash a foreign income dividend ("FID"). A FID will carry no refundable UK tax credit (and therefore, no entitlement to a refund of ACT under a UK tax treaty).

Initially, ACT must be accounted for in respect of a FID. However, if the FID can be matched with non-UK source profits which give rise to UK foreign tax credits, that ACT may be repayable in whole or in part (although generally without interest).

In order to be in a position to recover any of the ACT, the UK-resident company must pay a FID out of non-UK source profits of its current or immediately preceding accounting period or, if those profits are insufficient, out of the non-UK source profits of any subsequent accounting period. Alternatively, it can treat an FID as having been paid out of the non-UK source profits of any of its 51 percent UK-resident subsidiaries. There are very detailed rules for matching an FID with non-UK source profits, and for determining the amount of refundable ACT. The higher the foreign tax bill on the company's non-UK source income, the greater the potential ACT recovery.

There are anti-streaming rules designed to restrict the scope for shareholders to choose, in the light of their own tax position, whether or not to receive dividends in the form of FIDs.

A particularly important feature of the new rules is that a UK-resident company which is an international headquarters company ("IHC") may elect to pay an FID without being liable for ACT when the FID is paid. Broadly speaking, a company will be an IHC if none of its shareholders owns less than 5 percent of its share capital and at least 80 percent of its share capital is ultimately owned by non-UK residents. Percentage ownership of share capital of an IHC is generally to be determined by reference to voting rights in a general meeting.

Most importantly, a UK-resident company will in any case be an IHC if it is wholly-owned (directly or indirectly) by a non-UK resident company whose shares are quoted and dealt in on a non-UK stock exchange "recognized" by the Inland Revenue. Generally, the non-UK resident company's shares must not be quoted on a UK stock exchange, although a UK secondary quotation is permitted (i.e. a share quotation which is not subject to the full requirements of the UK "listing rules").

An IHC may subsequently have to account for ACT if it transpires that it was not an IHC or that any FID which it has paid cannot be fully matched with highly-taxed non-UK source profits.

There is no procedure for the Inland Revenue to rule in advance on whether the conditions for IHC status are satisfied. The absence of a ruling procedure is a significant defect in the new rules. The IHC definition is intricate and the UK-resident company must determine, for each accounting period, whether it satisfies the definition. Certainty would be enhanced if it were possible to obtain a formal ruling that a company was or was not an IHC.

The Finance Bill 1994 proposals aim to eliminate surplus ACT when highly-taxed non-UK source income is distributed in the form of a cash dividend by a UK-resident company (particularly a foreign-controlled holding company). The new rules do not and are not intended to create a "participation exemption"; non-UK source dividend income remains taxable in the United Kingdom (subject to foreign tax credits), and there is no exemption from UK tax on capital gains when a UK-resident company disposes of a share participation. However, the new proposals may enable highly-taxed non-UK source dividend income to be paid to and distributed by a UK-resident holding company with little or no UK tax cost, because of the absence of any UK domestic withholding tax on dividends, and the ability to avoid or recover any ACT liability. Furthermore, there are a number of techniques which may help to remedy the lack of a UK exemption for tax on capital gains. One such technique is discussed in Part II below.

L. Other UK tax considerations when setting up a UK holding company

1. Transfer pricing

A UK-resident company is subject to the UK's transfer pricing rules.[21] These are much less detailed than those in the

20. Schedule 14 Finance Bill 1994.
21. Notably, Secs. 770-3 Taxes Act 1988.

© 1994 International Bureau of Fiscal Documentation

United States and, in some respects, are less stringent. In particular, these rules are generally invoked only by Inland Revenue direction and there are no special valuation misstatement penalties for non-compliance. However, these rules still enable the Inland Revenue to tax transactions between certain related parties as if they had taken place for an "arm's length" consideration. In determining an "arm's length" consideration, the Inland Revenue has tended to adopt the four valuation methodologies set out in the 1979 and 1984 OECD Reports on transfer pricing. The United Kingdom has no equivalent to the US procedure for concluding "advance pricing agreements".

2. VAT

Supplies of goods and services made to and by a UK-resident company potentially attract VAT at 17.5 percent. In principle, VAT incurred on supplies made to a VAT-registered company can be recovered if and to the extent that the company uses the VATable supplies which it receives in order to make its own VATable supplies. Despite this basic principle, a 1992 decision of the European Court of Justice in relation to a Dutch holding company[22] caused considerable concern about the ability of EC holding companies to recover VAT. However, after consultation, the UK authorities announced that they would interpret the Court of Justice ruling narrowly. Therefore, it should be of limited impact if a UK-resident holding company is more than merely a passive investment vehicle and provides genuine management services to operating subsidiaries. A UK-resident company providing management services to non-UK subsidiaries should ensure that its supervision is not so intrusive that the Inland Revenue can argue that those subsidiaries are "centrally managed and controlled" (and therefore, tax-resident) in the United Kingdom.

3. Personal taxation

Nowadays, there are few special UK tax incentives for expatriates working in the United Kingdom, although there are tax-deferral possibilities for UK-resident expatriates who are not "domiciled" in the United Kingdom. In recent years, proposals have been put forward for reforming the UK law of "domicile". If implemented, these proposals could make it harder for UK-resident expatriates to qualify for these reliefs. However, at present, these proposals for reforming the law of domicile have been postponed indefinitely.

The United Kingdom also provides relatively generous reliefs to UK-resident employees who acquire share options or shares under Inland Revenue-approved share option or profit-sharing schemes. Finally, UK tax reliefs are available to employees who receive "profit-related pay" under arrangements approved by the Inland Revenue.

M. Other legal and commercial considerations

There are no longer any exchange control restrictions in the United Kingdom. Certain transactions involving shares and debentures of non-UK-resident companies require UK Treasury Consent,[23] if those companies are controlled by UK-resident companies (e.g. a UK international holding company). However, these restrictions have been relaxed considerably in recent years, especially in relation to intra-EC transactions,[24] which have been liberalized pursuant to EC Directive 88/361.

London is a, if not the, major financial centre in Europe and is increasingly well connected to mainland Europe.

II. MATURITY OF THE UNITED KINGDOM AS A HOLDING COMPANY JURISDICTION

This part highlights the principal strengths and weaknesses of the United Kingdom as a location for an international holding company, in the light of recent developments. In particular, comparisons are made between the UK position and the tax treatment of a Dutch international holding company. Inevitably, the comparison oversimplifies the position in practice. Although the Netherlands is a very well-recognized and old-established location for an international holding company, other jurisdictions are now competing with both the Netherlands and the United Kingdom as locations for such companies (notably Luxembourg, France, Germany, Belgium and Austria). A decision to set up a holding company in any of these jurisdictions requires detailed consideration of the circumstances surrounding the decision to establish a holding company.

A. Basic comparison with the Netherlands

United Kingdom	*Netherlands*
1. Participation exemption: Dividends	
No – although foreign tax credit rules can produce a similar result where a UK-resident company receives highly-taxed non-UK-source dividend income from a shareholding carrying 10% of the voting rights in the distributing company (cf 5% shareholding required in most cases to qualify for the Netherlands participation exemption).	Yes. A Bill restricting the exemption was dropped in December 1993.
2. Participation exemption: Capital Gains	
No – normal CGT rules and rates apply.	Yes
3. Capital Duty	
No.	Yes – 1%, although there are exemptions for certain types of corporate reorganization. Capital duty is deductible for Dutch corporate income tax purposes, even if funds are used to acquire foreign participations.

22. *Polysar Investments Netherlands BV v. Inspecteur der Invoerrechten en Accijnzen, Arnhem* [1993] STC 222.
23. Sec. 765 Taxes Act 1988.
24. Sec. 765A Taxes Act 1988. From 1 January 1994, these relaxations extend to transactions involving Austria, Finland, Iceland, Norway and Sweden. Where it applies, Sec. 765A removes the requirement of Treasury Consent. However, it may still be necessary to comply with fairly detailed reporting requirements.

© 1994 International Bureau of Fiscal Documentation

United Kingdom	Netherlands
4. Dividend withholding	
No.	Yes – although often reduced/eliminated by tax treaty/EC parent-subsidiary directive.
5. Ruling procedure to confirm availability of certain tax reliefs	
No.	Yes.
6. Equalization tax on dividend distributions by the holding company	
Yes – ACT, which, historically, has been an additional tax cost of utilizing a UK international holding company. Note the Finance Bill 1994 ACT relief for "international headquarter companies" which pay dividends from highly-taxed non-UK source income. The rules governing this relief are complex.	No. The Netherlands has a "classical" corporation tax system. Tax paid at the level of the Dutch company is not imputed to its shareholders. Therefore, there is no need for an equalization tax to ensure that tax imputed to shareholders has in fact been paid by the Dutch company.
7. Tax treaty network	
Extensive.	Extensive.
8. Anti-treaty shopping rules in tax treaties with US	
In principle, a UK "international headquarters company" should not fall foul of the "limitation of benefits" provisions in Art. 16 US–UK Treaty.	A Dutch holding company is vulnerable, under Art. 26 US-Netherlands treaty, to the denial of treaty reliefs in respect of US-source interest, dividends and royalties. Art. 26(7) allows the US to extend the benefits of that treaty to Netherlands entities which would not otherwise qualify. In extending such benefits, the US is to be guided by whether one of the principal purposes for setting up, acquiring or maintaining the Netherlands entity was the obtaining of benefits under the treaty. It is not entirely clear how the US will interpret Art. 26(7). Currently, there seems to be some hesitation about applying Art. 26(7) in favour of Netherlands mixer companies owned by UK publicly-quoted companies, even though mixer companies are set up in order to achieve tax benefits in the UK, not the US; and are usually owned by UK companies which would be fully entitled to the benefits of the UK–US treaty if they invested directly in the US.
9. Foreign exchange gains and losses	
Old rules used to cause tax mismatches, especially where non-sterling debt finance was used to finance acquisitions. Finance Act 1993 improves the position (although not yet in force).	Exchange gains or losses that affect the value of a share participation are exempt. However, mismatches can arise if non-guilder debt is used to acquire a share participation qualifying for the "participation exemption" from Dutch tax on gains.
10. Relief for costs of financing share participations	
Generally, interest costs can be set against any income of UK holding company (although it tends to be inefficient to set interest against non-UK-source income which gives rise to UK foreign tax credits).	Generally, no deduction for interest costs incurred in financing a non-Dutch participation which generates tax-exempt dividend income.
11. VAT recovery	
Adverse impact of *Polysar* (but Customs & Excise have indicated a readiness to interpret that decision narrowly).	Adverse impact of *Polysar* (especially in relation to a "classic" Dutch holding company whose activities are very limited).
12. Thin capitalization	
Most UK tax treaties deny treaty relief in respect of UK-source interest in cases of thin capitalization. A debt:equity ratio in excess of 1:1 and interest cover of less than 3:1 is prima facie evidence of thin capitalization. However, these treaty-based restrictions should not be relevant if the UK company can raise debt finance without resorting to UK tax treaty relief.	Interest and royalties can be deducted and paid gross, with little or no restriction. The Netherlands is considering measures to restrict earnings stripping where a Netherlands company is acquired by another highly-leveraged Netherlands company.
13. Withholding on liquidation of holding company	
No.	Yes.
14. Anti-deferral rules relating to CFCs	
Extensive anti-deferral rules.	No anti-deferral rules, unless shares are held as a portfolio investment.

B. Drawbacks in using an IHC as a European holding company

There are therefore a number of drawbacks in using an IHC as a European international holding company. In particular:

(a) There is no capital gains tax exemption when share participations are diposed of.

(b) The UK credit method of double taxation relief has two major drawbacks compared to the exemption method (of which the Dutch "participation exemption" is an example):
- low-taxed foreign-source profits will still give rise to residual UK tax even after foreign tax has been credited;
- UK foreign tax credit "limitation" rules. The UK does not permit the cross-crediting of "excess" tax credits from one income source against UK tax on income from another foreign source. "Excess" UK foreign tax credits are therefore effectively lost because they cannot be carried forwards or backwards. The overall result is that UK foreign tax credits are used inefficiently, and the UK tax burden on foreign-source income is increased.

(c) An IHC is a UK-resident company subject to the UK's CFC rules. These can restrict the scope for tax-free roll-up of income in non-UK companies whose shares are held by the IHC. In practice, if the IHC holds share participations in operating companies in taxpaying jurisdictions, or in certain kinds of holding company, the impact of the UK CFC rules should be limited because of the safe harbour for "exempt activities" and/or the effective rate of tax suffered by the non-UK companies. However,

© 1994 International Bureau of Fiscal Documentation

the UK CFC rules pose a significant compliance burden and they have become more restrictive in recent years.

(d) A non-UK-incorporated company will nevertheless be UK tax-resident if it is "centrally managed and controlled" in the United Kingdom. The "central management and control" test focuses on the highest level of control of the company. If a UK IHC is a headquarters company for non-UK-incorporated subsidiaries, there is a risk that its supervisory role may lead to those operating companies becoming UK-resident. In most cases, it should be possible to formulate supervisory and operating procedures which minimize this risk.

C. Combining the benefits of Dutch and UK holding companies

There are therefore complications if a UK IHC holds foreign share participations directly. In order to reduce these complications, it may be advisable for share participations in non-UK operating companies (assuming that they carry at least 10 percent of voting rights) to be held by a Dutch company whose income and gains from share participations benefit from the "participation exemption". This Dutch company will in turn be wholly owned by a UK IHC. Dividend income can be paid gross between the Dutch company and the IHC because of the EC parent-subsidiary directive. Dividends paid by the IHC do not attract withholding, nor should they give rise to ACT once Schedule 15 Finance Bill 1994 is in force, provided the underlying non-UK source income of the Dutch company is highly taxed. Under this modified structure:

- there is effectively no withholding or other tax on income received and dividends paid by either the Dutch company or the UK IHC;
- no Dutch capital gains tax is realized when the Dutch company disposes of a share participation. Generally, the gains realized by the Dutch company should not be subject to UK tax in the hands of the IHC, provided the Dutch company would not be a "close company" if it were UK-resident;
- non-UK-source taxed income can be "mixed" at the level of the Dutch company, thereby reducing the risk of "excess" foreign tax credits in the United Kingdom.

This alternative structure will not entirely eliminate the UK holding company's potential exposure under the UK CFC rules. However, if the Dutch mixer company owns controlling participations in non-Dutch operating companies, both the Dutch company and those operating companies should in most cases fall within the "exempt activities" exclusion from the UK CFC rules. Procedures can also be put in place to ensure that "central management and control" of the Dutch and operating companies remains outside the United Kingdom.

If this alternative structure is used to invest into the United States, the Dutch company may well be ineligible for reduced rates of US withholding on dividends, interest and royalties because of Article 26 of the US–Netherlands treaty. It is doubtful whether the United States will extend the benefits of the US–Netherlands treaty to the Dutch company under Article 26(7). At the very least, the United States would no doubt wish to examine which parties ultimately own and control the UK IHC (and hence the Dutch company).

On the other hand, if this alternative structure is used for investment into Europe from the United States, the limitations on US credits for underlying foreign tax need to be borne in mind. Section 902 of the Internal Revenue Code will deny a credit in the United States for underlying foreign tax of a fourth-tier foreign affiliate. Section 902 may pose problems if a European operating group is owned by a Dutch company, held in turn by a UK IHC which is itself owned from the United States. To avoid problems under Section 902, it may be advisable to structure the intermediate Dutch company as a "partnership" for US tax purposes, thereby eliminating one foreign corporate tier for US foreign tax credit purposes. One should not underestimate the problems in structuring a wholly-owned Dutch company as a "partnership" for US tax purposes.[25]

III. CONCLUSION

Recent changes in UK domestic tax rules have made the United Kingdom a more attractive jurisdiction (in tax terms at least) in which to locate holding company, headquarter company and group treasury operations. Furthermore, the United Kingdom may, for the time being, have particular advantages as a base for investing into the United States given the extensive "limitation of benefits" provisions in, for example, the new US treaty with the Netherlands, and the much more limited scope of Article 16 of the US–UK treaty. Nevertheless, in a world which is increasingly hostile to "treaty shopping", and in which a number of jurisdictions are offering tax benefits to international holding companies, the choice of location for such a vehicle needs to be considered very carefully and, above all, in the light of the controlling investor's particular requirements.

25. See US Rev. Rul. 93-4.

© 1994 International Bureau of Fiscal Documentation

LATIN AMERICA

SELECTED TAX ASPECTS OF INVESTMENT

Ruben Diaz, Jr.

Steel Hector & Davis, Miami, Florida

I. INTRODUCTION

US businesses have long recognized the tremendous potential of Latin American economies and markets. For many years, however, the combination of state control of important economic sectors, complex regulations restricting foreign investment and unstable political systems in many countries of Latin America, had limited severely US investment in the region. As almost every country in Latin America has opened its economy to foreign investment and embarked on an ambitious privatization programme during the last few years, US investment into Latin America has increased dramatically.

US investment in Latin America almost always includes – indeed, requires – the participation of foreign partners. The foreign partners at times are "regional", in the sense that their local market expertise extends beyond the borders of a single country, and, at times, are purely national in providing access to a local distribution network and employment base. In all cases, the foreign partner's planning concerns must be taken into account.

Each country in Latin America is, of course, different, with its own regulations governing foreign investment and rules of taxation. It is impossible to generalize the approach for tax planning in Latin American investment. But it is possible to draw some conclusions that can be applicable to more than a single country, or that may be applicable to the countries of greatest interest to US business, by reviewing specific examples of recent transactions. Although foreign investment planning issues generally can be analysed at three different stages – the investment structure stage, the income generation stage and the asset repatriation stage – the free repatriation of investments currently permitted under the laws of most Latin American countries leads us to focus on the other two stages of investment. The examples discussed below illustrate some approaches to issues commonly encountered when an investor from the United States is structuring an investment into Latin America or is planning for minimizing the tax burden on income generated in the region.

II. STRUCTURING THE INVESTMENT VEHICLE

A. General principles

The first planning stage for any foreign investment, is, of course, the "investment structure" stage. With respect to Latin American investment, at this stage it is important to focus on some important general principles of local taxation, as any investment structure is proposed and analysed.[1]

1. Territorial taxation

Latin American countries generally have territorial systems of taxation; that is, they impose tax on economic activity taking place or income arising within their borders, but do not impose tax on the extra-territorial activities of their residents.

2. Levels of tax

Several important Latin American countries do not impose tax on the distribution of dividends to foreign shareholders. For example, Venezuela does not impose a tax on dividend distributions to foreign investors. Mexico similarly imposes no tax, provided the dividend is distributed from the local company's "net after-tax profit account". Colombia does not impose a tax, although at the present time Colombian law provides for a "temporary surcharge" which is equivalent to a dividend withholding tax. The single level of tax makes the decision of whether to invest through a branch or subsidiary depend more importantly on liability issues and other "non-tax" considerations.

3. Anti-deferral provisions

Latin American investors can gain some important benefits from forming offshore tax haven holding companies for their investments, because the tax laws of Latin American countries generally do not have anti-deferral provisions equivalent to US rules applicable to controlled foreign corporations and foreign personal holding companies. The formation of an offshore holding company in a tax haven jurisdiction can often provide significant benefits to the Latin American investors without significant negative consequences to the US investors.

4. Patents, know-how and similar intangibles

US investment into Latin America often involves the contribution of patents, trade marks, trade secrets, technical knowledge, know-how or similar intangibles by the US investor into the local economy. Accordingly, US tax rules governing

1. Although "Value Added Taxes" are an important element of the tax structure of many Latin American countries, the discussion here focuses on income tax issues.

© 1994 International Bureau of Fiscal Documentation

gain on the transfer of intangibles play an important role in tax planning, particularly at the initial stage of structuring the investment.

B. Example: entity selection with patents and similar intangibles

When patents, know-how and similar intangibles are a crucial element of an investment into Latin America, the rules in both the United States and Latin America require careful planning. The US investor may have a valuable intangible for the production of a specific product, while the Latin American investor may have the distribution channels necessary to make the local business successful. The sometimes competing interests of both must be protected.

1. US rules

US law provides generally that a US person transferring intangible property to a foreign corporation as a capital contribution is treated as selling such property for payments which are contingent upon the property's productivity, use or disposition.[2] If the intangible property is not to be resold subsequently by the transferee foreign corporation, the US transferor must include the income annually over the useful life of the intangible property in amounts that reasonably reflect the amounts that would have been received had the US person entered into a contract for the sale of the intangible property in exchange for annual, contingent payments.[3] The amount of the income included in the US transferor's income pursuant to these provisions is treated as ordinary income from sources within the US, although the foreign corporation can reduce its earnings and profits by a corresponding amount in the year income is recognized to the US transferor.[4] If a US person licenses rights to intangible property to a foreign corporation or transfers intangible property to an entity which is not treated as a corporation for purposes of US tax law, the rules of IRC Section 367(d) should not apply, and the income received as a royalty or licence fee should be treated as foreign source income of the US person.

2. Latin American rules

The laws of most Latin American countries present special challenges to the protection of intellectual property rights, because the process for registering trade marks and patents is as cumbersome as the process for enforcing rights against potential violators. Accordingly, US investors should be hesitant to give Latin American investors any rights in the US business, even if they may be willing to grant to the Latin American partners rights over intangible property regionally or within a specific Latin American country. Most Latin American countries treat "technology payments" differently from many other distribution rights payments, because special registration requirements apply to technology transfer contracts. Royalty and licence fee payments are generally deductible to the company making the payments and subject to withholding tax in each country of source.

3. Proposed structure

(a) *Basic structure*

Figure 1

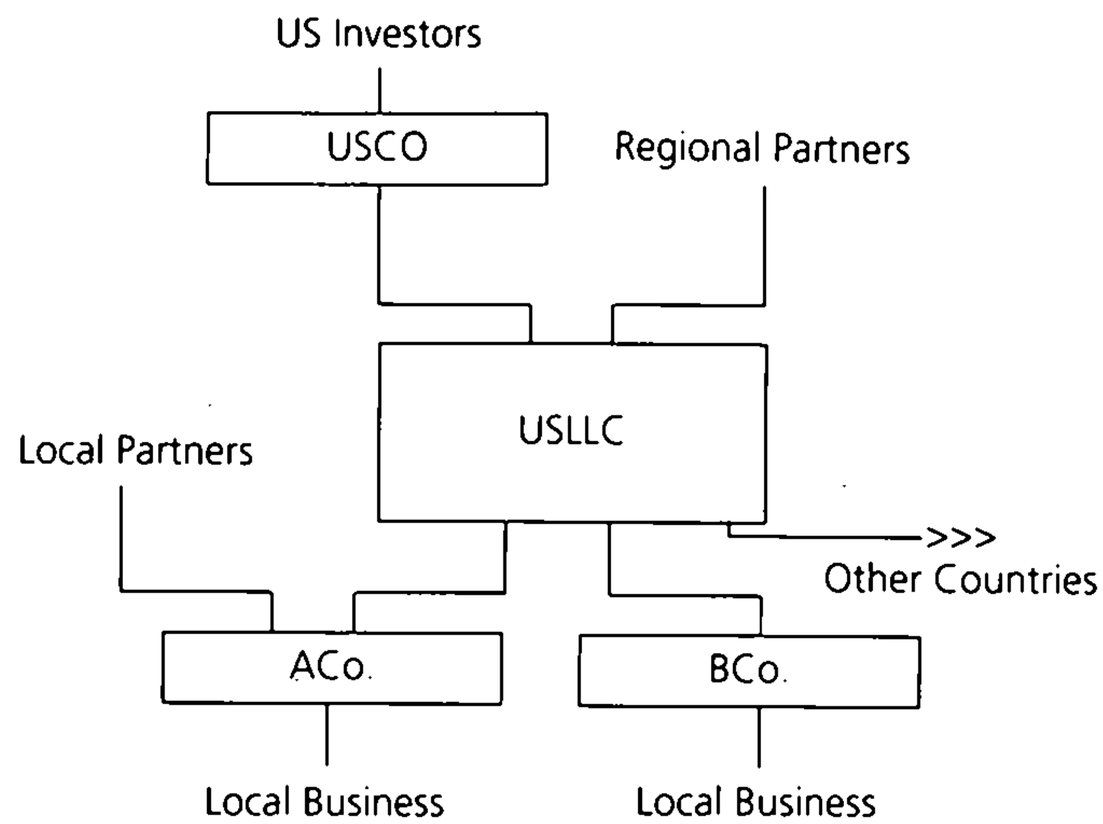


Figure 1 shows an investment structure which may be appropriate to deal with the various concerns outlined above. In the investment structure shown, US investors own a US corporation ("USCO") which holds intangible property rights which are crucial to the production and distribution of certain products in Latin America. USCO and a group of Latin American regional investors form a limited liability company ("USLLC") in the United States, to which USCO contributes the appropriate regional intangible property rights. USLLC in turn forms a corporation or partnership ("ACo.", "BCo.", etc.) in each country of Latin America in which it will do business. Local investors may participate in the investment in ACo., BCo., etc. USLLC licenses its intangible property rights to each company of ACo., BCo., etc., as appropriate, in exchange for royalty payments.

(b) *Consequences to US investor*

The proposed structure allows the US investor to avoid the tax consequences imposed by IRC Section 367(d) as discussed above. The IRS has taken the position that it may challenge this structure, particularly after it issues appropriate regulations this year.[5] But based on the existing provisions of the law, the transfer of intangible property rights to a limited liability company should not be subject to the provisions of IRC Section 367(d), provided the limited liability company complies with the appropriate requirements for being classified as a partnership for purposes of US tax law. Payments of royalties to the limited liability company by the

2. IRC Sec. 367(d)(2)(A). Intangible property is generally defined for these purposes to include any patent, invention, formula, process, design, pattern, know-how, copyright, literary, musical, or artistic composition, trade mark, trade name, brand name, franchise, licence, contract, method, programme, system, procedure, campaign, survey, study, forecast, estimate, customer list, technical data or similar item. See IRC Sec. 936(h)(3)(B).
3. IRC Sec. 367(d)(2)(A)(ii)(I).
4. IRC Sec. 367(d)(2)(B) and (C).
5. See IRC Secs. 704(c) and 721.

© 1994 International Bureau of Fiscal Documentation

local companies in each country should be subject to withholding tax in each country, but should be treated as foreign source income of the US company. Foreign source income characterization is important for the availability of tax credits for the foreign taxes paid by the local companies.

(c) *Consequences to the Latin American investors*

The formation of a limited liability company allows the Latin American regional investors to participate in the business regionally, without having to acquire an interest in the US company. However, the regional investors should not be deemed to be engaged in a trade or business in the United States, since the limited liability company should not be so engaged. The formation of local country companies permits each country to have local investors participating in the business. As a practical matter also, the formation of local country companies avoids an attempt to register locally a foreign investment vehicle, such as a US limited liability company, with which local authorities may be unfamiliar. The formation of local country companies allows each country's investment to be isolated from the applicability of often unpredictable intellectual property protection laws in other countries. Finally, royalty and other distribution payments made by each local country company should be deductible to each company in the determination of its own local taxes.

III. MINIMIZING TAX ON INCOME GENERATED IN LATIN AMERICA

A. General principles

Once an investment structure has been selected, it is important to continue planning for minimizing the taxation of income generated by the local business. Although US investors will not have the benefits of deferral through the use of holding companies in tax haven jurisdictions, largely due to the controlled foreign corporation and similar provisions of US tax law, they will obtain significant benefits from planning to ensure that foreign taxes are creditable against US taxes, and that the highest marginal tax rate outside the United States is not greater than the marginal tax rate imposed within the United States on the same income.

1. Territorial taxation

The principle of territorial taxation mentioned above plays an important role in tax planning in this context. The US investor often may need to ensure that sales of products into a Latin American country take place outside such country. The US investor will be subject to tax on the income from any sale of his products, but such investor and any Latin American partners will benefit from making sure that no tax on sales is paid outside the United States.

2. Levels of tax

Although the single level of tax enjoyed in most Latin American corporate structures can simplify the decision between doing business as a branch and as a subsidiary, the US investor will benefit from payments which are deductible to the Latin American business and subject to a low withholding tax when paid.

3. Equipment purchases and operations

US investment into Latin America often involves the sale of specialized industrial equipment, together with assistance in the operation of such equipment. Accordingly, Latin American tax rules on the territoriality of taxation on sales income and withholding taxes on payments for technical assistance and similar consulting services play an important role in tax planning, particularly as the Latin American investment begins to generate significant income.[6]

B. Example: payment for equipment and for technical assistance

US business activities in Latin America often consist of providing equipment of a specialized nature, together with technical assistance for the operation of the equipment. Such business activities often do not require an investment structure of holding companies, subsidiaries, and branches. Instead, they require a business plan which minimizes Latin American taxation on goods and services provided from the United States.

1. US rules

US companies which provide goods and services in Latin American countries will be subject to tax on net income from such goods and services, and will be entitled to foreign tax credits for income taxes paid to the various Latin American countries on foreign source income. US companies may not defer taxation until income is repatriated into the United States, and will not be able to avoid taxation on income transferred temporarily to holding companies in third countries (particularly tax haven jurisdictions).

2. Latin American rules

(a) *Foreign sales*

The laws of most Latin American countries do not impose tax on income from sales which take place outside their boundaries, even if the sales are made by local companies.

(b) *The case of foreign technical assistance to Venezuelans*

In some countries, payments made abroad for provision of technical assistance services are treated in a special manner which provides tax planning opportunities. Under Venezuelan law, for example, income realized by non-residents for "non-commercial professional services" (i.e. scientific, technical, artistic and similar services, such as services rendered by doctors, lawyers, engineers, accountants and similar pro-

6. Lease financing regulations are complex and varied throughout Latin America. Accordingly, opportunities for planning through leasing and similar transactions are not discussed here, but should be carefully considered as equipment is supplied to Latin America.

© 1994 International Bureau of Fiscal Documentation

fessionals) is taxed on the basis of 90 percent of the gross income realized (i.e. it is assumed that deductible costs related to the services are equal to 10 percent of income). Since the applicable tax rate is 30 percent, the effective tax rate is 27 percent of gross income (i.e. 30 percent of 90 percent). Income realized by non-residents for "foreign technical assistance" (i.e. services rendered by technicians in industrial and management matters, broadly defined) is taxed on the basis of 30 percent of gross income realized (i.e. it is assumed that deductible costs related to the services are equal to 70 percent of income. Since the applicable tax rate is also 30 percent, the effective tax rate is 9 percent of gross income (i.e. 30 percent of 30 percent). A non-Venezuelan company can render technical services from abroad, even if the company sends employees to Venezuela to render such services from time to time in a limited manner.

3. Proposed structure

(a) *Basic structure*

Figure 2

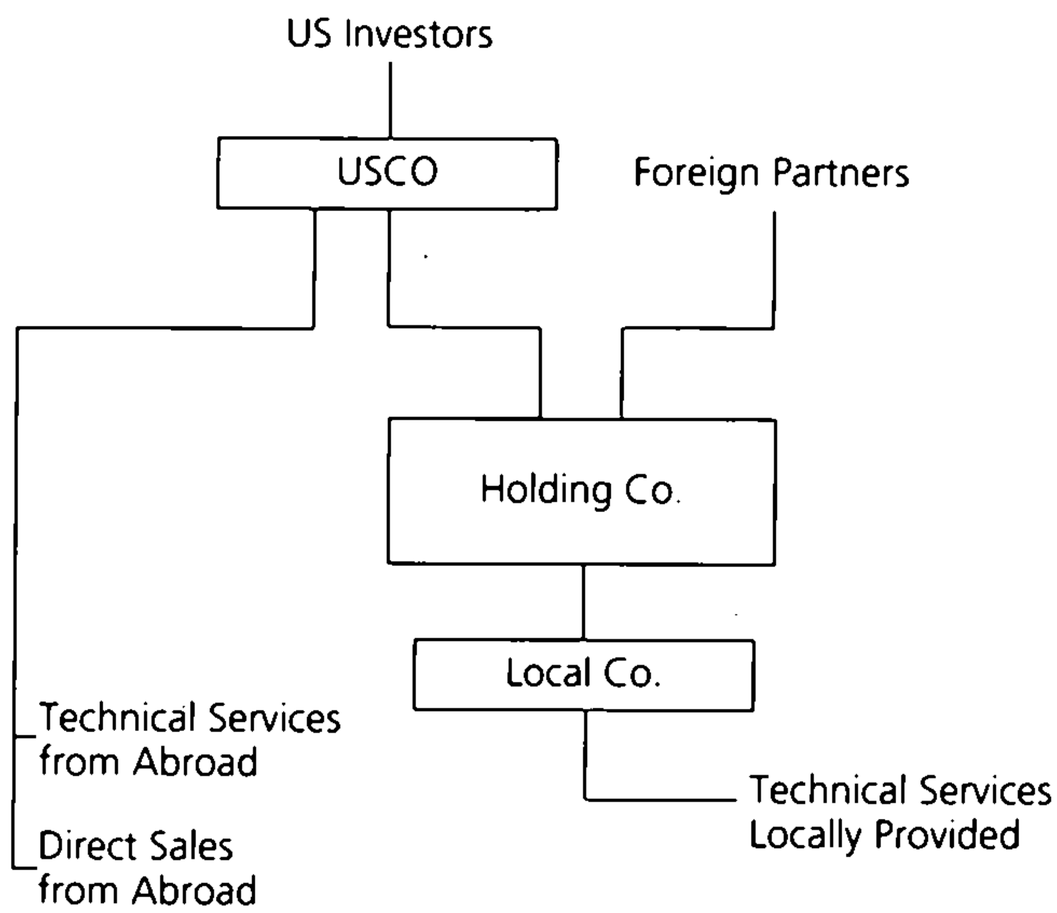


Figure 2 shows an transaction structure for the sale of technical equipment to Venezuela, together with the provision of technical assistance to the equipment purchasers and others. In the investment structure shown, US investors own a US corporation ("USCO") which provides equipment and related technical assistance. USCO enters into two contracts with independent Venezuelan purchasers, one contract for the purchase of equipment, and a second contract specifically designed for providing technical services in connection with the operation of the equipment. USCO also forms a local company ("VenCo.") with local investors. VenCo. does not sell equipment manufactured by USCO, but does provide technical services within Venezuela in certain cases. VenCo. itself received technical services from USCO, and pays USCO for such services.

(b) *Consequences to US investor*

The proposed structure allows USCO to sell its equipment in Venezuela without paying tax in that country, since the sales take place outside Venezuela.[7] The income received by USCO for technical services rendered outside Venezuela is subject to a flat 9 percent withholding tax in Venezuela, assuming it is not characterized as income from "non-commercial professional services". VenCo. allows the provision of services in Venezuela, to the extent it would be more advantageous to do so, in which case the income for the services will be taxed at the rate of 30 percent on *net* income, and no additional withholding tax will be imposed on distributions of dividends from VenCo. to USCO. If VenCo. is partially capitalized with loans from USCO, interest payments to USCO will be subject to a 5 percent withholding tax, but will be deductible to VenCo.

(c) *Consequences to Latin American investors*

The proposed structure allows the Latin American investors to avoid the payment of tax on sales in the territory. If, as a business matter, they must obtain a portion of the profit from the sales of the equipment, it would be possible to create an interim entity, between USCO and VenCo., in which the Latin American investors would have an interest and to which sales from USCO are made initially. It would not be inappropriate for the Latin American investors for such interim entity to be created in an offshore tax haven. Finally, the structure of the transaction allows for the payment of income from VenCo. in deductible payments. Once again, an interim entity could receive some of the foreign technical assistance payments in a manner that would benefit the Latin American

7. If the sales are deemed to take place in the United States, the income generated by the sales should be deemed to be income from US sources, and will not be available to increase applicable foreign tax credit limitations.

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

DEDUCTIBILITY OF INTEREST AND OTHER FINANCING CHARGES IN COMPUTING INCOME

David M. Benson and Matthew M. McKenna

David Benson is the partner in charge of International Tax Services at Coopers & Lybrand Washington National Tax Office. His responsibilities include analysing and disseminating international tax planning ideas and developments to the practice, providing technical consulting to Coopers' offices on international tax issues and assisting the practice offices in providing international tax services to clients.

Previously, Dave was a tax partner in the Boston office of Coopers & Lybrand and Director of International Tax Services for New England.

Dave, who is a frequent author and speaker on international tax subjects, is an attorney and a member of the District of Colombia Bar. He is Chairman of the OECD Model Treaty Committee of the IFA and a member of the AICPA International Tax Committee.

Matthew McKenna is Vice President, Taxes at PepsiCo, Inc. Prior to this position he had been a tax partner at Winthrop, Stimson, Putnam and Roberts since 1984. He is a graduate of Georgetown University Law School, where he received his JD in 1975, and a Masters in Taxation in 1978.

I. OVERVIEW – GENERAL DEFINITIONS

A. Definition of interest

Internal Revenue Code Section 163(a) provides simply that, "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Thus, in general, in determining taxable income a taxpayer may deduct the interest expense incurred during the year. From this simple beginning, however, Section 163 then goes on for several pages to describe various limitations on the general rule. Other Code sections prescribe additional limitations on the deductibility of interest expense, as well.

Section 163 does not actually define the term "interest" but it is understood to mean a charge for the use of money. Thus, interest has been held by the courts to mean "the amount which one has contracted to pay for the use, forbearance or detention of money"[1]. To be deductible, interest must be incurred in connection with a legally enforceable obligation to pay a principal amount and interest on that amount.

In general, a taxpayer's usual method of accounting will determine the timing of an interest deduction. However, in the case of certain interest accrued to a related person by a taxpayer using the accrual method of accounting, a taxpayer may not claim a deduction until the interest is actually paid. This will be the case when the related person is not taxable until actually receiving the interest; for example, where the recipient is a foreign person not subject to US taxation on its business income.

To be deductible as interest, an amount need not be designated as such. Thus, amounts paid in lieu of interest – whether called dividends, commissions, service charge, points, commitment fees, guarantee fees or otherwise – will be deductible as interest if there is a legal obligation to pay interest to a creditor.[2] Similarly, loan discount, including original issue discount (subject to certain limitations) that is the agreed charge from the use of money, is deductible interest. On the other hand, the mere designation of an amount as interest will not make it deductible as interest if, in substance, it is a payment of another kind.[3] This might be the case where an amount designated as interest is actually a payment of additional principal, a share of profits, capital gains or a payment for services. Thus, all of the facts and circumstances of a purported borrowing must be examined to determine if the amount sought to be deducted as interest is actually for the "use, forbearance or detention of money",[4] and thus properly characterized as interest expense for US tax purposes.

B. Debt v. equity

As mentioned above, an amount designated as interest may, in fact, be a dividend, while in other instances a purported dividend may, in fact, be a payment of interest. The significance of the distinction lies in the fact that interest, as discussed above, is deductible in determining taxable income while the payment of a dividend is non-deductible under US tax principles.

Code Section 385(a) authorizes the Secretary of the Treasury (and, thereby, the IRS) to issue regulations addressing whether an interest in a corporation is to be treated for tax purposes as shares in the corporation or as indebtedness, or partially as shares and partially as indebtedness.[5]

1. *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932).
2. *A.R. Jones Syndicate v. Commissioner*, 23 F.2d 833 (7th Cir. 1927).
3. *Bush Terminal Buildings v. Commissioner*, 204 F.2d 575 (2nd Cir. 1953).
4. For example, Rev. Rul. 82-94, 1982-1 C.B. 31; Rev. Rul. 83-51, 1983-1 C.S. 48; *Commercial Capital Corp. v. Commissioner*, 27 T.C.ff. 897 (1968).
5. The use of the phrase "interest in a corporation might itself seem confusing. The term "interest" is used in Sec. 385(a) to refer to a holding, rather than as interest incurred on indebtedness.

© 1994 International Bureau of Fiscal Documentation

Section 385(b) requires that such regulations set forth factors that are to be taken into account for purposes of determining in a given situation whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists instead. Among the factors that may be included in the regulations, according to Section 385(b), are:

- whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
- whether there is subordination to or preference over an indebtedness of the corporation;
- the ratio of debt to equity of the corporation;
- whether there is convertibility into the shares of the corporation; and
- the relationship between holdings of shares in the corporation and holdings of the interest in question.

Notwithstanding that Code Section 385 was enacted nearly a quarter century ago,[6] the IRS has never succeeded in issuing the regulations authorized by Section 385(a). Although regulations were issued in 1980, they were subsequently withdrawn by the IRS in 1983.[7] Perhaps the job of the IRS in issuing workable regulations under Section 385 was complicated by the Congressional committee report language that accompanied Section 385 as it was considered in its proposed form by the Congressional committees. This language indicated that it was not Congress's intent to require that the five factors set forth above and in Section 385(b) be included in the regulations prepared by the IRS or to limit the regulations to only these five factors or, indeed, to give any of the factors included in Section 385(b) more weight than any other factors that might be added by regulations.[8] Whatever the reasons for the IRS' failure to provided regulatory guidance, taxpayers must look to the decided court cases for guidance on this issue in the continued absence of regulatory guidance.

On this point, the courts have actually been somewhat more helpful. Over a period of years, several cases have cited a list of 11 factors that the courts believed needed to be considered in making a debt-equity determination.[9] These factors are:

- the names given to certificates evidencing the indebtedness;
- whether or not there is a stated maturity date;
- the source for the payments required by the instrument;
- the right to enforce payment of principal and interest;
- whether there is participation in the corporation's management;
- whether the status of the holder is equal to or inferior to that of regular corporate creditors;
- the intent of the parties;
- whether there is "thin" or adequate capitalization of the corporation;
- identity of interest between creditor and shareholder;
- whether interest arising under the instrument is paid out of "dividend" money;
- the ability of the corporation to obtain loans from outside lending institutions.

In a 1983 published ruling dealing specifically with the treatment of adjustable rate convertible notes,[10] the IRS indicated that among the factors that may be considered in making a determination as to whether an instrument represents indebtedness or an equity investment for tax purposes are:

- whether there is a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth;
- the intent of the parties in creating the instrument in question.

Whenever a determination based on an analysis of all facts and circumstances and an application of the various factors to be considered under the court decisions and IRS rulings is inconclusive as to whether the instrument is debt or equity, the IRS typically will consider the intent of the parties to be the crucial, determining factor.

In light of the difficulty that the IRS has experienced in promulgating workable regulations under Section 385, and the inherently factual nature of the inquiry, as well as the opportunity for abuse in situations requiring a debt-equity determination, a provision added to Section 385 in 1992 is particularly interesting.

Section 385(c)[11] provides that the characterization as of the time of issuance by the issuer of an instrument as to whether the interest created by the instrument is indebtedness or shares in a corporation is generally binding on the issuer and all holders of the instrument. The characterization by the issuer is not, however, binding on the IRS. In addition, there is also another specific exception to the general rule of Section 385(c) in the case of any holder of an instrument. In this connection, the holder may treat the instrument in a manner inconsistent with the characterization made by the issuer if the holder discloses such inconsistent treatment on its income tax return. This provision may prove problematic in, among many other instances, situations involving so-called hybrid instruments used in certain cross-border structures.

Finally, Section 163(i)[12] provides that a portion of original issue discount (which, as noted previously, is generally deductible as interest expense, subject to certain limitations) on certain "high yield discount obligations" issued by corporations may not be deducted as interest. In addition, the remainder of the discount on such obligations that is not disallowed in this manner cannot be deducted until paid.[13]

An applicable high yield discount obligation is a debt instrument that meets all three of the following requirements:

- its maturity date is more than five years from its date of issue;
- the yield to maturity on the instrument exceeds the "applicable federal rate" at the time of issuance by five percentage points or more;

6. F.L. 91-172, the Tax Reform Act of 1969.
7. T.D. 7920, effective 5 August 1983.
8. Senate Committee Report, F.L. 91-172.
9. See *Hardman v. US*, 827 F.2d 1409 (9th Cir. 1987), and the long line of cases cited therein.
10. Rev. Rul. 83-98, 1983-2 C.B. 40.
11. Added by P.L. 102-486.
12. Added by F.L. 101-239, Omnibus Budget Reconciliation Act of 1989.
13. Code Sec. 163(e)(5).

© 1994 International Bureau of Fiscal Documentation

– the instrument has significant original issue discount.

The applicable federal rate is an interest rate determined periodically by the Treasury Department with respect to short-term, mid-term and long-term federal obligations.[14] These rates are published regularly by the IRS.

Whether an instrument has "significant original issue discount" is determined by comparing the aggregate amount that would be includible in income with respect to the instrument for certain periods ending more than five years after its issuance with the aggregate amount of interest to be paid under the instrument during that period plus the product of the issue price of the instrument and its yield to maturity.

In general, the disqualified amount under Section 163(i) is treated as a distribution of shares.

C. Tracing rules

A variety of US tax rules disallow or limit the interest deduction where the interest expense is attributable to borrowed funds used for certain purposes. In general, these provisions reflect a legislative policy decision that certain activities should not be encouraged by the tax law and the associated interest deduction.

Section 163(d) limits an interest expense by individuals where the borrowed funds relate to investment activities as opposed to more active business transactions.

Section 163(e) relates primarily to the computation of the amount of interest to be allowed for tax purposes with respect to discount obligations (i.e. obligations either issued or sold for a value less than their face amount.)

The general original issue discount provisions added in 1982 required a calculation of interest expense based upon the time value of money, which attempted to approach a more accurate view of money lending.

This general concept was followed by addressing the particular concerns for abuses made possible through the separation of the accrual of interest and the ultimate payment of such amounts.

Section 163(e)(5) applies to discount obligations that bear a yield in excess of the applicable federal rate ("AFR") plus five percentage points and are described in Section 163(i) (discussed above). Generally, discount attributable to a yield in excess of the AFR plus six percentage points is not deductible (but corporate recipients thereof may be eligible for the dividends-received deduction), and the deduction of the remaining discount is deferred until payment in cash or qualified property is made.

Section 1277 provides a limitation for an interest deduction on funds used to acquire funds acquired at a market discount. Thus, if the bondholder chooses to defer the discount income associated with such an investment, the associated interest expense must also be deferred.

Section 265 has long restricted the ability of a tax-exempt bond (i.e. a bond whose interest is not taxable income) to qualify for both an interest expense and tax-exempt income. Similarly, under Section 246A, corporate investments in preferred stock could not qualify for a related "double dip" of using borrowed funds to acquire such shares with the associated dividends received deduction.

Section 172(h) limits an interest deduction for funds either in a major stock acquisition or a significant dividend distribution or stock redemption. Thus, the associated interest expense cannot be used to generate a net operating loss which could then be used to generate a refund claim.

Section 279 limits the deduction for interest on indebtedness incurred by a corporation to acquire the stock or assets of another corporation. For these purposes, corporate acquisition indebtedness is defined very narrowly to include only debt which is either subordinated to the claims of trade creditors or expressly subordinated to any substantial amount of unsecured indebtedness. In addition, the indebtedness must be either convertible or issued as a part of an investment unit which includes the rights to acquire stock of the issuer. Finally, the limitation would not apply unless either a debt:equity ratio or an earnings coverage test is also met.

II. PAYMENTS TO NON-RESIDENTS

The normal method of taxation for interest payments made to non-residents is either on a withholding basis, subject to treaty reduction, or on a net income basis, where the interest income is effectively connected to conduct of the trade or interest in the United States.

Section 163(f) disallows an interest expense on certain obligations issued in bearer form unless the issuer has undertaken arrangements reasonably designed to insure that such obligations will be sold to only non-residents.

Section 363(e)(3) defers an interest expense accrued on discount obligations until the interest payment is actually made. This provision applies only to interest received by parties related to the US issuer.

The IRC has recently been amended to provide for a limitation on the ability of the US corporation to deduct interest paid either to related parties organized outside the United States or on debt to third parties, where a related party has provided credit support. Section 163(j) is triggered only where the taxpayer is unable to meet either an earnings coverage test or an equity capitalization standard. In several areas, the regulations for these so-called "earnings stripping" provisions remain to be finalized.

III. US ALLOCATION RULES

A. Interest payments by residents

Under the US tax rules, a US citizen or resident individual and a US corporation is subject to US income tax on its worldwide income, irrespective of its geographical source or

14. Code Sec. 1274(d).

© 1994 International Bureau of Fiscal Documentation

type.[15] To the extent that income from sources outside the United States (hereafter referred to as "foreign-source income") is subject to income tax in another jurisdiction, a credit is allowable against the US tax that would otherwise be imposed on that income subject to certain limitations.[16] A credit is also allowed for a portion of the foreign income tax incurred by a foreign corporation, the voting shares of which are at least 10 percent owned by a US corporation upon receipt by the US corporation of a dividend from the foreign subsidiary or upon the inclusion in the US corporation's income of a deemed dividend under certain anti-abuse regimes.[17]

While the determination of these limitations is beyond the scope of this article, it may be said generally that the amount of the credit may not exceed the amount of US income tax that would be imposed on the foreign-source taxable income of the taxpayer. For this purpose, foreign-source taxable income is determined with reference to US tax accounting principles.

In general, in determining foreign-source taxable income, a deduction is allowed for all expenses, losses and other deductions properly apportioned or allocated to income from sources outside the United States, as well as a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income.[18] Interest expense that must be taken into account in determining foreign-source taxable income must, in the first instance, be deductible as interest under Section 163. In general, for purposes of allocating US interest expense to foreign-source income, US rules take the view that money is fungible, so that with certain exceptions, interest expense is considered to be attributable to all of the taxpayer's activities and property regardless of any specific purpose for which an obligation may have been incurred. Thus, the aggregate deduction for interest claimed by a taxpayer will be considered related to all income-producing activities and assets of the taxpayer. As such, the aggregate interest expense is allocable to all of the gross income that the taxpayer's assets generate, have generated or could reasonably have been expected to generate.[19]

Furthermore, for interest expense allocation purposes, the aggregate interest expense of all the members of an affiliated group of corporations must be considered to be allocable to all of the gross income of the members of the group.[20] For this purpose, an "affiliated group" is one or more chains of includible corporations connected through 80 percent share ownership with a common parent corporation that is also an includible corporation.[21] In identifying all the members of an affiliate group, the term "includible corporation" does not include a foreign corporation.[22] Thus, in general, a group of US corporations having a common US corporate parent (using the 80 percent test) must allocate interest expense for purposes of determining foreign-source income on an overall, affiliated group basis.

A US taxpayer's foreign-source gross income includes:

- interest income not derived from US sources;
- dividends derived from a foreign corporation (with certain limited exceptions);
- compensation for labour or personal services performed outside the United States;
- rents or royalties from property located outside the United States or from the right to use intangible property outside the United States;
- gains and other income from the purchase of inventory property within the United States and its sale outside the United States;
- income from the sale of certain other personal property, including shares of affiliated corporations, outside the United States if certain requirements are met.[23]

Interest expense is allocated against foreign-source gross income on the basis of the geographic location of the taxpayer's assets. Thus, the taxpayer must identify and value its assets that generate US-source income and assets that generate foreign-source income. In general, tax book values are used in determining asset values for this purpose, although a taxpayer may elect to value assets on a fair market value basis.

Deductible interest expense of the taxpayer – or of the affiliated group in the case of an affiliated group of corporations – is then allocated to foreign-source income based on the ratio of the taxpayer's, or group's, foreign assets to its total assets.[24]

US taxpayers having relatively high levels of deductible interest expense accordingly will find that they have relatively lower levels of foreign-source taxable income after taking into account interest expense (as well as certain other expenses) allocable to foreign-source income. This result is, of course, magnified when the taxpayer's foreign assets comprise a substantial portion of the taxpayer's worldwide assets. The effect of using tax book values for purposes of valuing assets for interest expense allocation purposes may be to even further exacerbate this effect if the taxpayer's foreign assets are, for example, newer (and thus have been subject to less depreciation or amortization) than its US assets.

In certain instances in which a US parent or group increases its levels of borrowing and on-lending of borrowed funds to its foreign subsidiaries, this will be considered to have been undertaken for tax avoidance reasons. If there were no restriction on such borrowing and on-lending, the US group or parent would potentially gain an advantage in determining its foreign-source taxable income. This is because it would have to reduce its foreign-source income by only an allocable portion of the increased US interest expense, but would have foreign-source taxable income on an undiluted basis in the form of interest income received from its foreign subsidiaries. To restrict this perceived abuse, interest netting rules apply which require the US borrower to allocate a por-

15. Code Sec. 61(a).
16. Code Secs. 901 and 904.
17. Code Secs. 902 and 960.
18. Code Sec. 862(b).
19. Treasury Regulation § 1.861-9T(a).
20. Code Sec. 864(e); Treasury Regulations §§ 1.861-9T(a) and 1.861-IIT.
21. Treasury Regulation § 1.861-11T(d)(1).
22. Code Sec. 1504(b)(3).
23. Code Secs. 862(a) and 865.
24. Treasury Regulation § 1.861-9T(g).

© 1994 International Bureau of Fiscal Documentation

tion of its third party borrowing to interest income received from the foreign subsidiaries.[25] A reduction of a taxpayer's foreign-source taxable income will have the effect of reducing the taxpayer's foreign tax credit limitation. In general, this makes it more difficult for a taxpayer to obtain a US credit for all of the foreign income taxes paid on its foreign-source income.

As discussed previously, all interest expense that meets the Code Section 163 definition of interest is deductible by the taxpayer. The allocation of interest expense that must be made for purposes of determining the taxpayer's foreign-source taxable income for foreign tax credit purposes, described immediately above, does not affect the amount of interest expense that may be deducted by the taxpayer in determining its overall taxable income on its return.

In some cases, the taxpayer may be able to deduct the same interest expense in another jurisdiction, as well as in the United States, thus obtaining a "double dip". This would be true, for example, in the case of a US corporation that is also taxable in another jurisdiction on a residence basis. This would be the case, of course, for the foreign branch of a US corporation that constitutes a permanent establishment in another country. It would also be the case where a US corporation is taxable in another jurisdiction because its place of management is in that jurisdiction, making it a so-called resident company.

US tax rules limit, however, the ability of a US company to take advantage of such a double dip if the benefit of the deduction in the foreign jurisdiction can ever be used to offset the income of an affiliate in that jurisdiction. Under these "dual consolidated loss" rules, the US deduction will not be allowed if any loss generated as a result of that deduction may be used in this manner in the other country.[26]

B. Interest payments by non-residents

If a foreign corporation is engaged in a trade or business in the United States (such as through a branch) special rules apply to interest expense attributable to that trade or business (generally referred to as the branch interest tax). Section 884(f)(1)(A) provides that any interest paid by the branch is deemed to be US source, and, if paid to a foreign person, is subject to the US 30 percent withholding tax on interest (which may be reduced or eliminated in certain cases). Section 882 and the regulations thereunder permit the foreign corporation to take deductions for the branch's interest expense. However, to the extent that a branch has been allocated interest deductions under Section 882 in excess of interest paid by it as determined under Section 884(f)(1)(A), such excess is treated as interest paid to a foreign corporation by its wholly-owned US subsidiary.[27] That deemed payment also is subject to the 30 percent withholding tax (which again may be reduced or eliminated in certain cases).

IV. INTEREST-FREE LOANS AND INTERCOMPANY PRICING

In general, US tax law authorizes the IRS to "distribute, apportion or allocate gross income, deductions, credits or allowances" between or among affiliated organizations, trades or businesses as necessary "to prevent evasion of taxes or clearly to reflect the income" of such persons. This provision extends to loans or advances between affiliates where either no interest is charged or the rate of interest charged is not equal to an arm's length rate.[28]

Thus, under US tax rules, for example, a zero rate of interest would not be allowable on loans between affiliated enterprises unless a zero rate were in fact the arm's length rate under the particular facts and circumstances being analysed. In practice, this is highly unlikely. The rules go on to address the period for which interest must be charged, as well as the acceptable rate of interest given the prevailing rates of interest in the currency and at the situs of the loan.

In general, interest must be charged beginning on the day after the indebtedness arises. With respect to trade credits, for intercompany trade receivables arising in the ordinary course of business of a non-US affiliate debtor, in general interest need not be charged until the first day of the fourth calendar month following the month in which the receivable arose.

The appropriate interest rate to be charged, as noted, is the "arm's length" interest rate. Under regulations, this is defined as a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances.

Safe Harbour: US rules also provide safe harbour interest rates that will be treated as arm's length in the case of term loans, demand loans or advances made between affiliates. The safe harbours are actually the upper and lower boundaries of a range against which a related party loan will be measured. The range is 100 to 130 percent of the AFR which was described above. If the interest rate actually charged is less than 100 percent of the AFR – or if no interest is charged – then the arm's length rate is to be 100 percent of the AFR, compounded semi-annually (unless a more appropriate compounding is demonstrated). If the interest rate actually charged exceeds 130 percent of the AFR, then the arm's length rate is to be 130 percent of the AFR (again, generally compounded semi-annually).

If a US borrower is found to have been charged a lower interest rate than is required (or if no interest was charged) on a particular intercompany loan or advance, the IRS may impute additional interest expense to the US borrower. This will have the effect of imputing an interest expense deduction and thereby reducing the lender's taxable income just as if the interest had actually been paid or accrued.

25. Treasury Reg. § 1.861-10(e).
26. Code Sec. 1503(d).
27. Code Sec. 884(f)(1)(B).
28. Code Sec. 482; Treasury Reg. § 1.482-2(a)(1)(i).

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

HYBRID ENTITIES

James J. Tobin and William R. Seto

James Tobin is Ernst & Young's Director of International Tax, where he is responsible for coordinating international tax services within the United States and with Ernst & Young's practice overseas. He is also the chairman of Ernst & Young International's worldwide Taxation Committee.

A CPA and attorney, Jim became a partner of the firm in 1983. From 1983-1986, he was based in Brussels, where he served as the Director of European Tax Services for US multinational clients. He transferred to New York in 1986 to assume his current position.

Jim has written or co-authored many articles and books in the international tax area and is a frequent lecturer at various international tax conferences, and a contributor to the international tax journals of various organizations.

William Seto is a tax partner in Ernst & Young's Atlanta office and Director of International Tax Services for the firm's Southeast area where he heads up a group of Ernst & Young tax professionals dedicated solely to international tax consultation. Prior to moving to Atlanta Bill spent nine years in Ernst & Young's international tax department in New York. Bill has a B.S. in economics from the Wharton School of the University of Pennsylvania and a J.D. from Cornell Law School. He is a member of the AICPA, ABA, New York State Bar Association, IFA and the Society of International Business Fellows. He is also a member of Ernst & Young's International Tax Committee, Section 482 Task Force, and Multinational Partner Group, and was appointed to the firm's first Partners Advisory Council.

Bill has authored numerous articles and is a frequent lecturer at programmes presented by the World Trade Institute, Tax Executives Institute and at other outside and Ernst & Young sponsored programmes.

The focus on hybrid entities by US multinationals has increased dramatically in recent years. Correspondingly, the level of ruling activity and IRS consideration of the area have increased as well.

As a general rule, the use of a hybrid provides significant commercial flexibility to US multinationals. It enables them to achieve a desired tax objective without being restricted as to the legal form of operation which they need to use in a foreign jurisdiction. It is the rare case where a US tax objective, which can be achieved by use of a hybrid, could not have been achieved directly by use of a branch or partnership legal form. Rather, the ability to hybridize an entity allows a US company to use a more convenient legal form in the foreign jurisdiction, and in some cases, achieve foreign tax savings which a branch or partnership could not provide.

I. HYBRID ENTITIES

From the perspective of the country in which it is organized, a hybrid entity does not differ for tax purposes from other entities of the same form created in that country. A hybrid entity is a hybrid solely by reason of being viewed differently for tax purposes in a second jurisdiction. Thus, for example, a German Gesellschaft mit beschränkter Haftung ("GmbH") is taxed in Germany as a corporation, regardless of the provisions of its memorandum of association. For US tax purposes, however, that same entity may be viewed as a partnership if certain conditions are met. In such a case, the GmbH is a hybrid for US/German purposes. That same entity, viewed through Canadian eyes, would be viewed as a corporation. Accordingly, for Canada/German purposes, the entity would not be a hybrid. Thus, the ability to create hybrid entities depends on divergence between two countries in determining an entity's tax status.[1]

II. ENTITY CLASSIFICATION IN THE UNITED STATES

US tax rules are amenable to the use of hybrid entities, in that the tax status of the entity in its home jurisdiction is essentially irrelevant to the determination of the entity's tax status in the United States. Rather, the United States bases the tax status of an entity on what it most closely resembles in US terms.[2] A foreign corporation is classified as either a partnership or a corporation for US tax purposes according to which of the two entities it more closely resembles. That resemblance is determined by reference to six attributes of a "pure" corporation enumerated in regulations: (1) associates, (2) an objective to carry on business and divide the profits therefrom, (3) limited liability, (4) centralization of management, (5) continuity of life, and (6) free transferability of interests. Of these, the first two are considered common to partnerships and corporations, and so are disregarded. If a foreign corporation possesses a majority of the remaining four characteristics (i.e. three or four of them), it will be classified as a cor-

1. For the sake of convenience, an entity taxed as a corporation in its home jurisdiction but viewed as a flow-through entity in another jurisdiction will be referred to as a hybrid. An entity treated as a flow-through in its home jurisdiction but considered a corporation by the second jurisdiction will be referred to as a reverse hybrid.

2. The entity classification regulations and case law generally divide entities into three broad classes: trusts, partnerships and associations taxable as corporations. This discussion will concern only the distinction between partnerships and corporations.

© 1994 International Bureau of Fiscal Documentation

poration for US tax purposes. If it possesses fewer than three, it will be considered a partnership for US tax purposes.

Interestingly, the home jurisdiction status of the entity as a taxable body separate from its members is not considered a relevant corporate characteristic, let alone a controlling one. However, local corporate law is relevant for determining which if any of the corporate characteristics listed above are present. Regulations and case law define each of the characteristics in detail. As a general rule, limited liability and centralized management are the characteristics which are least easy to manipulate, because they are usually considered commercially necessary, and because they are often mandated (for entities most conducive to hybridization) by local law.

A. Limited liability

According to Treas. Reg. §3301.7701-2(d)(1), an entity possesses the corporate characteristic of limited liability if, under local law, there is no member who is personally liable for the debts of or claims against the entity. The regulation defines "personal liability" to mean that a creditor of the entity may seek personal satisfaction from a member to the extent the entity's assets are insufficient to satisfy the creditor's claim. Regulations provide that a limited partnership will be considered to possess limited liability notwithstanding the existence of a general partner, provided the general partner has no substantial assets, other than its interest in the partnership, that could be reached by creditors and is merely a dummy acting as the agent of the partners. Generally, limited liability is considered commercially necessary to insulate a foreign investor from legal liability in the investee country. Thus, even where it might be legally possible to provide unlimited liability (e.g. in the United Kingdom it is possible to form an unlimited company, which is a corporation for UK purposes, but which lacks limited liability), it is often not commercially viable.

B. Centralized management

Treas. Reg. §301.7701-2(c) provides that an entity possesses the corporate characteristic of centralized management if any person, or any group of persons which does not include all the shareholders of the entity, has continuing authority to make management decisions necessary to the conduct of the business for which the entity was formed without the ratification of such decisions by the members. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation. Generally, centralized management is difficult to avoid. Often, local corporate law will dictate that a company must have a body akin to a board of directors. In recent rulings on US limited liability companies ("LLCs"), a US reverse hybrid entity, the IRS has held that centralized management will exist even if all members of the company are elected managers, since they are acting in a representative capacity, rather than as shareholders.

C. Freely transferable interests

According to Treas. Reg. §301.7701-2(e), an entity possesses the corporate characteristic of freely transferable interests if each of its members (or those owning substantially all of the interests in the entity) can, without the consent of the other members, substitute for themselves in the same organization a person who is not a member. The members must be able to confer on their substitute all of the attributes of their interests in the organization. Thus, if a transfer without consent confers only a right to share in the profits of the entity, and not a right to participate in the management, the entity does not possess the corporate characteristic of freely transferable interests. Furthermore, if the transfer of a member's interest will cause a dissolution under local law, free transferability will not exist. If a member may transfer his interest subject only to the restriction that the other members have a right of first refusal, a modified form of free transferability exists (counting as a corporate characteristic for purposes of classifying the entity). Freely transferable interests is generally a characteristic which may be restricted by the members of an organization by agreement amongst themselves. In many countries, a corporation is governed both by local law and the organization's articles of association or other governing document. Local law frequently allows some latitude in the provisions which may be adopted in a company's articles, and it is often possible to include either a total ban on the transfer of interests or provide that a transfer of a member's interest will cause a dissolution of the entity. Revenue Ruling 93-4 emphasized that where an entity is controlled by related parties, the consent of other members must be obtained before transferring shares, as there would be no separate interests to create an impediment to a transfer. Where there is a third party member of the entity, it may still be possible to limit transferability of interests by requiring the consent of all members to a transfer.

D. Continuity of life

Treas. Reg. §301.7701-2(b) provides that an entity has the corporate characteristic of continuity of life if the death, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the entity. On the other hand, if one or more of these events will, without further action, cause a dissolution of the entity, continuity of life does not exist. This is the case notwithstanding that the remaining members may, by majority vote, elect to continue the entity. Rev. Rul. 77-214 held that where all interests in an entity were held by persons under common control, there were no separate interests which could compel a dissolution and thus the entity must have continuity of life. This ruling was superseded by Rev. Rul. 93-4, which held that the existence of separate economic interests was not relevant to determining continuity of life where upon one of the specified events the entity will dissolve *without further action* by the shareholders. The IRS has indicated informally that this principle will also apply outside the commonly controlled area. This position makes it virtually impossible to lack continuity of life in those jurisdictions that require shareholder action (such as a vote) to dissolve an entity following the occurrence of a dissolution event. It may be possible to structure an entity in such a way that all shareholders are bound to take whatever action the law requires to dissolve the entity

© 1994 International Bureau of Fiscal Documentation

upon the occurrence of a dissolution event. It could then be argued that such action was ministerial in nature and that the entity's fate was sealed by the occurrence of the dissolution event. However, this approach is untested and may not be effective. The IRS has indicated that it will publish a ruling in this area, but will refuse to rule privately on the issue.

The IRS has issued rulings on several common foreign entities which may be used as hybrids. The GmbH, Germany; Società a responsabilità limitata (S.r.l.), Italy; Società per Azioni (S.p.A), Italy; and Société à responsabilité limitée (S.a.r.l.), France, have all been held to be partnerships in certain circumstances for US purposes. Each of these entities is treated as a corporation for tax purposes in its home jurisdiction. Each of them may also be structured so as to be considered corporations for US purposes. Generally, hybridization is accomplished by restricting the transferability of interests in the entity and providing for a finite life by altering the articles of association such that the bankruptcy of a shareholder will cause dissolution.

III. TAX BENEFITS OF HYBRID ENTITIES

A. Foreign tax credit planning

The US foreign tax credit regime is extremely complex, and can result in double taxation of foreign-source income. Among the pitfalls of the system are the limitation of deemed-paid credits to the first three tiers of foreign subsidiaries (which often necessitates costly restructurings of acquired groups), the "10-50" basket (which allows foreign tax credits only on a subsidiary- by-subsidiary basis if certain ownership thresholds are not met), and restriction of the deemed-paid credit only to corporate investors. Hybrid entities may be used to avoid each of these problems.

B. Foreign tax credit tiers

The United States grants a deemed-paid credit only for the first three tiers of non-US subsidiaries. Frequently, for foreign tax or legal reasons (or in an acquisition setting), it is desirable or unavoidable to use fewer than four foreign tiers. Hybrid entities, because they are considered partnerships for US purposes, do not count as a tier in the chain of ownership (rather, they represent branches of their shareholders). Thus, each entity in a direct chain of ownership which is hybridized eliminates a tier. This can be a relatively inexpensive way to restructure an acquired foreign target with several tiers already in place.

In analysing a group with more than three foreign tiers, several issues arise in connection with hybridization as a solution. First, if the entity to be hybridized has a single owner, there is an issue with respect to whether the entity will be treated as a separate entity for US tax purposes or as a branch of its shareholder.[3] The IRS currently has an open project on the subject of single owner LLCs. An LLC is a US entity which has been ruled to be a partnership in certain contexts for federal tax purposes.[4] An LLC is generally a more flexible entity in terms of administration and ownership requirements than a Subchapter S corporation or a limited partnership and is thus a more flexible entity to use when flow-through treatment is desired. Any ruling on a single owner LLC would also be applicable to single owner foreign entities.[5] According to one IRS official, there is an internal dispute at the IRS. Some IRS officials think that because an LLC shields its owner from liability it should be treated as a separate entity (i.e. a corporation) in the single-owner context, while others would permit flow-through treatment. In view of the uncertainty in this area, it may be prudent to use more than one shareholder in establishing a hybrid entity.

Revenue Ruling 93-4, cited above, contains several caveats with respect to shareholders all of which belong to the same consolidated group. Specifically, in establishing whether an entity has the corporate characteristic of freely transferable interests, a provision requiring consent of all other members is not considered to restrict transferability, as there are no separate interests to create a realistic impediment to a transfer. Thus, in order to insure that the entity will not have freely transferable interests, either local law or the organizing documents of the entity (articles of association, by-laws or other document which legally binds the entity) must either contain an outright ban on the transfer of an interest in the entity, or provide that the transfer of an interest will cause the entity to dissolve.[6] Such a provision must be binding and fully enforceable under local law.[7]

The transfer to a second shareholder of shares in the hybrid also creates the potential for gain recognition on the transfer. It must be structured carefully to avoid potential dividend income in a Section 304 transaction or gain recognition under Section 367.

The hybridization of the foreign entity (generally accomplished by a change in the entity's articles of association or other governing document) will generally be treated for US tax purposes as a liquidation followed by a contribution of the property received in liquidation to a newly formed foreign partnership. The deemed liquidation, often a foreign-to-foreign Section 332 liquidation, will be generally tax-free. However, where two shareholders are involved, there is the possibility of gain recognition to the minority shareholder, as well as to the "liquidating" corporation. Such gain could be Subpart F income. Accordingly, the choice of which entity in a chain of more than three tiers to hybridize may depend on which entity would be least impacted by these consequences.

The choice of entity to hybridize will also depend on the E&P profile of the companies in the chain. As a general rule, a foreign company receiving a distribution in complete liquidation

3. GCM 39395 (6/24/83) holds that a trust with a single beneficiary is not a trust for tax purposes under the §7701 regulations. In determining its characterization, the GCM held that the trust more closely resembled a partnership than a corporation, but for the sole owner. Thus, the GCM held the trust to be an extension of the beneficiary, i.e. a sole proprietorship. By analogy, it may be argued that a corporation which is the sole member of a foreign entity which would be a partnership but for the sole owner, is in effect operating a foreign branch.
4. See e.g. Rev. Rul. 88-76, 1988-2 CB 360, holding a Wisconsin limited liability company to be a partnership for federal tax purposes.
5. See Karls, "Hybridizing Foreign Entities Can Cause Disaster", 4 *J. Int'l Tax'n* (1993), at 340, 347.
6. Rev. Rul. 93-4.
7. Reg. § 301.7701-1(c).

© 1994 International Bureau of Fiscal Documentation

of a foreign subsidiary will succeed to and take into account the E&P of the liquidating company as if it had earned the E&P itself.[8] The E&P of the subsidiary are thus not segregated from that of the parent. When the property received in the deemed liquidation is recontributed to the hybrid, the E&P remain with the shareholder. The hybrid, now a partnership for US purposes, has no E&P. In analysing which tier to hybridize, consideration should be given to the impact on the E&P pools of the resulting structure. For example, if one company in the chain offsets Subpart F income with non-Subpart F losses on an ongoing basis, it would generally be inadvisable to hybridize the tier below if it generates substantial non-Subpart F E&P on an ongoing basis, as this may result in the recognition of Subpart F income by the combined entity.

1. Avoiding the 10-50 basket

A US shareholder which owns at least 10 percent of any foreign corporation and which it receives a dividend from is allowed a credit for foreign tax paid by that subsidiary.[9] If the foreign company is a controlled foreign corporation ("CFC"), those foreign tax credits may be blended with credits from other foreign subsidiaries. If the company is not owned 50 percent or more by US shareholders (i.e. a "10-50" company), credits from that subsidiary may be used only against the US tax on income from that subsidiary.[10] This can be very inefficient in terms of the US parent's worldwide effective rate. Generally, however, when a US company has a 10 percent or greater interest in a foreign partnership, look-through treatment generally applies to income from the partnership – that is, the foreign taxes may be blended with credits from other sources. Furthermore, if the foreign company is a 10-50 company and receives income which would otherwise fall into the "high withholding tax interest" basket (generally, interest subject to a withholding tax of at least 5 percent),[11] any foreign taxes paid with respect to this income are not creditable.[12]

Often, a US company engaged in a foreign joint venture is unable to have the vehicle qualify as a CFC, either for commercial reasons (the joint venture partner is unwilling to give the US partner majority ownership) or for legal reasons (e.g. local partner must have at least 50 percent ownership). As noted above, the joint venture company would thus be a 10-50 company. This would result in the loss of foreign tax credits with respect to high withholding tax interest and possible generation of excess credits on other income of the joint venture. By using a hybrid entity as the joint venture vehicle in such situations, these effects can be avoided. Generally, a US company with a 10 percent or greater interest in a foreign partnership is entitled to look-through treatment on its income from the partnership.[13] Thus, a US company may be able to substantially improve its foreign tax credit result from foreign joint ventures in which it is a minority partner by using a hybrid entity as the joint venture vehicle.

2. Availability of foreign tax credits to non-corporate investors

Deemed paid credits are available only to corporate shareholders of a foreign company. By contrast, a US partner in a foreign partnership does not claim a deemed-paid credit, but a direct credit. That is, since a partnership is fiscally transparent, the partner is considered to have paid the foreign taxes directly. Thus, a US individual investing in a foreign corporation will suffer a very high rate of tax on distributed profits from the foreign company. Only withholding taxes imposed on dividends will be creditable. A US individual investor in a foreign partnership, however, is considered to have paid directly his *pro rata* share of taxes imposed on the partnership. Thus, foreign taxes paid by the partnership will be creditable by the US partner. Often, the tax credit benefits of a partnership and the commercial advantages of a corporation can be combined through the use of a hybrid.

For example, where a US Subchapter S corporation owns 79 percent of a foreign subsidiary (and the US shareholder owns the remaining 21 percent), the foreign taxes paid by the subsidiary are generally not creditable. However, if the foreign subsidiary is hybridized, the US shareholder should be able to obtain credits under Section 901 for the taxes paid by the foreign subsidiary. By structuring the foreign investment as a hybrid, it may even be possible to have the S corporation own 100 percent of the foreign entity, as there is no restriction on partnership investments by S corporations. However, this structure would risk terminating the corporation's S election if the IRS were to determine that the foreign investment should be treated as a corporation for US purposes. In a similar vein, this structure would also fail if the IRS were to rule adversely on the single owner hybrid issue discussed above.

C. Foreign loss utilization

1. High tax foreign jurisdictions

A US company cannot use the losses of its foreign subsidiaries to offset its own income. In jurisdictions where consolidation or carry-over of losses is not permitted, there is effectively no tax benefit for such losses. If, by contrast, the foreign subsidiary is a hybrid, it will be considered for US purposes to be a partnership or a branch of the US company. As such, any losses it generates will be includible in the US consolidated return. However, under the US dual consolidated loss rules, the US company generally must certify that the losses will not be used in the foreign jurisdiction to offset the income of another party.[14] If in the future the losses are so used (or another "triggering event" occurs), the US company must recapture the previously deducted losses, incurring an interest charge on the deferred tax.[15] Generally, de-hybridizing the subsidiary would be such a triggering event.[16] Fur-

8. Reg. § 7.367(b)-3(e).
9. IRC Sec. 902.
10. IRC Sec. 904(d)(2)(E).
11. IRC Sec. 904(d)(2)(B).
12. IRC Sec. 904(d)(2)(E)(ii).
13. Reg. § 1.904-5(h).
14. Reg. § 1.1503-2.
15. *Id.*
16. De-hybridizing a foreign corporation so that it is considered a corporation for US purposes as well would be deemed the incorporation of a branch (or the termination of a partnership) and the contribution of the assets to a *newly formed* corporation. Because for foreign tax purposes the same entity is continuing, the losses generally survive the transaction. When they are then used in the foreign jurisdiction, for US purposes they will be considered used by a person other than the person who incurred them.

© 1994 International Bureau of Fiscal Documentation

thermore, the de-hybridization would also be subject to the branch loss recapture rules of Sections 367 and 904(f)(3). Thus, de-hybridizing the foreign subsidiary will generally carry a high US tax cost, unless the de-hybridization is deferred until the foreign subsidiary has contributed an amount of income to the consolidated return equal to the losses it has generated. Thus, the cost of hybridizing a loss-making subsidiary is that when the subsidiary becomes profitable, its income is also includible in the US consolidated return.

That cost, however, is bearable if the subsidiary is located in a high-tax jurisdiction, as the income it generates may be covered by foreign tax credits. One caveat here is the overall foreign loss recapture rules.[17] If the hybrid is the sole source of foreign-source income, at least 50 percent of its income in profitable years will be recharacterized as US source to the extent its losses have offset US-source income in the past. The strategy is thus not appropriate except in circumstances where the US company's foreign operations are diversified.

2. Low-tax jurisdictions

Hybridizing may make sense in low-tax jurisdictions as well, as a means of sheltering Subpart F income. The appropriate scenario is one in which a foreign subsidiary with Subpart F income has a subsidiary with non-Subpart F start-up losses. If the loss company is hybridized, then for US purposes its earnings will be combined with those of its parent. Subpart F income is limited to current E&P of the company.[18] Accordingly, the losses of the hybrid will offset Subpart F income dollar for dollar. Many of the complications discussed above relating to recapture of losses are not relevant in this context. The dual consolidated loss rules, as well as the branch loss recapture rules of Section 367(a)(3), are inapplicable in foreign-to-foreign transactions. However, future profits of the loss company may be recaptured as Subpart F income.[19] Depending on the US company's foreign tax credit profile, such recharacterization may have little impact.

3. Avoidance of 70 percent full inclusion rule

Subpart F provides that where 70 percent or more of a foreign corporation's gross income is Subpart F income, all of its income will be considered Subpart F income.[20] Where a foreign subsidiary would fall afoul of this provision, hybridizing can be advantageous. In a situation, for example, where a foreign holding company has two subsidiaries, one of which generates at least 70 percent Subpart F income (Sub 1), while the other (operating) subsidiary generates non-Subpart F income (representing the larger part of the group's income as a whole), each of the foreign subsidiaries is tested separately for purposes of the 70 percent full inclusion rule. Thus, even though the group as a whole may generate less than 70 percent, all of Sub 1's income would be includible in the US company's return. By contrast, if the two subsidiaries are hybridized, the entity to be tested for purposes of the 70 percent full inclusion test (and all other Subpart F purposes) will be the holding company, the sole remaining foreign corporation for US purposes. Its earnings will include those of both of its subsidiaries. Since the Subpart F gross income of Sub 1 is less than 70 percent of the total earnings of the group, only the actual Subpart F income would be subject to inclusion in the US company's return.

IV. PFIC PLANNING

A foreign company will be considered a passive foreign investment company ("PFIC") if either its income or its assets are excessively passive (passive income in excess of 75 percent or passive assets in excess of 50 percent, broadly). The tax consequences of PFIC status to a US shareholder are either current taxation of the shareholder's pro rata share of PFIC income or deferred taxation with interest charged on the deferral when an event occurs which triggers taxation. Where a company is in danger of becoming a PFIC, hybridizing it may avoid PFIC classification. As a hybrid, the entity would be considered a branch of its parent company. Thus, the PFIC test would be based on the assets of the combined entity. Where the active assets and income of the parent are sufficiently large, the combined entity would not be a PFIC.

V. INBOUND HYBRID

It is also possible to use hybrids (or reverse hybrids) for investment into the United States. For example, a German individual investor may establish a KG, considered a partnership for German purposes, but a corporation for US purposes. Such a structure may make it possible to obtain the lower treaty rate of withholding (5 percent vs. 15 percent) afforded to corporate investors with at least 10 percent ownership in the payor of dividends. This is subject to the interpretation of the definition of "company" in the treaty. The treaty defines company as "any entity treated as a body corporate for tax purposes".[21] Clearly, for US purposes, the KG if properly organized is considered a corporation for US tax purposes. However, for German purposes the KG is not considered a corporation. Arguably, since treaty benefit is sought from the United States in this instance, it is the US perspective that matters. However, there is no authority on the entitlement of hybrid entities to treaty benefits under the US–Germany treaty.

VI. REVERSE HYBRIDS – OUTBOUND INVESTMENT

It may be possible to use a reverse hybrid to enhance a US corporation's foreign tax credit position where the US company is in an excess limitation position. The US company would organize its foreign subsidiary in such a way that the entity is considered a corporation for US purposes but a partnership for foreign purposes. In that case, the US company

17. IRC Sec. 904(f)(5).
18. IRC Sec. 952(c).
19. IRC Sec. 952(c)(2).
20. IRC Sec. 954(b)(3)(B).
21. US/Germany income tax treaty, Art. 3(1)(e).

© 1994 International Bureau of Fiscal Documentation

becomes directly liable for foreign tax. However, the income of the foreign subsidiary, since it is a corporation for US purposes, is not includible in the US company's return. Thus, the US company has available additional foreign tax credits without additional foreign-source income. The primary US tax issue to be addressed is whether the US company is paying its own tax liability or that of another person. Clearly, for foreign law purposes, the tax liability would be on the US company where the reverse hybrid is a partnership for foreign tax purposes. However, from the US perspective, the US company is paying foreign tax on the earnings of another corporation. There is some authority which casts doubt on the viability of the strategy.[22] However, in that case, the determination was based largely on a finding that the US company did not actually pay the tax in question. Thus, there may be some scope in a jurisdiction with a partnership taxation scheme akin to that of the United States to use this structure.

22. *Abbot Laboratories v. United States*, 160 F. Supp. 321 (N. D. Ill., 1958), Aff'd per curiam, 267 F. 2d 940 (7th Cir, 1959). [58-1 USTC 9454; 59-2 USTC 9543].

IBFD'S NAFTA LIBRARY: COMPLETE INFORMATION ON TAXATION AND INVESTMENT POLICIES IN CANADA AND MEXICO...

TAXATION & INVESTMENT IN CANADA

The laws and systems of federal and provincial governments.

Individual, corporate, business and property tax systems
Determination of tax base, application of rates and tax credits
Description of Canada's treaty network and measures for the relief of double taxation
International transfer pricing and anti-avoidance rules
Taxation of branches of foreign companies and other types of vehicles for international investment in Canada
Overview of federal Goods and Services Tax (GST)
Taxation of financial institutions, insurance companies and specialized industries
Income tax incentives
Important details of provincial taxes
Full information on investment for companies and individuals

Includes information on both the Canada-United States Free Trade Agreement and the North American Free Trade Agreement.

New subscription 1994: NLG 400
Includes 1994 updates
One binder, updated twice a year

TAXATION & INVESTMENT IN MEXICO

A complete picture of business and taxation in Mexico.

Taxation of resident entities' income
Taxation of resident individuals
Taxation of non-resident entities and individuals
Taxation of specific businesses or activities
Taxation of specific types of income, with particular reference to investment income
Taxation of capital and capital transfers
Taxation of transactions
Other business taxes and charges
Tax incentives and reliefs
International tax aspects
Tax administration

A general introduction to Mexico provides background information and a separate section gives a brief analysis of NAFTA.

Includes all tax treaties concluded by Mexico (in English), with a treaty chart showing the final withholding tax on outbound investment income.

New subscription 1994: NLG 400
Includes 1994 updates
One binder, updated twice a year

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on prices given

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

NEW IRS TRANSFER PRICING DOCUMENTATION REQUIREMENTS

Kenneth J. Krupsky, Esq.

Ken Krupsky is a tax partner in the Washington, D.C. law firm of Arnold & Porter. He has practised for over 20 years in all aspects of tax law, with particular emphasis on the planning and negotiation of international and domestic business transactions; general corporate and financial tax counselling; representation of taxpayers in administrative proceedings and litigation against the IRS; and representation of industries, trade associations and companies on tax legislative and tax policy issues before Congress, the White House, the Treasury Department and other federal agencies.

Mr Krupsky works extensively in the international tax area, advising US companies and individuals doing business abroad and foreign persons doing business in the United States. He regularly represents taxpayers in cross-border mergers and acquisitions, financial transactions and tax controversies involving the IRS and foreign taxing authorities, including transfer pricing, IRS APAs and government-to-government competent authority proceedings under tax treaties.

This article reviews the new IRS transfer pricing documentation requirements, identifies key issues and unanswered questions and provides recommendations for compliance with the new rules. Section I provides an overview of the general problem. Section II provides recommendations. Section III reviews the new 1994 transfer pricing penalty rules, including the 27 January 1994 temporary regulations. Section IV describes the penalty rules applicable prior to 1994. Section V discusses documentation requirements under the substantive Section 482 regulations.

I. INTRODUCTION AND OVERVIEW

In 1994, controlled taxpayers and their professional advisers must address significant new US statutory and regulatory requirements for documenting compliance with the arm's length standard for transfer pricing. The new rules create major risks of international double taxation, including severe US penalties, unless taxpayers prepare extensive "contemporaneous" documentation – before, during and after the taxable year – to demonstrate their efforts to set arm's length prices and to achieve an arm's length result on the tax return.

In the past, many taxpayers set transfer prices based on a variety of their own business, legal and tax considerations, including requirements of law and practice in relevant foreign countries. "The taxpayer, not having attempted to structure the transaction in accordance with the arm's length standard, seeks to defend its position on examination by finding whatever uncontrolled transaction or transfer pricing method provides a result that most closely approximates the result initially reported."[1] The taxpayer and the IRS typically would develop sharply contrasting "post hoc" data and analyses, to support extremely different positions. On occasion, both sides would prepare complete and careful analyses only in preparation for trial, often abandoning the positions originally taken in the audit or even the appeals process. Documentation prepared for submission to the Tax Court is hardly "contemporaneous".

The 1994 rules drastically change the "playing field" for both taxpayers and the IRS. Under these rules, the IRS international examiner will request, and will expect to receive within 30 days, a complete file of documents, including (i) documents prepared when transfer prices were first set, typically before the taxable year began; (ii) documents prepared when prices were reviewed and perhaps changed, during the year; (iii) documents prepared when the final results of the prices (i.e. income for the year) became known, after the year ended; and (iv) in some cases, documents prepared when "compensating adjustments" were made, to change the results after the year ended but before the tax return was filed. This thick file may include business documents and correspondence of the affiliated companies, data and analyses prepared by in-house tax managers, expert reports and studies prepared by independent qualified tax economists and even legal opinions by outside counsel.

In many cases of smaller or mid-size companies, the taxpayer's thick file, if properly prepared, may satisfy the international examiner and end the transfer pricing examination, literally before it begins. However, for major multinational companies with large amounts potentially at stake, the IRS may bring in its own economists to develop sophisticated refutations of the taxpayer's approaches. The IRS can produce comparable third-party data, obtained by summons, which were unavailable to the taxpayer during the tax year (and the IRS may refuse to disclose the details of the data prior to litigation). On the other hand, if a controversy arises, it may be more difficult for the taxpayer to justify new "post hoc" analyses, which differ significantly from the thick file originally given to the examiner. Thus, as a practical matter, the new rules may "commit" the taxpayer to the positions which it was forced to adopt during the tax year and when it files the return.

These rules obviously raise serious legal and business problems for companies, and also for the taxing authorities of interested foreign governments. For example, foreign tax systems may be unable to accommodate the IRS concept that

1. IRS preamble to the 27 January 1994 temporary penalty regulations, Treas. Reg. §§ 1.6662-5T and -6T, 1.6664-4T(d).

© 1994 International Bureau of Fiscal Documentation

the income results for the year can or should be changed by "compensating adjustments", after the year is over. (Some foreign systems would question *ex post facto* changes to the tax result of a particular transaction, even within a tax year.) Of course, foreign authorities may not object to the taxpayer's creation of extensive documentation, which will enhance foreign as well as US tax audit processes. The competent authority process will have an even more important role.

The documentation process will be expensive and, as noted, will create new kinds of risks. The IRS recognizes that the taxpayer's level of effort may reasonably depend upon the amounts potentially at stake (see III.E. below). Multinational taxpayers must allocate appropriate effort and resources to facing these new challenges. Professional tax advisers will bear even more responsibility than previously, to assure that their clients are thoroughly and properly advised in advance and to prepare for defending against a subsequent IRS audit, if necessary.

II. RECOMMENDATIONS FOR REDUCING THE RISK OF PENALTIES

The focus of many companies will be on complying with the new documentation rules, in order to reduce the risk of major US transfer pricing adjustments and penalties. Assuming that compliance is the taxpayer's objective, this section provides some initial recommendations on how to proceed.

In general, in determining whether a penalty should be imposed, the IRS and the courts will evaluate "the extent of the taxpayer's efforts" to apply Section 482 properly. Therefore, I recommend the following:

- Initial pricing recommendations for a tax year should be based on the most complete data and analyses available prior to setting prices. This will typically occur at the beginning of the year, prior to the first intercompany transaction.
- At the beginning of the year, the taxpayer should adopt a transfer pricing method for each relevant transaction and apply that method as completely as possible to conform with the substantive Section 482 regulations and the Section 6662 penalty regulations, including the new requirements for contemporaneous documentation.
- During the year, the taxpayer should review the actual results of its transfer pricing methods, any changes in critical assumptions (e.g. changes in economic conditions) and any new comparable data which become available. Changes in transfer pricing may be required for business or tax compliance reasons. These reviews and any changes in pricing should also be documented.
- After the end of the year but before the tax return is filed, the taxpayer's final tax results and any newly-available data or analyses should again be reviewed. "Compensating adjustments" to reduce the risk of major tax controversy should be considered. Final documentation for the year should be prepared, before the tax return is filed.
- Taxpayers should seriously consider retaining a qualified tax economist and/or other experts to provide independent reports or studies of the taxpayer's transfer pricing methods, before they are adopted for the year, and of the actual results achieved, after the year is completed.
- The experts should be retained by outside legal counsel under the attorney-client and attorney work-product privileges. This procedure should allow the company to avoid disclosure of a particular expert's reports or studies, if that is desirable.
- All relevant internal taxpayer business documents, and any additional documentation and analyses prepared for tax purposes, should be carefully reviewed before the tax return is filed.
- Based on all of the above documentation and prior to filing the return, the taxpayer should consider obtaining a final legal opinion from outside tax counsel.

III. TRANSFER PRICING PENALTIES: TAXABLE YEARS BEGINNING AFTER 31 DECEMBER 1993

Under amendments to Section 6662 enacted by Congress in the 1993 Omnibus Reconciliation Act:

A. The 20 percent substantial valuation misstatement penalty[2] is automatically imposed if:

- the value or the adjusted basis of any property is 200 percent or more of the correct amount; or
- the price for any property or services, or for the use of property, is 200 percent or more, or 50 percent or less, of the correct amount; or
- the net Section 482 transfer price adjustment for the year exceeds $ 5,000,000 or 10 percent of gross receipts.

B. The 40 percent gross valuation misstatement penalty[3] is automatically imposed if:

- the value or the adjusted basis of any property is 400 percent or more of the correct amount; or
- the price for any property or services, or for the use of property, is 400 percent or more, or 25 percent or less, of the correct amount; or
- the net Section 482 transfer price adjustment for the year exceeds $ 20,000,000 or 20 percent of gross receipts.

C. Defense based on regulatory methods

The taxpayer may prevent imposition of the penalty if:[4]

- it is established that the taxpayer determined the transfer price using a specific pricing method under the Section

2. IRC Sec. 6662(e)).
3. IRC Sec. 6662(h)).
4. IRC Sec. 6662(e)(3)(B)(i) and (D)).

© 1994 International Bureau of Fiscal Documentation

482 regulations and the taxpayer's use of such method was reasonable;
- the taxpayer has documentation at the time of filing the return which sets forth the determination of the price using a method under the Section 482 regulations and which establishes that the use of such method was reasonable; and
- the documentation is provided to the IRS within 30 days of an IRS request.

The legislative history states that:

- Specific regulatory methods include only CUP, RPM, cost plus and the comparable profits method. Profit split is an "other" method (i.e. until new profit split regulations become effective).
- All the procedural or other requirements of the regulations must be satisfied, including the "best method" rule under Temp. Reg. § 1.482-1T(b)(2).

D. Defense based on an "other" method

The taxpayer may also prevent imposition of the penalty if:[5]
- the taxpayer establishes that none of the regulatory methods was likely to result in a price that would clearly reflect income, the taxpayer uses another method to determine the price and such other method was likely to result in a price that would clearly reflect income;
- the taxpayer has documentation at the time of filing the return which sets forth the determination of the price in accordance with such "other" method; and
- the documentation is provided to the IRS within 30 days of an IRS request.

The legislative history states that:

- Unavailability of data on comparable uncontrolled transactions can be one basis to establish that a specified method likely would not result in a clear reflection of income.
- One reason that an "other" method would be likely to result in a clear reflection of income might be that it properly took into account the significant factors which unrelated parties engaged in transactions at arm's length would have considered, and accorded appropriate weight to such factors.
- Another reason for use of an "other" method might be prior development by the IRS and the taxpayer (e.g. in an APA) of a particular other method. The taxpayer's documentation must establish that the taxpayer applied the agreed method reasonably and consistently with its prior application and that the facts and circumstances surrounding the use of the method have not materially changed since the time of the agreement.
- Importantly, the legislative history also states that the use of either a specified regulatory method or an "other" method will not be reasonable if the taxpayer became aware, prior to filing its return, that such application more likely than not did not result in a clear reflection of income. Sole reliance on data from a preceding taxable year is acceptable (as a defense to the penalty), *unless more current reliable data become available prior to filing the tax return* (emphasis added).

E. New January 1994 temporary penalty regulations

New regulations under the 1993 amendments to the statute were issued in temporary (and proposed) form on 27 January 1994.[6] They apply to taxable years beginning after 31 December 1993, and they went into effect upon publication in the Federal Register (2 February 1994). A hearing is scheduled for 2 June 1994. The proposed regulations issued in January 1993 were withdrawn (but see below concerning prior tax years).

The preamble states that the failure by a majority of taxpayers to analyse their transfer pricing, and provide contemporaneous documentation explaining the application of arm's length standards, prior to audit, increases controversy and the time and expense incurred by both taxpayers and the IRS. Thus, the regulations were designed to "encourage" taxpayers to make "a serious effort" to comply with the arm's length standard, report an arm's length result on their tax returns, document their transfer pricing analyses and provide the documentation to the IRS upon request.

Following the statute, the regulations provide a two-part exception to the imposition of the penalty, depending on whether the taxpayer used a specified or unspecified method under the substantive Section 482 regulations.

If the taxpayer used a specified method, the taxpayer must have reasonably concluded, based on the available data and the potentially applicable alternative specified methods, that its application of the selected method resulted in the most accurate measure of an arm's length result (under the principles of the best method rule). The application of the specified method must produce "a more accurate measure" of an arm's length result than *any* alternative specified measure and *any* alternative application of the method chosen. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances.

Comment: The proposed profit-split and qualified cost sharing arrangement methods will become specified methods if and when regulations describing those methods are finalized.

If the taxpayer used an unspecified method, the taxpayer generally must have reasonably concluded, based on the available data, that none of the specified methods was likely to provide an accurate measure of an arm's length result and that the method used was likely to achieve such a result. The taxpayer's conclusion must be based on all the facts and circumstances.

The regulations provide that a taxpayer's analysis of its transfer prices must include the *most current data* that are available at the time the taxpayer files its tax return. Accordingly, it may be necessary for taxpayers to make *compensating adjustments* to reflect changes in the data between the time

5. IRC Sec. 6662(e)(3)(B)(ii) and (D)).
6. Treas. Reg. §§ 1.6662-5T,-6T, 1.6664-4T(d).

© 1994 International Bureau of Fiscal Documentation

that prices were established for the year and the time the return is filed.

Comment: The requirement for possible compensating adjustments after the end of the tax year is highly controversial. Several foreign taxing authorities have indicated that they will not recognize such adjustments, thus increasing the chances of double taxation. Also, such adjustments may cause serious business and management problems.

The regulations discuss four non-exclusive factors that are to be taken into account in determining whether a taxpayer reasonably concluded that its application of the method selected would provide the most accurate measure of an arm's length result:

- The experience and knowledge of the taxpayer (including all members of the taxpayer's controlled group).
- The extent to which accurate data were available and were analysed in a reasonable manner. A taxpayer must engage in a reasonably thorough search for the necessary data. The expense of collecting data relative to the dollar amount of the transactions in question is a factor in determining the scope of a reasonably thorough search for data.
- The extent to which the taxpayer followed the relevant requirements set forth in the Section 482 regulations.
- The extent to which the taxpayer reasonably relied on the analysis of, or a study done by, a professional qualified to conduct such an analysis or study, including either an independent or an employee attorney, accountant or economist. The analysis or study must be objective, thorough and well reasoned, and all relevant information must be disclosed to the professional.

The regulations describe two classifications of documentation that must be maintained.

Principal documents must accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The principal documents *must* include the following:

- an overview of the taxpayer's business, including an analysis of the economic and legal factors that affect pricing;
- an organizational chart and description covering all parties and transactions "potentially relevant" under Section 482;
- any documentation explicitly required under the Section 482 regulations;
- a description of the specified method, if used, and why it was selected;
- a description of the unspecified methods that were considered and an explanation of why they were not selected;
- a description of the controlled transactions and any internal data used to analyse them;
- a description of the comparables used and adjustments made;
- an explanation of the economic analysis and projections relied on; and
- a general index of the principal and background documents and a description of recordkeeping system used for cataloguing and accessing those documents.

A District Director has discretion to extend the 30-day period for producing principal documents only if the taxpayer has made a minor or inadvertent failure to provide the required documents, has otherwise made a good faith effort to comply and remedies the failure when it becomes known.

Background documents are documents that support the assumptions, conclusions and positions contained in the principal documents. A District Director has discretion to extend the 30-day production period for background documents for a short period.

IV. TRANSFER PRICING PENALTIES: TAXABLE YEARS ENDING AFTER 5 NOVEMBER 1990 AND BEGINNING ON OR BEFORE 31 DECEMBER 1993

A. 20 percent substantial valuation misstatement penalty

The 20 percent substantial valuation misstatement penalty is automatically imposed if:[7]

- the value or the adjusted basis of any property is 200 percent or more of the correct amount; or
- the price for any property or services, or for the use of property, is 200 percent or more, or 50 percent or less, of the correct amount; or
- the net Section 482 transfer price adjustment for the year exceeds $ 10,000,000.

B. 40 percent gross valuation misstatement penalty

The 40 percent gross valuation misstatement penalty is automatically imposed if:[8]

- the value or the adjusted basis of any property is 400 percent or more of the correct amount; or
- the price for any property or services, or for the use of property, is 400 percent or more, or 25 percent or less, of the correct amount; or
- the net Section 482 transfer price adjustment for the year exceeds $ 20,000,000.

C. Defense

The taxpayer may prevent imposition of the penalty by showing that there was a reasonable cause for the taxpayer's determination of the transfer price and that the taxpayer acted in good faith with respect to such price.[9]

7. IRC Sec. 6662(e).
8. IRC Sec. 6662(h)).
9. IRC Secs. 6662(e)(3)(B) and 6664(c)(1)).

© 1994 International Bureau of Fiscal Documentation

D. General meaning of reasonable cause and good faith[10]

- Determined on a case-by-case basis, taking into account all pertinent facts and circumstances.
- "*The most important factor* is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability" (emphasis added).
- Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer.
- Reliance on the advice of a professional (appraiser or attorney), or on facts which unknown to the taxpayer are incorrect, do not necessarily demonstrate reasonable cause and good faith. Such reliance is a good defense if, under all the circumstances, reliance was reasonable and the taxpayer acted in good faith. For example, a corporation should employ internal controls and procedures, reasonable under the circumstances, designed to identify any factual errors.
- Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between the appraised value and the purchase price, the circumstances under which the appraisal was obtained and the appraiser's relationship to the taxpayer.

Comment: There is no specific IRS guidance and no case law on the question of how to evaluate the "extent of the taxpayer's effort" in applying Section 482 properly.

E. January 1992 Proposed Regulations[11]

1. Effective date

The regulations were originally proposed to be effective for taxable years beginning after 21 April 1993. For returns filed prior to 21 April 1993, "any reasonable interpretation of Section 6662(e) is acceptable". The IRS considers these proposed regulations to be "*a reasonable interpretation*" of Section 6662(e), except that no requirement of *contemporaneous documentation* is imposed for "past transactions" (i.e. transactions prior to 21 April 1993).[12] However, contemporaneous documentation may be helpful in establishing reasonable cause and good faith. Taxpayers may elect to apply the proposed regulations to prior years.

2. Reasonable cause and good faith

Reasonable cause and good faith are determined by taking into account all relevant facts and circumstances.

3. Elements

Two elements must be satisfied in all cases:

- *Reasonable effort to accurately determine proper tax liability*: the taxpayer must have contemporaneous documentation, not later than the filing of the return, demonstrating that the taxpayer made a reasonable effort to accurately determine its tax liability, including an analysis indicating that the result was an arm's length result under the Section 482 regulations. Such documentation must be provided to the IRS within 30 days of an IRS request.

Reasonable belief in arm's length result: the determination of whether the taxpayer had a reasonable belief is made in light of the experience and knowledge of the taxpayer. Use of a Section 482 pricing method (but not including "other methods") is a factor to be considered. In addition:

(a) *Result to be sustained on merits*

The taxpayer must show that at the time the return was filed the taxpayer "*reasonably believed that the result would more likely than not be sustained on the merits*". This test is met if: (1) the taxpayer had a reasonable belief at the time the prices were established that the methodology would produce an arm's length result and that the underlying critical assumptions would not change during the year, and (2) the assumptions had not changed by the time the return was filed. If a critical assumption changes before the return is filed, the taxpayer has an obligation to review the reasonableness of its initial result. If before the return is filed, the taxpayer has actual knowledge that an assumption changed and that the methodology did not produce an arm's length result, then the taxpayer is obligated to review the reasonableness of its initial result and "make any adjustments necessary to reflect an arm's length result".

(b) *Reliance on advice of a professional*

Reliance on the advice or study of a professional (attorney, accountant, economist) is relevant to the taxpayer's reasonable belief, but only if the reliance is well-founded. Factors include the professional's relevant experience and expertise; whether all relevant information has been disclosed to the professional; the methodology and critical assumptions underlying the advice or study; and the quantity and quality of data used in the study relative to the quantity and quality of data available in the industry.

(c) *Defense based on methodology other than that used in preparing return*

A taxpayer may defend its tax return results with a methodology different than that used in preparing its return, provided that the reliance on the initial rationale was reasonable at the time the return was filed.

Comment: For taxable years beginning after 31 December 1993, the "more likely than not" proposed regulatory standard has been replaced by the statutory (and regulatory)

10. Treas. Reg. § 1.6664-4.
11. Prop. Reg. § 1.6662-5.
12. The preamble to the January 1994 temporary regulations repeats the same effective date rule for the January 1993 proposed regulations.

© 1994 International Bureau of Fiscal Documentation

"specified method" standard. The IRS says the two standards are "different". Which test is harder to meet?

F. Case law interpreting "reasonable cause"

There are numerous cases generally interpreting the "reasonable cause" standard in situations not involving transfer pricing.

In evaluating a professional's qualifications, courts have looked to: (1) the professional's educational background, see e.g. *Estate of Hatchett v. Commissioner*;[13] *Frazee v. Commissioner*;[14] (2) years of professional experience, see e.g. *Estate of Jung v. Commissioner*;[15] (3) experience in performing analyses in the specialized area at issue, see e.g. *Frazee*;[16] *Hatchett* (while expert performed hundreds of real estate appraisals, court noted that he had never before valued type of farmland at issue);[17] *Schacter v. Commissioner* (expert found to be qualified gem appraiser but not a specialist in valuing opals);[18] and (4) membership in professional associations, see e.g. *Frazee*.[19]

Taxpayers have been held liable for accuracy-related penalties where they asserted reliance on an accountant, attorney or other professional but could not show that they provided *all relevant and necessary information*.[20]

Courts have noted that a professional's analysis must be *well-reasoned* and must utilize the most appropriate methodology.[21]

Experts must *not act as advocates* in performing analyses.[22] (expert's report was "result-oriented" and lacking in objectivity); *Estate of Halas v. Commissioner* (court will reject expert testimony on valuation where methods opined by an expert constitute advocacy).[23]

Importantly, the taxpayer must *fully comply* with the advice of the professional on whom the taxpayer claims to rely to support a finding of reasonable cause. In several accuracy-related penalty cases, the courts concluded that the taxpayer did not follow the advice given or that the professional did not offer any opinion on the matter.[24]

V. SUBSTANTIVE SECTION 482 REGULATIONS (JANUARY 1993)

A. Assumption of risks

The District Director may disregard the nominal assumption of a risk by a controlled taxpayer, unless (i) documentation reflecting the allocation of risks among the controlled taxpayers was executed *before* the results of such risks were known or reasonably knowable, and (ii) the actual conduct of the controlled taxpayer is *consistent* with such documentation.[25]

This rule does not apply to routine risks that are assumed by a controlled taxpayer under normal commercial practices (e.g. where risk of loss during shipment is assigned under the UCC).

Comment: Although the IRS may disregard a "nominal assumption" of a risk, presumably the IRS must respect the *actual* assumption of a risk, as reflected in the actual conduct of the parties.

Query: How should the IRS treat a currency risk sharing arrangement which is evidenced in consistent practice among the controlled taxpayers over several years, but has not been reduced to a specific written agreement?

B. Contractual arrangements

The District Director will ordinarily respect the terms of contractual arrangements between controlled taxpayers if such terms are consistent with the *economic substance* of the underlying transactions and the *actual conduct* of the parties.[26]

Query: Suppose the controlled taxpayers have a written currency risk sharing agreement, but in actual practice they share the risk on a different basis (i.e. using a different formula)?

C. Compensating adjustments

The District Director will take into account the effect of an arrangement among controlled taxpayers for reimbursement or other compensating adjustments only if the adjustment is made pursuant to a written agreement.[27]

Query: Is this test satisfied by an *ad hoc* written agreement, entered into immediately before the payment of a compensating adjustment for a particular tax year and which is based on a methodology and data applicable only for that year?

D. Small taxpayer safe harbour election

An eligible taxpayer may elect the small taxpayer safe harbour by attaching a written statement to a timely filed tax return.[28]

E. Deferred income method of accounting

Under proposed regulations, if certain requirements involving foreign legal restrictions are satisfied, a taxpayer may

13. 58 T.C.M. (CCH) 801 (1989).
14. 98 T.C. 554 (1992).
15. 101 T.C. No. 28 (1993).
16. 98 T.C. at 554.
17. 58 T.C.M. at 804.
18. 51 T.C.M. (CCH) 1428, at 1431 (1986).
19. 98 T.C. 554.
20. See e.g. *Estate of Reinke v. Commissioner*, 63 T.C.M. (CCH) 2570 (1993).
21. See e.g. *Estate of Jung*, 101 T.C. No. 28 (1993); *Frazee v. Commissioner*, 98 T.C. 554 (1992).
22. See e.g. *Estate of Mueller v. Commissioner*, 63 T.C.M. (CCH) 3027 (1992).
23. 94 T.C. 570 (1990).
24. See e.g. *Loftus v. Commissioner*, 63. T.C.M. (CCH) 2944 (1992).
25. Treas. Reg. 1.482-1T(c)(3)(ii)(C).
26. Treas. Reg. § 1.482-1T(d)(3)(ii).
27. Treas. Reg. § 1.482-1T(e)(2).
28. Treas. Reg. § 1.482-1T(f)(1).

© 1994 International Bureau of Fiscal Documentation

elect the deferred income method of accounting on a written statement attached to a timely filed tax return, filed before the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year to which the foreign legal restriction applies.[29]

F. Costs or deductions of rendering services

Where an arm's length charge for services is determined with reference to costs or deductions, and a controlled taxpayer has allocated and apportioned costs or deductions to reflect arm's length charges by employing in a consistent manner a method of allocation and apportionment that is reasonable and in keeping with sound accounting practice, such method will not be disturbed.[30]

G. "Other" transfer pricing methods

A taxpayer may use an "other" pricing method for transfers of tangible property only if the taxpayer discloses the use of the method by attaching an appropriate disclosure statement to the timely filed tax return and prepares contemporaneous supporting documentation.[31] A taxpayer may use an "other" pricing method for transfers of intangible property only if the taxpayer discloses the use of the method by attaching an appropriate disclosure statement to the timely filed tax return and prepares contemporaneous supporting documentation.[32]

H. Periodic adjustments for intangibles

If controlled taxpayers enter into a written agreement satisfying certain detailed requirements, they will not be subject to the general periodic adjustment rule for transfers of intangibles that cover more than one year.[33] This exception is narrow in scope and probably will not be used frequently.

I. Proposed profit split election

Under proposed regulations, a controlled taxpayer which is eligible to use a profit split method may elect to apply the method by including a written statement in a timely filed tax return.[34] Prior to making this election, the controlled taxpayers must have executed a written profit split pricing agreement describing the relevant business activity and the mechanism under which each participant's share of the combined profit or loss will be determined.[35] Once made, an election applies to the current tax year and all subsequent years and may be revoked only with the consent of the IRS.[36]

Comment: If profit split calculations are used by the taxpayer as a secondary "test" of reasonableness, rather than as a primary pricing method, a written profit split agreement probably is not necessary. However, contemporaneous documentation of the taxpayer's reliance on the "test" may be necessary to avoid a penalty.

J. Cost sharing arrangements

Under existing regulations, a "bona fide cost sharing arrangement" must be in writing.[37] Under proposed regulations, a "qualified cost sharing arrangement" also must be in writing.[38]

29. Prop. Reg. § 1.482-1(f)(2).
30. Treas. Reg. § 1.482-2T(b)(6).
31. Treas. Reg. § 1.482-3T(e).
32. Treas. Reg. § 1.482-4T(d).
33. Treas. Reg. § 1.482-4T(e)(2).
34. Prop. Reg. § 1.482-6(d)(1).
35. Prop. Reg. § 1.482-6(d)(2)(ii).
36. Prop. Reg. § 1.482-6(d)(1).
37. Treas. Reg. § 1.482-7T.
38. Prop. Reg. § 1.482-2(g).

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

JULY 1994

Leyden–Amsterdam–Columbia Summer Program in American Law, Leyden, 3-29 July 1994 (English):

Mrs B. Zaaijer, University of Leyden, Faculty of Law, Columbia Summer Program, Hugo de Grootstraat 27, 2311 XK Leyden, The Netherlands, Tel.: 31-71-277 632, Fax: 31-71-277 600.

Workshop on special economic zones in Asia (Asian Studies Association of Australia Biennial Conference), Perth, 13-16 July 1994 (English):

George Sanderson, Asian Studies, Griffith University, Nathan, Queensland 4111, Australia, Tel.: 61-7-209 8645, Fax: 61-7-875 5111.

AUGUST 1994

50th Congress of the International Institute of Public Finance, Harvard University, 22-25 August 1994; subject: public finance, environment and natural resources (English, French, German):

International Tax Program Harvard Law School, Pound Hall 400, 1563 Massachusetts Ave., Cambridge, Massachusetts 02138, USA, Tel.: 1-617-495 4406, Fax: 1-617-495 0423, Telex: 211384 ITP HIID.

Principles of International Taxation, Amsterdam, 22 August-2 September 1994 (English):

IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam, The Netherlands, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

48th Annual IFA Conference, Toronto, Canada, 28 August-2 September 1994; main subjects: deductibility of interest and other financing charges in computing income, national and international tax consequences of demergers (English, French, German, Spanish):

Congress Secretariat Toronto 1994, 191 Niagara Street, Toronto, Ontaria, Canada, M5V 1C9, Tel.: 416-860-1772, Fax: 416-860-0380.

Current Legal Issues in the Internationalization of Business Enterprises, Singapore, 31 August-2 September 1994 (English):

The SCIBL Organizers, Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 0511. Tel.: 65-772 3102, Fax: 65-779 0979, Telex: RS 33943.

OCTOBER 1994

International Tax Conference, Toronto, 28 October 1994 (English):

Ernest & Young, Attn: Joseph Gill. Tel.: 1-416-943 3063.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

A PRIMER ON TAX EVASION

Vito Tanzi and Parthasarathi Shome

Vito Tanzi is Director of the Fiscal Affairs Department of the IMF. He received his Ph.D. in economics from Harvard University. He has also been on the faculty of various universities and a consultant for the World Bank, the United Nations, the Organization of American States and the Stanford Research Institute. He has written numerous books and articles. His major interests are public finance, monetary theory and macroeconomics. He is currently the President of the International Institute of Public Finance.

Partho Shome is Division Chief for Tax, Fiscal Affairs Department, IMF. He received his Ph.D. from Southern Methodist University and Masters degrees from the University of Rochester and the Delhi School of Economics. Earlier, he was Professor at American University, Washington, D.C., Visiting Fellow at Australian National University and Delhi School of Economics, Academic Visitor at London School of Economics, and Consultant at the World Bank. He has published a book and articles in international journals in the area of public finance.

I. INTRODUCTION

Tax evasion is a universal phenomenon. It takes place in all societies, in all social classes, in all professions, in all industries, in all religions and in virtually all economic systems. Two thousand five hundred years ago, Plato was already writing about this phenomenon, and on the Ducal Palace of Venice built many centuries ago there is a stone with a hole in it, through which people who knew about tax evaders could inform the Republic about the culprits. The only surprise is how little attention this phenomenon had received in some places and especially in the United States until recent years. For example, there is no reference to it in the index to Richard Goode's (1964) classic *Individual Income Tax*; none in Richard Musgrave's (1959) *The Theory of Public Finance*; and none in Joseph Pechman's (1966) *Federal Tax Policy*. These authors either did not think that tax evasion was important or opted to ignore it.

In recent years, however, there has been growing attention paid to this phenomenon. In the United States the attention to it may have started with a somewhat political view that the problem of the rising fiscal deficit could be solved by reducing the so-called "tax gap" rather than by raising tax rates or cutting public spending.[1] Because of its policy of reducing tax rates and its inability to reduce public spending, the Reagan administration promoted the idea that the fiscal deficit could be reduced by reducing or eliminating the tax gap. In other countries, the concern for tax evasion was in part prompted by a growing preoccupation with horizontal equity. The realization that people with similar incomes often ended up paying very different taxes because of different possibilities of tax evasion, led many governments to worry about the implications of tax evasion. Also, a growing concern about underground economic activities and how these affected economic policies, and the realization that the underground economy was often the other face of tax evasion, led in the 1980s to increasing attention being paid to tax evasion.[2] This is certainly true of Latin America where the authorities, after introducing major tax policy reforms, have demonstrated increasing interest in the measurement and diminution of tax evasion in both income taxes and consumption taxes.[3]

In what follows, Section II surveys some of the sources of tax evasion and recounts how economists have attempted to provide a theoretical underpinning to them. It also discusses some of the limitations of this theoretical literature. Section III reviews the role of tax administration and sanctions in limiting tax evasion, and mentions, briefly, the relation between society at large and tax evasion. Section IV provides some concluding remarks. They are followed by an appendix that lists some of the methodologies developed for estimating tax evasion.

II. THEORETICAL UNDERPINNINGS FOR CAUSES AND EFFECTS

A. Sources and implications of tax evasion

Tax evasion comes in different forms. It comes, for example, through the non-declaration of income; through the under-reporting of income, sales or wealth; through the over-reporting of deductible expenses; through smuggling activities; and through many other forms. In fact, the variety of tax evasion is truly remarkable, and one finds always new ways by which taxpayers attempt to reduce their tax burden.[4] Many authors have reviewed these matters including Sisson (1981) and Richupan (1987), among IMF studies, and more recently,

1. The tax gap is the measure of tax evasion that emerges from comparing taxable income declared to tax authorities with taxable income calculated from other and presumably more accurate sources.
2. Scholars have often made a distinction between tax evasion and tax avoidance. In theory tax evasion implies violation of the law whereas tax avoidance implies the taking advantage of ambiguities in the law to reduce the tax burden. This distinction, however, is not always easy and in fact in some countries, such as India, the courts have considered tax avoidance with the intention of evading taxation as tax evasion.
3. Several requests by Latin American countries for IMF technical assistance have had the objective of measuring tax evasion.
4. In recent years new developments in industrial organization and in technology have introduced totally new ways of evading taxes, for example, through transfer pricing and thin capitalization.

© 1994 International Bureau of Fiscal Documentation

Cowell (1990) and Webley et al. (1991). Evidence of empirical findings are often of a confidential nature, as they are the work of technical assistance to countries or of the technical staff of Ministries of Finance.

The opportunity for tax evasion varies between sectors, and this may lead to social turmoil. In Italy, for example, salaried workers have demonstrated in large numbers in the streets to call for reduction in tax evasion by independent professionals and other groups. Activities in which tax evasion is easier are those of independent contractors; of professionals such as doctors, lawyers, architects, etc.; and of those who engage in agricultural activities. There is increasing evidence that enterprises that operate in different countries can also reduce their tax burden through the judicious use of transfer pricing.[5]

Tax evasion has much to do with the structure of the economy. The more atomized is production, the more likely it is that tax evasion will flourish. A country where much production takes place in large enterprises or establishments is unlikely to have a lot of tax evasion. However, a country where much economic activity takes place in small shops, in small farms and on the part of single individuals, is likely to experience a lot of evasion.

Tax evasion is also strictly connected with the structure of the tax system. It is likely to vary according to the use of different tax bases. For example, in the case of income taxes it is likely to vary between dependent and non-dependent income sources; as well as between large, small and multinational enterprises. In the case of sales taxes, it is likely to be connected with the under-reporting of sales or the over-reporting of purchases. In theory, at least, tax evasion is connected with the accounting concepts of tax liabilities. When a country relies on presumptive concepts of taxation, tax evasion is likely to be more limited unless there is hiding of the assets on which the presumptive estimate of the tax payment is based. The tax structure will also influence tax evasion by its number of taxes. At times governments introduce additional taxes in order to neutralize the losses connected with tax evasion associated with existing taxes. However, an increase in the number of taxes will produce inefficiencies in the tax system and will facilitate for taxpayers the search for new ways of avoiding paying taxes.

The policy implications of tax evasion would be quite different depending on whether evasion is an individual or a social phenomenon. A single tax evader in a country of honest taxpayers typifies the behaviour of just that individual. However, a tax evader in a country where tax evasion is a national sport is a somewhat different phenomenon. Tax evasion has implications for the equity of the tax system, for both its horizontal and its vertical equity. It has implications for the efficiency of the tax system and even for the competitive market framework. For example, it is impossible to have pure competition when some of the sellers can evade taxes, while others cannot. In this case the former will be able to undersell the latter. Tax evasion affects the productivity of the tax system reducing the amount of revenue that could be raised given the statutory system. It affects the general attitude of citizens *vis-à-vis* the government, often building cynicism about the role of the public sector. Often it affects even the statutory system in the sense that the tax laws begin to anticipate the tax evasion by particular groups and try to penalize tax evasion by increasing the tax rates for those particular groups. This often results in increased horizontal inequity since not all the taxpayers in those groups behave like the average.

B. The theory of tax evasion and its limitations

Since Allingham and Sandmo (1972) wrote a classic theoretical paper on tax evasion, the problem of tax evasion, seen from the point of view of the taxpayer, has been discussed as a kind of game theory.[6] The taxpayer is faced with the decision whether to evade or not to evade. In other words, the decision on whether to pay the tax becomes similar to playing a lottery where one is free to buy or not to buy a lottery ticket. For a rational individual, the choice will be made on the basis of the expectations of gains or losses associated with the decision made. The objective is to maximize the utility of the taxpayer.[7]

The benefit derived from tax evasion is related to the expected value of the money (and thus to the utility of the money) that the individual does not pay. The cost of tax evasion is connected to the probability of being caught and the consequences of this outcome. These consequences, in the Allingham and Sandmo model, are associated with fines which can considerably exceed the original tax due. But, of course, the probability that the individual will pay these fines depends on the probability of being caught and that probability can be very low.

The Allingham and Sandmo theory has some important implications for tax administration. In fact, the theory implies that tax evasion can be reduced by either increasing the penalties associated with it, or by increasing administrative expenses, assuming that this increase raises the probability that the tax evader will get caught.[8] In an extreme interpretation of the Allingham and Sandmo theory, it has been argued that the penalties should become so high and the cost of administration so low that at the limit the tax evader who gets caught should be hanged but that the probability of being caught would approach zero.

The theoretical and especially the practical limitations to the theoretical literature have not received the attention they deserve. But some of these have been discussed by various writers. A first limitation has to do with risk aversion which may vary among individuals and may depend on the level of the taxpayer's income or wealth. In the more recent theoretical advances, the taxpayer's behaviour toward tax compli-

5. During the electoral campaign, President Clinton argued that the reduction of tax evasion by multinationals could generate a lot of revenue. Recent work by the US Internal Revenue Service has given some support to this view (see US Treasury (1992)).

6. There is actually a close relationship between Allingham and Sandmo's theory of tax evasion and Becker's theory of crime (1968).

7. Becker's theory assumes that individuals evaluate the expected benefits and costs of various activities including criminal activities and choose those that provide the highest income.

8. The theory assumes a close relationship between increasing costs of administration and increasing the probability of catching tax evaders. The importance of this assumption has to be kept in mind.

© 1994 International Bureau of Fiscal Documentation

ance turns entirely on his attitude toward risk. For example, treating tax evasion in the context of intertemporal choice models, Banerji (1991), concludes:[9]

> Is there a more subtle way of enforcing compliance without such elaborate calibration – by simply increasing the risk of detection for the evader, and thereby making him or her switch from the riskier asset to the safer one of declared income? Unfortunately, this plan would work with certainty only if we were willing to assume that all possible evaders in the economy had constant absolute risk aversion, i.e. that their willingness to take risks did not depend upon their level of income or consumption.

A second limitation has to do with the use of penalties which are applied to only those unfortunate fellows who get caught. In other words, there are many tax evaders who should be penalized but who do not get caught and who are, thus, not affected by those penalties. This raises the question of whether the judiciary system and the community at large will be willing to penalize fully the unlucky few individuals who get caught when many more individuals are committing the same offenses but are not being punished. Anecdotal evidence from many countries indicates that the judiciary system is unwilling to fully apply the penalties under these conditions. This means that one of the basic conclusions of the theoretical literature is unlikely to fully hold if the penalties actually implemented differ from those which are in the books.

Third, the theory assumes that the taxpayers know precisely the probability of being caught and the penalties that they will receive so that they can make the cost-benefit calculations. However, tax administrations often keep this information highly confidential so that for most, if not all, taxpayers the probability of being caught is an unknown. And the penalties may be highly uncertain.[10]

Fourth, the theory ignores costs in terms of embarrassment, loss of self-esteem and social status, etc. experienced by those who get caught. These costs vary from society to society and from individual to individual. In a society where tax evasion is condoned because of the unpopularity of the government, tax evaders may be admired and the social costs associated with tax evasion are, consequently, low or even negative. In a society where tax evasion is taboo, these costs can be very high.

Finally, many countries rely on means-testing based on declared income for determining access to many government-provided benefits such as food stamps, free health care, free education or scholarships, and so forth. Therefore, the advantages from tax evasion may far exceed those measured by the non-payment of the tax.

C. The role of penalties and amnesties

Perhaps a few comments on the penalties themselves would be appropriate. Some of these comments have relevance for the theoretical literature on tax evasion. The higher the penalties, the more probable it is that they will not be applied to those who get caught. If the high penalties have led to a reduction in the cost of administration, this would have reduced the probability of detection and thus the number of cases requiring the imposition of penalties. Many societies would feel uncomfortable about singling out and punishing particular individuals, almost by a lottery process, when many other individuals may have committed the same offenses. Second, for the penalties to be effective, they must be applied quickly. A penalty that is delayed for years, because of appeals on the part of the taxpayer, is unlikely to have the same effect as a deterrent to evasion, as one that is expected to be applied immediately. In some legal systems, as for example the Italian and Tunisian ones, it has at times been possible to postpone for many years, through appeals, the application of the penalties.[11] The impact of penalties on tax compliance may not always be great under the circumstances described above. For example, using a model of varying attitudes toward risk and applying econometric estimation techniques to Mexican data for 1982-89, Dunn (1992), concludes:[12]

> large changes in the odds of being detected and the penalty for illegal evasion are required to even modestly alter compliance...a doubling of the fines for tax evasion would increase declared taxable income by about 10 percent. Similarly, a large increase in the number of audits would achieve only a modest rise in compliance.

Of course, in the pre-penalty period, the appeal may be successful or a tax amnesty may come along.[13] Appeals mechanisms and tax amnesties bring a lot of confusion in the theory which assumes that the probability of application of the penalty and the penalty itself are known and are precisely defined. The theory is also affected by the existence of administrative corruption. If the individual who gets caught can bribe some tax officials, and if the bribe is less than the penalty, then the theory becomes ambiguous. Tax amnesties which continue to be used in some countries also have important implications for tax evasion because in many ways they encourage tax evasion at least over the longer run and, by so doing, they have an impact on the equity of the tax system, on tax revenue, on the future of the tax system and on the tax administration. For example, using a game-theoretic approach to an economic analysis of tax amnesties, Stella (1989), concludes:[14]

> while in general it may be correct to impose a reduced penalty on individuals who voluntarily disclose tax evasion, short-lived amnesties of the type most frequently observed in practice are unlikely to generate significant revenue when judged against the potential danger of reducing future tax compliance.

Also, analysing the sustainability of revenue intake from tax amnesty experiences in different countries, including Argentina, Colombia and India during the 1980s, Uchitelle (1989), concludes:[15]

9. At 98.
10. In some cases they may be so delayed in time that they lose their deterrence effect.
11. Sometimes the taxpayers benefit from the delay due to the low interest rates charged on the taxes that were due. Some countries require an advance payment of the tax assessed after the tax evasion is discovered even when the taxpayer contests the assessment.
12. At. 14.
13. However, appeals are not costless in terms of time, worries, and lawyers' and other fees.
14. At i.
15. At 53.

© 1994 International Bureau of Fiscal Documentation

most of the programmes have not led to a widening of the overall tax base, and many have failed to produce even very large one-time revenue gains.

III. TAX ADMINISTRATION AND TAX EVASION

The tax administration of a country plays an important role in the extent to which tax evasion prevails in that country. To the best of our knowledge the theory of the firm has not yet been applied to the activities of a tax administration.[16] But a tax administration is not very different from a firm even though it should be compared to a monopolistic firm. The tax administration has a given budget assigned to it by the state and with this budget it has the task to maximize an output, that is, tax revenue, taking into account certain important constraints. The allocation of resources within the tax administration is obviously very important for determining the output. Under optimal conditions the tax administration would not be able to increase its output by shifting resources within its various activities such as assessment, collection, auditing, etc.[17]

A. Size and targeting of administrative resources

Some of the constraints on the tax administration are imposed by tax policy, others are objectives that the tax administration needs to take into account (i.e. equitable treatment of taxpayers). How much revenue should a country allocate to the administration of taxes remains a subject that has received little attention. There is a remarkable variance among countries in both the share of resources allocated to tax administration in the national income of the country and the share of these resources in the total tax collection by the tax administration.[18] It should not be concluded that a low share of resources to either of those two denominators is necessarily good. In fact, a country that wanted to minimize collection costs would simply collect the taxes which are easiest to collect and collect them from the largest taxpayers. This behaviour would condone a lot of tax evasion and would generate tax revenue in a way that would be far from optimal. It would also conflict with other objectives of taxation such as neutrality and equity.

A tax administration should be careful to minimize not only the explicit costs borne by itself (its collection costs) but also the costs borne by the taxpayers and by the economy. These latter costs do not show up in the balance sheet of the administration and thus, often, tend to be ignored. These are essentially welfare costs, compliance costs and perhaps those that could be called "good relations" costs.

B. Welfare and compliance costs

The welfare cost per dollar collected can be defined as the excess cost to society of collecting $ 1 of tax revenue. These are the costs that have attracted the attention of economists. These costs have been estimated by various authors for the United States, such as Ballard, Shoven and Whalley (1985, 1985), Hansson (1987), and others. They have shown that the marginal dollar raised by the US tax administration may have cost the country more than $ 1.50. Usher has discussed the marginal cost of taxation in the presence of tax evasion (see Usher (1986)). Clearly, the above estimates indicate that the tax system is far from optimal. These welfare costs are often imposed by the particular tax policy followed by the country. However, attempting to make the system optimal may raise other costs such as administrative and compliance costs. These latter costs have not received much attention by economists. There is still no literature that has attempted to deal with the administrative and compliance costs of trying to pursue "optimal" tax policies.[19] However, some recent literature has been trying to assess the implications of tax evasion for optimal taxation (see Cremer and Gahvari (1993)).[20]

The compliance costs are more closely associated with the behaviour of the tax administration, and are more likely to be connected with tax evasion. These compliance costs refer to the cost to the taxpayers in terms of lost time, payments to tax accountants and lawyers, trips to the tax office and so forth, associated with a given tax payment.[21] In some countries, and for some taxes, these compliance costs can be enormous, especially if the taxpayers have to stand in line for hours and sometimes for days, and perhaps several times a year, in order to meet their tax obligations. They are also likely to be extremely high when the tax laws are so complicated that the taxpayer has to rely on experts' advice, or in the case of enterprises, has to hire experts whose only function is to comply with the tax obligations. There have been reports from Latin American countries that even relatively small enterprises sometimes have had to establish sizable tax departments to simply find their way through the jungle of fiscal laws and regulations. When this situation prevails, the tendency to begin to evade taxes is likely to rise. There must be a direct and positive relationship between the size of tax evasion and the cost of compliance. When firms create tax departments to comply with existing tax obligations, those same departments will be used to scrutinize the laws for any possible loopholes or for any ambiguity that might justify tax avoidance.

C. Public relations

Let us now turn briefly to what could be called "good relations" costs. This is essentially the public relations activity of a tax administration. This public relations activity is connected with the way in which tax administrations are organized, with the number of employees and with the use of these employees, with the level of their salaries, the quality of their working conditions and the controls that the tax administration is able to extend on the behaviour of the tax inspectors.

16. But see Goode (1981).
17. For a recent important contribution to the literature on tax administration, see Bird and Casanegra (1992).
18. See Sandford, et al. (1989).
19. However, see Slemrod (1990).
20. This literature concludes that in the presence of tax evasion some of the standard conclusions of optimal taxation do not hold.
21. Thus, the compliance cost per dollar paid can be defined as the excess cost to the taxpayer in terms of lost time, payments to lawyers and accountants, etc. of $ 1 of tax payment.

© 1994 International Bureau of Fiscal Documentation

These controls are necessary to minimize or eliminate the possibility that these inspectors, or other tax administrators, will take advantage of their positions for their own benefits.[22]

A tax administration that wants to improve taxpayer compliance and minimize tax evasion must be available to the taxpayer who needs information, forms, specific instructions and so forth. It must show courtesy toward the taxpayers since resentment on their part is likely to lead to a lower propensity to pay taxes. It must also show punctuality in sending refunds to those who have overpaid since a taxpayer who expects to wait for years to get a refund is likely to begin to underpay.

D. Use of withholding, presumptive and minimum taxes, and cross controls

Collection systems are also important for minimizing tax evasion. There is now overwhelming evidence that evasion is minimized whenever there is withholding at source. In the United States, for example, the difference in tax evasion between independent contractors, for which there is no withholding at the source, and dependent workers, whose taxes are withheld by enterprises, is enormous. The same evidence is available on taxes on interest income and dividends.

Various countries have tried to minimize evasion by resorting to minimum taxes or to presumptive methods of taxation. In the presumptive methods now in use in a large number of countries, the government tries to assign a particular income to taxpayers on the basis of their standard of living, the value of the houses in which they live, the value of the cars they drive and so forth.[23] It also tries to estimate, for example, the value added of a company on the basis of sales statistics or other criteria (employees, floor space, etc.). The minimum income tax of a company or individual can also be based on their gross assets, a system that has been introduced, for example, in Argentina and Mexico.

Tax administrations utilize various instruments of control to limit tax evasion. For example, cross controls between the information available to the tax administration, to the social security institution and to the customs administration, can play a very important role. The assignment of a taxpayer identification number which can be used in this cross control is extremely important since it facilitates the use of computers. Instruments of control which also play a role are: (1) the government's ability to access the accounts of individuals or companies in the banks; (2) detailed audits of taxpayers; and (3) reporting requirements by employers or by those who make payments.

E. Social ethics

Before leaving the section dealing with the role of the tax administration *vis-à-vis* tax evasion, it may be worthwhile to refer to another relationship, that between society at large and tax evasion. Tax evasion prospers when society condones it. In a society that does not condone tax evasion, this phenomenon will remain isolated and will concern relatively few individuals. When, however, society condones it, then the phenomenon becomes much more widespread. Citizens at large should have a responsibility in preventing tax evasion. Since tax evasion is often facilitated by the acquiescence on the part of some citizens *vis-à-vis* the tax-evading behaviour of other citizens, laws should be passed that penalize not just the tax evaders but also those who collaborate either passively or actively in the tax-evading activities of other individuals. For example, in many countries, the tax evasion of professionals, such as doctors or of independent contractors, is facilitated by requests to their customers on the part of these individuals that payments should be made in cash or by the acceptance, on the part of those who buy the services, of invoices given by these professionals which underestimate the payment. Also the examples provided by those who govern are very important. When those who govern themselves engage in tax evasion or similar activities, they send an unmistakable signal that non-compliance with the law is acceptable.

F. Penalties

As can be anticipated from the preceding discussions, the severity of the penalties would have some impact on the extent and spread of tax evasion. Taxes may be paid in arrears without the intention to evade them especially if the interest charges are low. Usually, interest charges and pecuniary penalties are applied to any tax in arrears which does not reflect tax-evading motivation. Tax evasion or fraud, however, is a more serious matter and, at least in the tax laws, carries much heavier sanctions against it.

1. Interest on and penalties for tax arrears

Usually, the amount of interest charged on taxes paid in arrears is calculated in one of two ways: (1) either fixed percentage points above some key central bank rate or above the average of bank rates; or (2) a specified percentage per month of amount due in taxes up to a maximum amount. In some countries, additional surcharges are also applied.

Penalties on taxes paid in arrears vary depending on whether the cause is late filing of returns, failure to file returns at all or filing incorrect returns. In the case of taxes withheld at source, penalties depend on the type of infraction. For example, penalties differ depending on whether the correct amount has been withheld or whether the amount withheld has been surrendered to the tax authorities. In all cases, repeated offenses or offenses not corrected or admitted within a specified time period are subject to higher penalties. Sanctions are often in the form of a percentage of the tax due and range between 25 and 100 percent; several countries also charge penalties fixed in nominal terms.

22. Anecdotal reports have referred to countries where some key posts in the tax administration have been in high demand by those who took civil service exams or have even been "sold" to the highest bidders. Obviously these posts provided possibilities of high "incomes".
23. Italy has been, perhaps, the most imaginative in the use of presumptive taxes in recent years.

© 1994 International Bureau of Fiscal Documentation

2. Sanctions for evasion or fraud

Sanctions for tax evasion and tax fraud are much more severe with higher penalties (up to 15 times the amount of the defrauded amount), possible closure of establishments for a specified time period, and/or jail sentences ranging from a few months to several years. Giving the tax administration the power to close establishments for a few days without the possibility of appeal has been an effective deterrent to tax evasion in Argentina and in other Latin American countries.

IV. CONCLUDING REMARKS

This paper has surveyed the factors that give rise to tax evasion as well as its ramifications. Tax evasion varies by sector (agriculture, industry, commerce), organization of production (small trader or business, companies) or type of economic agent (salaried, self-employed, capital owner). It is also affected by social ethics and the standards set by those that govern. Given those standards, it is further affected by the attitude toward risk of a potential taxpayer.

Tax evasion affects the horizontal and vertical equity of a tax system, as well as the efficiency of the free market in general and of its tax system in particular. It certainly affects the revenue productivity of the tax system. Unchecked or deficiently controlled tax evasion builds cynicism about the role of the public sector. It tends to complicate the tax structure as legislators begin to anticipate tax evasion through the tax legislation. The use of effective and quickly applied penalties to counter tax evasion has an impact on its extent and spread. However, their application does not necessarily imply even a second-best solution for the correction of inequities or for the efficiency of the competitive mechanism if many tax evaders do not get caught and remain unaffected by penalties.[24]

The theoretical foundation for modelling tax evasion remains somewhat wanting. It is really too simple to be of much practical use. The theory relates the taxpayer's behaviour toward tax compliance to his attitude toward risk, while ignoring other factors that influence tax evasion. The theory assumes that taxpayers know precisely the probability of being caught and the consequences of such an event; however, tax administrators often keep this information confidential and the consequences of being caught may not be fully predictable.

Estimates of tax evasion of income and consumption taxes have been selectively reported in the published literature for many countries. More information of a confidential nature exists as a result of exercises carried out by tax authorities or in the context of technical assistance by international organizations. The methodologies utilized leave much to be desired because of lack of data but, more importantly, because of what the data are able to capture. The data may only partially capture the effects of tax evasion while including the effects of other leakages (e.g. legitimately used tax incentives or deductions whose total effect may be difficult to remove). Thus, it would not be prudent to base economic policy solely on the results that emerge from these estimations.

Given their limitations, methods of estimation include the matching of information from tax declarations with either national accounts data or survey (or sample) data blown up to population levels. Because of the lack of reliability of surveys (e.g. respondents may not reveal the truth regarding tax evasion even in surveys) and because of their cost, the national accounts approach is more commonly used. If the objective is to estimate evasion of the VAT, however, a national input-output framework has to be utilized because of the VAT's method of collection at different stages of production, some of which may be exempted from the VAT base. An indirect way of estimating tax evasion has been to estimate the extent of the underground economy and, once that has been done, to estimate the taxes that should have been paid. It appears from the published literature that perhaps a third of potential tax revenue may be evaded in selected Latin American and in some Mediterranean countries. Some estimates would indicate even higher percentages. These estimates, however, must be taken with a grain of salt since they would at times imply very high tax burdens in the absence of tax evasion.

If tax evasion is so high, the role of tax administration becomes doubly important. The size of tax administration resources, the main target groups (large enterprises or all taxpayers), the efficiency with which the resources are utilized (collection costs), the ease with which taxpayers can pay taxes (compliance costs), the relation between the tax administration and the taxpayer (good public relations rather than the spreading of fear) and the methods of tax collection (withholding, presumptive taxes, minimum taxes and cross controls) all play a role in determining the level and lowering of tax evasion.

Finally, one interesting aspect of the evasion phenomenon is that it has a counterpart on the expenditure side of the budget but the counterpart has not as yet received the attention that tax evasion is receiving today.[25] While tax evasion is the non-payment of taxes duly owed to the government, the equivalent phenomenon on the expenditure side is the abusive receipt of government payments. In a way, one finds a parallel in a comparison between indirect taxes and consumer subsidies, one being the negative of the other. Activities connected with the illegal receipt of government expenditures may be those associated with corruption. For example, the receipt of a percentage of government contracts; the receipt of pensions not deserved, for example, by claiming disability when one is not disabled; the payment of wages to so-called "ghost workers", a phenomenon common in several developing countries; the taking of leave on the basis of fictitious illnesses; and so forth. This is the other side of the coin of tax evasion; the government loses when taxes are not paid, but it also loses when payments that should not have been made are made. Economic theory and the law should treat the two phenomena in the same way and economists should pay the same attention to both.

24. In fact, the theoretically advocated and practically followed procedure of selecting taxpayers through audits to detect tax evaders raises serious questions of equity when many other tax evaders remain undetected and unpunished.
25. For some discussion of this issue, see Chapter 8 of Smith (1986).

© 1994 International Bureau of Fiscal Documentation

APPENDIX

Estimating Tax Evasion

In recent years, many scholars and governments have attempted to measure the size of tax evasion in particular countries, either for specific taxes or for the whole tax system. The measurement of tax evasion is obviously fraught with difficulties. Many of these difficulties have to do with the fact that the information available is, by its very nature, limited and often unreliable. However, there is a more philosophical difficulty often not acknowledged – namely, the problem that the *statutory* tax system that exists in a country that has a lot of tax evasion has been "contaminated" or influenced by the existence of the tax evasion. In other words, it is not the system that would exist in the absence of tax evasion: statutory rates have often been increased to compensate for the revenue losses associated with tax evasion.[26] But if this is true, then when one uses the current statutory rates to measure tax evasion, one exaggerates the size of the evasion, since the rates would have been lower if the evasion had not been there.

Various methods have been used to measure tax evasion. Some of these try to measure it directly, some indirectly. Among the direct methods one can identify: (1) the use of the national accounts; (2) the use of direct controls; (3) the use of household budget surveys; and (4) direct surveys of taxpayer behaviour. The indirect methods are largely related to estimates of the underground economy. Once the size of the underground economy has been measured, the extent to which the existence of the underground economy has implied tax revenue losses to the government must be assessed. In other words, undeclared income or some other unreported tax base must first be measured. Subsequently, an estimation of the unpaid tax must be made.

1. National accounts method

Perhaps the commonest and most often used method for assessing the size of tax evasion is by comparing the estimate of the base of a particular tax made by the national accounts authorities and the base as reported to the tax authorities after making appropriate adjustments. An early study that attempted this technique for several industrial countries was Tanzi's (1969). A similar one for Argentine data was by Herschel (1978). The Internal Revenue Service of the United States has been following this approach routinely for the income tax; various other authorities have used it for measuring the base of the VAT and other taxes. Given that the VAT is collected at various stages of production, a careful use of information based on a sectoral input-output table would also be necessary. This was initiated by Aguirre and Shome (1988) for the case of Mexico, who developed a methodology for constructing the VAT base on a sectoral basis while allowing for differential tax rates for the VAT. It was applied by Serra (1991) for Chile, and clarified by Mackenzie (1993) on methodological issues. It has since been attempted in various unpublished technical assistance studies by IMF staff, and is being used by technical units in the Ministries of Finance, for example, in many Latin American countries.

The difference between the base as reported to the tax authorities and the base as estimated by the national accounts authorities gives an indication of unreported income. If the tax is a fully proportional one, then this unreported income automatically and directly provides an estimation of the unpaid tax. If the tax is progressive, as would be the case with income taxes, then the estimation of the unpaid tax becomes more complex since one would have to make assumptions about the effective tax rate at which the unreported tax base would have been taxed. In other words, the unreported income must be allocated among the tax brackets. It would also be necessary to reinstate, into the information based on data from income tax declarations, the various exemptions and deductions at the different tax brackets in order to make that data comparable to the national accounts data.

(a) *Individual income tax*

In the context of the individual income tax an actual framework, for *non-wage earners*, may be described as follows. To the declared personal income, adjustments should be made for those components of income that are included in the concept of income in the national accounts but are deductible for tax purposes.[27] These include personal exemptions, deductions, investment allowances and other deductible direct taxes paid. The adjustments need to be made for individual tax brackets if the tax structure is progressive. The result of the exercise would be a series for gross taxable, declared income (by income class). A comparison with gross, taxable income from the national accounts would yield an estimate of undeclared non-wage income.

Tax evasion among wage earners is often limited because of withholding at source and also because wages are an important cost to the enterprises. To claim this cost they need to report the wages paid. However, contrary to the obvious, there may also be some difficulties in estimating tax evasion by *wage earners*. Information on tax withheld by employers may not be readily available since this is not the form in which wage income is usually declared for tax purposes. It may be even more difficult to obtain this kind of information by bracket or by sector. Small- and medium-sized firms that do not pay profits taxes would also tend to under-report tax withheld on wage income or may actually withhold less than that required by law. However, the overall revenue loss from this source should not be significant due to the small firm size. In general, estimates of tax evasion from wage earnings would be attempted through sampling techniques.

(b) *Corporate income tax*

Similar techniques as used in the case of the individual income tax may be applied to the *corporate income tax*, adjusted for the kinds of deductions and incentives that apply

26. This point was clearly recognized by Luigi Einaudi, the prominent public finance scholar who became President of Italy. Once he remarked that if all the Italian tax laws on the books were fully enforced, the Italian level of taxation would be 120 percent of national income.

27. The reverse is also true for capital gains which may be in the concept of taxable income but are not in the national accounts.

© 1994 International Bureau of Fiscal Documentation

specifically to the corporate sector. The task is not easy, however, since over and above the kind of problems discussed for the individual income tax, corporate sector tax incentives would have to be accounted for. These can be used legitimately or otherwise, making the task of adjustment difficult. One redeeming feature in the case of corporate income tax evasion is that the corporate form of business in developing countries is often primarily confined to large and/or easily identifiable firms which are under more conscious scrutiny of the tax authorities. It is common in developing countries for tax administrations to establish special units to control large taxpayers which are mainly big – and often foreign – corporations.

(c) *VAT*

The VAT has emerged as the most important revenue earner in many countries and attempts to estimate its evasion have become relatively commonplace over the last few years. The widest VAT base is all purchasable goods in the economy, that is, GDP plus imports minus exports. Thus, again, the starting point is the national accounts. However, the estimate can be made either from the expenditure side or from the supply/production side.

The expenditure side method could be summarized as follows. To total domestic expenditure (including imports), add net private expenditure from abroad, subtract non-taxed expenditure (typically, government expenditure on wages and salaries, fixed capital formation – except private expenditure on new houses – and change in inventories), to obtain taxable expenditure. Adjust for taxes on expenditure, to obtain adjusted taxable expenditure. Further, subtract exempted expenditures (typically, the financial sector, non-profit and social organizations, small businesses below a legally defined threshold and gross rents paid) but add back taxable inputs and capital purchases of exempt sectors, to obtain the potential VAT base.

The VAT base calculation from the production side is quite similar, except that zero-rated exports have to be subtracted and imports added.[28] It is more convenient to use the production side method whenever the VAT contains many exemptions by economic sectors rather than by products for final consumption. Sectoral data are more amenable to production side estimates, while exemptions specified for particular products would be more amenable to expenditure side estimates. Further, given the nature of the VAT, that is, collection based on stages of production, sectoral data are again more amenable to base calculations.

Using the above-mentioned methodologies, IMF staff have made some interesting inferences regarding the relationship between the VAT rate and the ratio of VAT revenue to GDP. For example, Table 1 introduces the concept of "revenue productivity ratio – the amount of revenue raised per point of the VAT rate". The last column of Table 1 indicates that the average amount of revenue per point of the VAT rate is 0.37 percent of GDP for 22 countries in the sample. A country whose ratio approaches 0.5 percent could be said to be performing at a high VAT effort.

Some economists have sharply criticized the national accounts approach on the grounds that if tax evasion is significant, the national accounts are also likely to be underestimated. Therefore, the calculation described above may become meaningless. However, these economists have failed to realize that often the information that the national accounts offices receive from the tax authorities contributes very little to the estimation of the national accounts since the national accounts authorities often rely on other methods for measuring production. For example, the agricultural sector's income is often under-reported to the tax authorities because of tax evasion. However, the estimations for the national accounts are made on the basis of sampling or surveys of directly observed average productivity per acre and the average prices at which the crops are sold.[29]

2. Sampling method

The second method of estimation, *the tax compliance measurement method*, has been used largely by the United States. In this method, a random sample of about 55,000 taxpayers is selected from data available to the IRS and to the social security administration. This sample is subject to close scrutiny in order to detect tax evasion for the taxpayers chosen.[30] The average tax evasion for the sample is then blown up to provide results for the whole population. The results, called *the gross gap, or the tax gap*, represent the unpaid income taxes on legally earned individual and corporate income. For 1987, the last year for which this information has been published, the tax gap amounted to $ 85 billion of which $ 63.5 billion was tax evasion of individuals, $ 21.4 billion was tax evasion of corporations, and $ 1.1 billion was tax evasion by non-filers. Those who generate the data have expressed scepticism that this money could actually be collected.

3. Budget survey method

The third direct method relies on *household budget surveys*. These surveys show the relationship between the spending of families and the income declared. A family that earns its declared income and spends much more than that income can be expected to have engaged in tax evasion unless other factors, such as accumulated wealth or borrowing against future income, account for these differences. The results from this method are not very reliable and they can only provide a gross order of magnitude. The rationale behind this method has been used by the Italian authorities in the development of the *redditometro*, an index that established a minimum taxable income for taxpayers on the basis of external indices of wealth such as expensive cars, second houses, etc.

28. In the expenditure side method, exports are already excluded from the domestic expenditure base.
29. For a discussion of this point, see the paper by Reuter in Tanzi (1982).
30. See Internal Revenue Service (1979). This method is different from that outlined for estimating evasion by wage earners in the previous section. The sampling method that is being described here is based on a sample selected for special scrutiny on a continuing basis, and is used in lieu of the national accounts method.

© 1994 International Bureau of Fiscal Documentation

Table 1. Value-Added Tax Data Series, 1988
(Countries with single rate VATs)

Country	Actual VAT Revenue: GDP Ratio	VAT Rate	Revenue Productivity Ratio
Bolivia	2.6	10.0	0.26
Chile	8.8	16.0	0.55
Costa Rica	3.8	10.0	0.38
Denmark	9.5	22.0	0.43
Dominican Rep.	1.6	6.0	0.27
Ecuador	2.5	10.0	0.25
Finland	8.4	19.1	0.44
Grenada	4.5	6.0	0.75
Guatemala	2.4	7.0	0.34
Guinea	0.6	13.6	0.05
Haiti	1.8	10.0	0.18
Indonesia	4.5	10.0	0.45
Israel	9.8	15.0	0.65
Korea	3.3	10.0	0.33
Madagascar	1.5	15.0	0.10
Mauritius	2.1	5.0	0.41
New Zealand	6.7	12.5	0.54
Norway	9.4	20.0	0.47
Panama	1.1	5.0	0.22
Peru	2.0	13.0	0.15
Taiwan	2.6	5.0	0.52
United Kingdom	6.0	15.0	0.40
Average	4.3	11.6	0.37

Source: Carlos Silvani, unpublished memorandum, Fiscal Affairs Department, IMF, September 1992.

4. Direct taxpayer survey

A few countries, especially Nordic countries such as Sweden and Norway, have used *direct surveys of taxpayers*. A random sample of taxpayers is chosen and, among other questions, they are asked to describe their tax reporting behaviour.[31] This approach has been subjected to several criticisms which range from whether individuals remember how they behaved as taxpayers in years past, to whether an individual would be willing to convey accurate information about an activity which may be considered anti-social even when he/she is assured anonymity. The common belief is that tax evasion is often under-estimated by these surveys even when they try to guarantee anonymity for the taxpayers.

5. Indirect methods

Indirect methods essentially relate to the quantification of the so-called underground economy, which has been attempted for various countries. The connections between this quantification and the size of the tax evasion are often ambiguous and difficult to establish, especially when taxes are progressive. For example, if those who participate in the underground economy are mostly people with very low incomes who would have paid very little taxes, then the existence of an underground economy may not imply the existence of significant tax evasion.

There is often a lot of confusion in the way people define the underground economy. In some cases, people refer to taxes not paid, in other cases they refer to the alleged under-estimation of the national accounts, and often they do not specify which of these two definitions they have in mind. The problem is that, in many cases, one could have tax evasion without under-estimation of the national accounts, or little or no tax evasion with under-estimation of the national accounts. A further confusion comes from the fact that the attempt to evade taxes is not the only cause for the existence of the underground economy, since corruption, regulations and various forms of prohibitions, are also important factors. Despite these questions, as already indicated, the underground economy is often taken as a proxy for tax evasion.

Discussion of the various methods used for the measurement of the underground economy would require extensive elaboration. Perhaps it would suffice just to mention the methods used.[32] The first method is the so-called *expenditure and income discrepancy method*, which assumes that the incomes which are hidden will show up as expenditures, so that the difference between national accounts measured from income flows and national accounts measured from consumption flows can give an indication of the size of the underground economy. This method was first applied to the United Kingdom. A second method is the *employment census method*, which tries to compare measured unemployment with the probable participation rate for the population in certain age classes. This method has been applied to Italy, Spain and some other countries. Third is the *physical input method*, which is based on the idea that there is a predictable relationship between the use of some inputs, such as electricity, and the value of the output. Finally, there are various versions of the so-called *monetary approach*, an approach that associates evasion with currency or money holding. This monetary approach, developed in various forms by Guttman (1977), Feige (1979) and Tanzi (1980), has been widely used in a large number of countries to estimate the size of the underground economy.[33] All of the above approaches have problems. It would, therefore, be prudent not to base economic policy, or even estimates of tax evasion, solely on the results that emerge from these estimations.

To conclude, there are many methods that have been used to estimate tax evasion. In recent years, IMF technical assistance missions have routinely calculated the potential yield of selected taxes using some variant of the national accounts method. Unfortunately, these results cannot be provided because of the confidentiality of the reports.

REFERENCES

Aguirre, C.A., and Shome, P., "The Mexican Value-Added Tax: Methodology for Calculating the Base," *National Tax Journal*, Vol. XLI, No. 4 (December 1988), pp. 543-54.

31. See paper on Norway, by Isachsen, Klovland, and Strom, and paper on Sweden by Hansson in Tanzi (1982).
32. These methods are discussed in Tanzi (1982).
33. Tanzi used this method to first estimate the size of the underground economy in the United States and then to estimate tax evasion (1980 and 1983).

© 1994 International Bureau of Fiscal Documentation

Allingham, M.G., and Sandmo, A., "Income Tax Evasion: A Theoretical Analysis," *Journal of Public Economics*, Vol. 1, No. 3/4 (November 1972), pp. 323-38.

Ballard, C.L., Shoven, J.B. and Whalley, J., "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," *National Tax Journal* (June 1985), pp. 125-40.

_____, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review* (March 1985), pp. 128-38.

Banerji, A., "Tax Evasion, Enforcement, and Intertemporal Choice," *Proceedings*, 1991 National Tax Association Conference, Williamsburg (1991), pp. 90-100.

Becker, G., "Crime and Punishment: An Economic Approach," *Journal of Political Economy*, Vol. 76, No. 2, 1968, pp. 169-217.

Bird, R., and Casanegra de Jantscher, M., eds., *Improving Tax Administration in Developing Countries*, (Washington: International Monetary Fund, 1992).

Cowell, F.A., *Cheating the Government: The Economics of Evasion* (Cambridge: M.I.T. Press, 1990).

Cremer, H. and Gahvari, F., " Tax Evasion and Optimal Commodity Taxation," *Journal of Public Economics*, 50 (1993), pp. 261-75.

Dunn, D., "Tax Compliance with Untaxed Fringe Benefits: Evidence from Mexico" (unpublished, International Monetary Fund, 1992).

Feige, E.L., "How Big is the Irregular Economy," *Challenge*, Vol. 22 (November/December 1979), pp. 5-13.

Goode, R., *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1964).

_____, "Some Economic Aspects of Tax Administration," *IMF Staff Papers*, Vol. 28 (1981), pp. 249-74.

Guttman, P.M., "Subterranean Economy," *Financial Analysts Journal*, Vol. 33 (November/December 1977), pp. 26-27, 34.

Hansson, I., "The Welfare Costs of Deficit Finance," *Economic Inquiry* (July 1987), pp. 479-96.

Internal Revenue Service, *Estimates of Income Unreported on Individual Income Tax Returns* (Washington, D.C.: Government Printing Office, September 1979).

Mackenzie, G.A., "Estimating the Base of the Value-Added Tax (VAT) in Developing Countries: The Problem of Exemptions", *Public Finance* (forthcoming, 1993).

Musgrave, R., *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw Hill, 1959).

Pechman, J.A., *Federal Tax Policy* (Washington, D.C.: The Brookings Institution, 1966).

Richupan, S., "Determinants of Income Tax Evasion: Role of Tax Rates, Shape of Tax Schedule, and Other Factors," in *Supply-Side Tax Policy: Its Relevance to Developing Countries*, ed. V.P. Gandhi (Washington, D.C.: International Monetary Fund, 1987).

Sandford, C.T., Godwin, M. and Hardwick, P., *Administrative and Compliance Costs of Taxation* (Bath, England: Fiscal Publishers, 1989).

Serra, P., "Estimación de la Evasión Tributaria en el Impuesto al Valor Agregado," Servicio de Impuestos Internos, Publicación No. 91/05/C, Universidad de Chile, August 1991.

Sisson, C.A., "Tax Evasion: A Survey of Major Determinants and Policy Instruments of Control," IMF Departmental Memorandum, DM/81/95 (1981).

Slemrod, J., "Optimal Tax Systems," *Journal of Economic Perspectives*, Vol. 4 (Winter 1990), pp. 157-78.

Smith, S., *Britain's Shadow Economy* (Oxford: Clarendon Press, 1986).

Stella, P., "An Economic Analysis of Tax Amnesties," IMF Working Paper, WP/89/42 (1989).

Tanzi, V., *The Individual Income Tax and Economic Growth* (Baltimore: The Johns Hopkins University Press, 1969). A Japanese edition is also available.

_____, "The Underground Economy in the United States: Estimates and Implications," Banca Nazionale del Lavoro, *Quarterly Review*, No. 135 (December 1980), pp. 427-53.

_____, *The Underground Economy in the United States and Abroad* (Massachusetts: Lexington, 1982).

_____, "The Underground Economy in the United States: Annual Estimates, 1930-80," *Staff Papers*, International Monetary Fund (Washington), Vol. 30 (June 1983), pp. 283-305.

Uchitelle, E., "The Effectiveness of Tax Amnesty Programs in Selected Countries", *Quarterly Review*, Federal Reserve Bank of New York, Vol. 14, No. 3 (1989), pp. 48-53.

Usher, D., "Tax Evasion and the Marginal Cost of Public Funds", *Economic Inquiry*, No. 24 (1986), pp. 563-86.

US Department of the Treasury, Internal Revenue Service, *Report on the Application and Administration of Section 482*, Washington, D.C., April 1992.

Webley, P., Robben, H., Elffers, H. and Hessing, D., *Tax Evasion: An Experimental Approach* (Cambridge: Cambridge University Press, 1991).

© 1994 International Bureau of Fiscal Documentation

RUSSIA

RESULTS OF INITIAL IMPLEMENTATION OF TAX REFORM

Dr Elena Markina

Dr Elena Markina is a lecturer, State Financial Academy (Moscow), currently working in the Tax Department, Faculty of Law, University of Groningen, the Netherlands.

This research was sponsored by the Foundation for Law and Public Administration (REOB), which is a part of the Netherlands Organization for Scientific Research (NWO).

I. INTRODUCTION

Transition to a free market economy required radical changes in the Russian tax system as the system used under the centrally planned economy discouraged the transformation process. A package of new tax laws was adopted by the Russian Parliament in 1992. These laws completely abolished the former tax legislation.

The tax legislation of Western countries has been used as a model in designing the new tax system. However, none of the Western systems was fully copied, as the economic circumstances of the transitional period in Russia, under which tax reform is being implemented, are very specific and differ from the circumstances in Western countries (and even from those in other Central and Eastern European countries). These economic circumstances include not only an increasing budget deficit, monetary expansion and growing inflation, but also continuing decreases in production, shortages and disintegration of distribution.

Under these conditions of instability and economic crisis the state tries to maintain a certain control over money supply, using various means, including taxation, to limit the expenditure on consumption, to restrain the inflationary process and to encourage the rational use of limited natural resources. Specific tax measures have been adopted to achieve these goals. Therefore only main principles of taxation in Western countries have been implemented in the new Russian tax legislation. However, peculiarities of the present legislation, caused by the features of the transitional period, should be gradually abolished in line with further moves towards a market economy.

This article concentrates on three main issues. It describes the basic characteristics of the new Russian tax system and analyses its advantages compared with the previous system. It then analyses the first results of the initial tax reform and subsequent amendments in tax legislation according to the present economic situation. Finally, the possibility of bringing the Russian tax system in line with the Western model will be discussed.

II. BASIC CHARACTERISTICS OF THE NEW RUSSIAN TAX SYSTEM

A. Structure of the present system

In 1992 – for the first time in the history of taxation in Russia – a tax system was created. Until this time taxes (which were taxes in name only), and numerous compulsory contributions to the budget were levied on the basis of instructions of the Ministry of Finance and Decrees of the former USSR Government.

A package of new tax laws provides the main types of taxes, which are similar to taxes used in Western countries. The Act "Concerning the basic principles of the tax system in the Russian Federation" contains definitions of tax, tax system and taxpayers, the objects of taxation (in general),[1] and the rights and liabilities of taxpayers and the tax administration. The kinds of taxes to be levied at federal, republic and local (such as regional, municipal, district, etc.) levels are set out in this Act.

The most significant taxes levied are the following:
- Tax on profits of enterprises and organizations
- Tax on income of banks
- Tax on income from insurance activities
- Individual income tax
- Value added tax
- Excise duties
- Property tax on individuals
- Property tax on enterprises
- Inheritance and gift tax
- Tax on security transactions
- Land tax
- Tax on the use of natural resources
- Tax on the use of forestry resources
- Payments for use of water resources by industrial enterprises
- Registration duty on individuals starting a business activity
- State duty
- Customs duty

In addition, local government authorities may levy certain types of local taxes, defined in the federal Act, including tax on trading activity (in the form of patent), clean street tax, duty on dog owners, parking duty, etc. A detailed description of each tax is beyond the scope of this article, but a brief

1. The object of each tax and the definition of taxable base are given in the relevant tax law (profit tax law, individual income tax law, etc.).

© 1994 International Bureau of Fiscal Documentation

explanation is given of those taxes which are usually not levied in Western European tax systems.

Tax on profits of enterprises and organizations, having much in common with the corporation tax, is levied on taxable profits of legal entities.[2] In 1992 and 1993 banks and legal entities carrying on insurance activities were not subject to the tax on profits, but were subject to specific taxes on income. The main distinction in the definition of taxable profits was whether wages and salaries are deductible or non-deductible items in achieving the object of the tax. Banks and legal entities carrying on insurance activities were not entitled to deduct wages and salaries in calculating the tax base, whereas for all other legal entities this deduction was allowed (although restricted by a normative amount based on four times the minimum monthly wage fixed by law). Therefore the tax rate on the income of banks and from insurance activities was lower, i.e. 30[3] and 25 percent,[4] respectively, whereas for other legal entities it was 32 percent.[5] From 1 January 1994,[6] the taxation of banks and insurance organizations became the same as for other legal entities. Taxable profits and the rate of tax on profits (i.e. 32 percent) is now the same for all legal entities. Under this Decree the normative deductible amount of wages and salaries has been increased from four to six times the minimum monthly wage per employee. There is no separate dividend tax in the Russian tax system, but a tax on dividends is provided by the Act concerning the tax on profits of enterprises and organizations. Legal entities paying dividends must withhold the dividend tax at a rate of 15 percent.[7]

Individual income tax is imposed on the annual aggregate income of individuals derived from different sources at progressive rates (ranging from 12 to 30 percent). The system of taxation on individuals is similar to that used in Western countries. Only one variation should be pointed out: under the Individual Income Tax Act, the procedure for tax calculation and the terms of payment depend on the sources of income (income from employment and business income), although equal rates are used for income derived from these sources. Tax on income from employment is similar to wage tax, as applied by Western European tax systems. This tax is withheld monthly by the employer and is transferred to the tax administration. If the individual has only one place of employment and one source of income, the income tax is final, and the employee is not obliged to file an income tax declaration. In all other cases, the taxpayer must file an income tax return and will have to pay tax upon receipt of an assessment.

Property tax on enterprises is imposed on all legal entities, except social institutions and municipal organizations (non-profit organizations receiving subsidies from the State) at a flat rate of 2 percent of the book value of the enterprise's property.

Tax on security transactions is charged on the issue of securities (in the form of a registration duty) and on the purchase and sale of securities.

Land tax is paid by both the owners and users of land; thus an owner-occupier pays under both heads. The taxpayer may be a legal entity or an individual.

Payments for the use of different kinds of natural resources, such as gas, oil, mineral ore (on extraction); payment for the felling of wood and charges for use of water are levied on legal entities.

Registration duty is levied only upon registration of individuals starting a business (not in the form of a legal entity). The rate is fixed by the local government, but may not exceed the amount fixed by the federal tax law.

State duty is paid for the services of courts, notary offices and executive bodies.

Customs duty is paid by either legal entities or individuals upon the importation of goods. Customs duty is levied as a percentage of the import value.

B. Classification of taxes levied at different governmental levels

Taxes levied in the territory of the Russian Federation are distinguished as:

- federal taxes;
- taxes levied by autonomous republics within the Russian Federation; and
- local taxes levied by territories, regions, municipalities, etc.

Property tax on enterprises, tax on the use of forestry resources and payments for the use of water are levied by a member of the Russian Federation. Property tax on individuals, land tax and registration duty on individuals starting a business are levied by the local authorities. All other taxes are levied by the Federation. The existing budget regulation system, however, provides for a partial redistribution of these tax receipts to separate budgets. Part of the main federal taxes is being passed to the republic and local budgets in order to strengthen their revenue basis. For example, in 1992 100 percent of revenue from income tax on individuals, 20 percent of revenue from value added tax, and 50 percent of revenues from certain excises[8] had to be passed to the republic and local budgets. The appropriate percentage of the various federal taxes to be passed to the different governmental levels is determined annually in the adoption of the budget for the next year. The amount of federal taxes to be passed to the local budgets is defined as the difference between proposed public expenditure and local taxes to be levied during the

2. According to Russian legislation legal entities for tax purposes are state enterprises and organizations, corporations, joint stock companies, limited liability companies and limited partnerships.
3. The Act of the Russian Federation of 12 December 1991 "Concerning taxation of banks' income", Art. 5.
4. The Act of the Russian Federation of 13 December 1991 "Concerning taxation of income from insurance activities", Art. 4.
5. The Act of the Russian Federation of 27 December 1991 "Concerning tax on profits of enterprises and organizations", Art. 5.
6. President's Decree of the Russian Federation No. 2270 of 22 December 1993 "Concerning some changes in the taxation and interrelations between the budgets of the different levels", Art. 1.
7. The Act of the Russian Federation of 27 December 1991 "Concerning tax on profits of enterprises and organizations", Art. 10.
8. The Act of the Russian Federation "Concerning the budget system of the Russian Federation in 1992", Art. 4.

© 1994 International Bureau of Fiscal Documentation

next financial year. The reason for this distribution system is that the greater part of public expenditure, especially social expenses (such as public health, education, pensions, etc.) is incurred at the local level and these expenses cannot be covered by local taxes alone.

C. Advantages of the new tax legislation

The tax system prior to 1992 was incompatible with a system of a market-oriented economy. This explains the attempt to introduce a new tax system more in line with that of developed countries. The following main features distinguish the new tax system from the former one.

First, the arbitrariness of the former system has been removed. Numerous compulsory payments by enterprises (including the payment on fixed and working capital,[9] rent payments,[10] payments on the unused part of the depreciation fund,[11] etc.) have been replaced by a single tax on profits. These compulsory payments were the result of negotiations between enterprises and local organs of the Ministry of Finance on the basis of a financial plan, which was worked out by every enterprise for the next financial year. This financial document consisted of four parts: revenues; expenses; loans and interest payments; and compulsory payments for the budget and subsidies. On the basis of an analysis of the financial plans two main aims were pursued: ensuring that the financial needs of the state were met and that all necessary expenses of the enterprises were covered. As a result of such negotiations, the tax rate and the planned amount of compulsory payments were established. Under such a system, including changes of tax rates from year to year, enterprises have no incentive to raise their revenues. Increasing income led in most cases to larger payments having to be made to the budget in the following financial year, while the amount at the disposal of the enterprise was not being increased at all. The arbitrariness of these tax obligations must be imputed to the absence of tax laws in the USSR at that time. Tax liabilities were defined by the numerous instructions of the USSR Ministry of Finance which provided the typical definitions of taxable profits, depending on the branch of industry concerned. In a market economy one of the main tasks of the tax system is to establish an equitable treatment based on explicit tax laws. Under the present new Russian legislation, tax treatment no longer depends on the type of enterprise, property form, kind of industry or sector of the economy.

Secondly, tax rates have been unified for enterprises. In the former planned economy the applicable tax rates differed from sector to sector. Furthermore, the rates were differentiated not only by ministries for the different industries,[12] but also between the various enterprises under the supervision of each ministry. More efficient enterprises were taxed at a higher rate in order to subsidize the less efficient and even loss-making enterprises. The tax system provided for various allowances and subsidies for the producers of certain kinds of production and services (e.g. food, children's clothes and shoes, etc.). Now the differentiation of tax rates between ministries has been abolished and the number of tax rates and tax allowances has been reduced considerably.

In the former planned economy, individual taxation was based on schedular taxes, whereby each source of income was subject to a separate rate schedule, and generally to a separate set of tax allowances. Steeply progressive tax rates were applied to certain groups of the population employed in the private sector (doctors, lawyers, etc.) and to certain professions (authors, writers, artists, etc.). For other groups of taxpayers a relatively low flat rate was applied. This schedular system has been replaced by a synthetic income tax system under which different sources of income are aggregated. The total income is subject to a single progressive rate schedule. Tax liabilities of all categories of taxpayers have been put on an equal basis.

Thirdly, the new tax legislation contains provisions, designed to raise funds, aiming at macroeconomic stability, and at the same time to influence economic development. Many incentives have been introduced to promote investment, modernization, reconstruction and infrastructure development, ecologic protection measures, etc., which will be described in detail below.

Finally, an attempt has been made to solve the problems of revenue distribution between the central and local government. The problem of fiscal decentralization is especially acute for Russia, which has a complex federal state system.[13] The new legislation provides that federal government and republic taxes are being shared between the federal, the republics and the local governments. At the same time local governments are entitled to raise their own revenue by levying local taxes. A clear distinction between state and local

9. This payment was imposed on the average annual fixed assets and working capital of enterprises and other legal entities (in percentage) in order to ensure a better use of machinery and equipment and to prevent the accumulation of unused fixed assets and inventory.

10. Rent payments were made by the enterprises of different branches of mining industries, having more favourable conditions of exploitation of coalfields or oilfields, for instance.

11. Part of the depreciation fund, which according to the financial plan of enterprises exceeded the planned amount needed for repair of the equipment or its renewal, was transferred to the state budget.

12. Under a centrally-planned economy the management of the economy was accomplished through the ministries of the different branches of the economy. The state enterprises and organizations were subordinated to a particular Ministry, created on the basis of the classification of the branches of the national economy (e.g. Ministry of the gas and oil industry, Ministry of the chemical industry, Ministry of machine-building, Ministry of trade, Ministry of education, etc.).

Each ministry fulfilled the following main functions:

- planned the output of the main kinds of production needed by society and the financial resources through the adoption of financial plans, worked out by every enterprise;
- organized the continual supply of raw materials to the enterprises under its supervision and promote the sale of their production;
- controlled the fulfilment of the financial plans.

During the process of planning the ministry also redistributed financial resources between enterprises. The main instrument of such redistribution was compulsory payments to the budget. The Ministry of Finance fixed certain rates of the tax on profits for the relevant Ministry. But the latter was given the right to differentiate this rate between enterprises in order to provide for a certain level of profitability for each enterprise.

13. According to the Constitution of the Russian Federation (Art. 65) the Russian Federation includes: 21 autonomous republics, 6 territories, 49 regions, 2 federal cities, 1 autonomous region and 10 autonomous districts. Furthermore, there are thousands of districts, towns and villages. The population of the Russian Federation is 148.3 million.

© 1994 International Bureau of Fiscal Documentation

taxes has been made, and the tax law now contains direct instructions, specifying to which budget (federal, republic or local) these taxes should be allocated.

III. TRENDS IN THE ADAPTATION OF THE INITIAL TAX LEGISLATION TO THE PRESENT ECONOMIC SITUATION

A. Main economic factors constraining the tax reform

Western observers[14] have of course noted peculiar provisions laid down in Russian tax legislation. These peculiarities are explained not only by the lack of experience of Russian tax specialists in implementing tax reform, but to a greater extent, by the specific economic and social conditions in which the economic reforms are being undertaken. Economic processes in Russia will be briefly explained below in order to make these peculiarities in the present tax system comprehensible.

On the one hand, with the announcement of economic freedom of enterprise and price liberalization, state control over the volume of production and prices became almost negligible. The system of "state order", which functioned at the beginning of the economic reforms, under which the state established for an enterprise assignments for certain types of necessary public production, has been abolished. On the other hand, a market mechanism of regulation of production is still not functioning sufficiently in Russia. Any real change in the economic structure takes place slowly. There is still no free labour market or sufficiently functioning capital market, nor is there privately owned land to any extent. According to official data of the Statistics Committee of the Russian Federation the level of unemployment equals 1 percent of the economically active population.[15] There is unemployment mainly in the unproductive sectors (state organizations, services, etc.). The low level of production technology by enterprises demands additional workers. Furthermore, the continuation of loss-making enterprises, which are still supported by the state, constrains the creation of a free functioning labour market. The present capital market is characterized by an acute shortage of money resources because of considerable excess of demand over supply. This process is reflected in the rapidly-growing interest rates of commercial banks (300-400 percent a year). At the same time the low level of interest rates offered by saving banks, which is defined by the Government, and the high rate of inflation discourage savings, limiting internal sources of accumulation and investment. Finally, despite the adoption of the President's Decree concerning the sale of land owned by the state, the procedure for its realization has not yet been finalized.

Several reasons can be identified for the relatively slow changes in the economic structure. Firstly, the privatization process is proceeding very slowly in the fundamental branches of heavy industries; state restrictions on privatization of such enterprises still exist. In fact, privatization covers mainly the trade and services sectors. Moreover, privatization can not be expected to have an immediate positive effect. The privatization process is further hampered by the excessively monopolized structure of the economy, the result of former state policy, namely concentration and specialization in production; gigantic enterprises were considered to be more efficient. Thus it would be difficult to expect the immediate creation of conditions for real competition between enterprises. The absence of a competitive environment may be considered the most important factor constraining the implementation of tax reform.

Secondly, the Russian economy is confronted with a steeply reduced output. In 1992 the fall in output reached 19 percent compared to the previous year.[16] This process is aggravated by the existence of loss-making state enterprises. At the beginning of 1993 such enterprises represented 21 percent of all state enterprises, an increase of 300 percent compared to the previous year.[17] Application of the recently adopted law concerning bankruptcy has been delayed until a bankruptcy mechanism (criteria, procedures, etc.) has been established.

Thirdly, a typical feature of the present economic development is fast growing and protracted inflation. In August 1993 inflation had reached 30 percent monthly,[18] which created a real danger of hyperinflation. This situation is the result of government policy of further monetary expansion, and subsidizing different enterprises, particularly agriculture, which radically derogates from market behaviour. As a result, under the condition of falling output, the gap between goods supply and money supply is increasing, threateningly in favour of the latter. Shortages of goods lead to a prevalence of less efficient models of distribution, such as barter trade and the direct exchange of goods between enterprises. When such conditions prevail, enterprises have the opportunity to earn income to a greater degree at the expense of increased prices. When there is a considerable excess of money supply over goods supply enterprises sell their goods, even if the cost of production, including wages, constantly increases. Classic market mechanisms based on real competition restraining production cost do not function in such "unreal" market conditions. So, due to these specific features of the Russian economy in the transitional period, the state, by means of taxation, tries to eliminate these negative tendencies by using specific taxes (such as taxes on the use of gas, oil, wood, water) and through specific provisions in the definition of taxable profits, concerning expenses which could be deducted from the taxable base.

14. Tanzi, V., "Tax reform and the move to a market economy: overview of the issues", in *The Role of Tax Reforms in Central and Eastern European Economies* (Paris, 1991); Andersson, K., "Efficiency considerations in tax policy", in *Fiscal Policies in Economies in Transition* (IMF: Washington, 1992); Riordan, J. and McLure Jr., Ch.E., "Tax aspects of improving the investment climate in Russia", 47 *Bulletin for International Fiscal Documentation* (January 1993, at 17); McLure Jr., Ch.E., "Tax Foundation signs agreements with Kazakhstan and Russia", 47 *Bulletin for International Fiscal Documentation* (July/August 1993, at 444); Erdös, G., "Trends in the taxation of profits", 33 *European Taxation* (June/July 1993, at 214); Holzmann, R., "Tax reform in countries in transition: central policy issues", in *Public Finance in a World of Transition* (St. Petersburg, 1991).
15. Izvestiya (Official Russian newspaper, Moscow), 21 December 1993.
16. Izvestiya, 8 September 1993.
17. Financial weekly international (joint publication by the Financial Times and Izvestiya, Moscow), 1993, No. 12.
18. Izvestiya, 18 September 1993.

© 1994 International Bureau of Fiscal Documentation

One of the main constraints of tax reform is the need to reduce the rapidly growing budget deficit. The solution to this problem necessitates changes in the tax system, which without a doubt, will have a negative influence on achievement of the final goal of tax reform. The planned size of the budget deficit in 1993 adopted by the Russian Parliament is estimated at the astronomical sum of 21.8 billion roubles,[19] which represents almost 50 percent of the total expenditure budget.[20] The deepening economic crisis, with the fall in production, produces a trend of declining tax revenues. But the reduction in public expenditure cannot be made as rapidly during the period of transition. Despite the reduction in certain expenditure, such as capital investments, defence, direct subsidies to loss making enterprises, foreign aid and administration costs, the economic reforms call for significant additional public outlays in the short run. For example, expenses connected with the conversion of complex military enterprises, the development of an economic infrastructure, the restructuring of industrial enterprises, social expenses for education, public health and welfare (to avoid social tensions and to cushion the transition to a market economy) are simply essential for the successful implementation of economic reforms. Consequently, the urgent need to reduce the budget deficit does not allow any reduction in the tax burden. By mid-1993 the rate of inflation and the budget deficit had become sharply aggravated. With growing inflation, the budget deficit amounted to 14 percent of the GDP at the end of 1993.[21] An important factor in this situation was the continuing subsidy of enterprises in the coal industry and grain purchases in agriculture. Subsidies to agriculture represent 15 percent of GDP.[22] The recent decisions of the International Monetary Fund and the World Bank to stop granting international credit to Russia until the Government stabilizes the financial situation confirm the almost total loss of state control over the inflationary process. Consequently, the Government intends to pursue a stricter financial policy, reducing monetary expansion and cutting part of public expenditure, including the periodic indexation of salaries of civil servants and pensions due to inflation. Such a policy would without doubt not be popular, but is the only way out of the crisis situation.

Bearing in mind the above, under current circumstances the function of taxation in raising funds for public expenditure is paramount for stimulating economic development. Nevertheless, in pursuing this policy, the Government, understanding the significance of such stimulation and its close connection with the taxation, is searching for a compromise between strengthening the tax revenue basis and the encouragement of capital investment and business activities. It is also searching for a compromise between the desire to restrain inflation, and at the same time to support low income groups. Understanding the need for such compromise is reflected in the character of the 1992-93 amendments to the new tax legislation.

B. 1992–1993 amendments

An unstable tax system discourages domestic and especially foreign investments and saving. However, during a transition period, where the main tendencies for economic development are not always predictable, adhering to the principle of stability may have negative effects on timely solutions to economic and social problems. Hence, the tax system must be flexible during the period of instability and must be able to react to the changes in economic conditions. However, it should be kept in mind that flexibility does not imply too radical changes in a tax regime, such as the replacement of basic types of taxes. The implementation of tax reform, based on the major features of the Western tax model, revealed discrepancies between new tax legislation and the actual conditions and tendencies of economic development, especially after price liberalization. On the one hand, tax legislation was too severe for taxpayers, discouraging investment and business activity, making the problem of tax evasion more acute. On the other hand, some vague provisions in tax laws allowed enterprises to reduce their taxable base and to avoid taxation legally. Taking these tendencies into account, numerous amendments to the initial legislation were adopted by Parliament. An analysis of these amendments allows some identification of the main trends in improving tax legislation.

Firstly, the amendments provided for a reduction in the tax burden, especially for individuals. In 1992, the marginal rate of individual income tax was reduced from 60 to 40 percent. Additionally, the amount of income, above which the progressive rates are applied, was considerably increased from 42,000 to 200,000 roubles.[23] Under the President's Decree in 1993,[24] this amount was further increased to 3 million roubles and the marginal rate was reduced to 30 percent. With inflation of 30 percent a month and a corresponding growth of wages and salaries, a situation was created where average incomes and even below-average incomes became the object of progressive taxation.

The lowering of the tax burden was also achieved by a reduction of tax rates in value added tax from 28[25] to 20 percent[26] in 1992. With a shortage of goods, the new tax ("VAT") was expected to constrain consumer demand. But in the early stages of the price liberalization process, actual growth of prices on goods surpassed the proposed estimates. VAT increased the prices of goods almost by one-third. Consequently, settlements between enterprises (e.g. payments for goods supplied) have been impeded. Buyers were unable to afford purchases including VAT because of shortages of financial resources. Such a situation demanded urgent changes in the VAT rates; otherwise, the high rate would have led to bankruptcy for the majority of enterprises, and would have demanded new subsidies from the state.

19. US$ 1 equalled 1742 roubles in March 1994 (for comparison, in July 1993 it was 1059 roubles, and in January 1993, 417 roubles), an increase of 418% from the previous year.
20. Izvestiya, 31 August 1993.
21. Izvestiya, 12 November 1993.
22. Izvestiya, 21 September 1993.
23. The amendments are defined by the Act of the Russian Federation from 16 July 1992 "Concerning amendments and additions to the tax system of Russia", Art. 6.
24. The Russian President's Decree No. 1430 of 13 December 1993 "Concerning the regulation of the taxation of individuals".
25. The Act of the Russian Federation of 6 December 1991 "Concerning the value added tax", Art. 6.
26. The Act of the Russian Federation of 16 July 1992 "Concerning amendments and additions to the tax system of Russia", Art. 6.

© 1994 International Bureau of Fiscal Documentation

Secondly, amendments to the tax legislation provided for new tax incentives to encourage the technical reconstruction and re-equipment of enterprises; additionally, new construction and reconstruction of social infrastructure such as public health, education, culture and sports institutions (which are on the enterprises' balance sheets) was encouraged. Now actual expenses made for these purposes may be deducted from the taxable profits of enterprises of all industries. Furthermore, new tax exemptions are granted to enterprises carrying out the conversion of production, to state and municipal educational institutions, to enterprises and organizations relating to the liquidation of consequences of Chernobyl, etc.

Thirdly, taking into consideration the need to reduce the fast growing budget deficit, Parliament has adopted amendments designed to increase tax revenue. The broadening of the scope of enterprises subject to tax on profits is among such measures. For instance, agricultural enterprises of an "industrial type"[27] (which were previously exempt from taxation) are now subject to profits tax. The other enterprises in agricultural production, including "kolhozy", "sovhozy" and farms, are still exempt from taxation. Such exemption is one of the elements of the state support of agriculture. The amendments concerning the increase of tax rates on certain kinds of activities with excessive profitability also resulted in the growth of tax revenues. In particular, income from casinos, other gambling-houses and gambling business is now taxable at a rate of 90 percent rather than 70 percent.

Fourthly, some amendments were aimed at achieving a more accurate definition of deductible expenses of profits for tax purposes. In Russia, definitions of profits for tax purposes have a number of peculiarities; for instance, not all expenses connected with business are deductible. There is a particularly comprehensive list of deductible expenditure.[28] The main deductible expenses are:

- raw materials used in production;
- wages expenses within fixed normative amount;
- depreciation of fixed assets according to set depreciation rates; social insurance expenses (including obligatory medical insurance);
- property insurance expenses;
- interest payments within fixed normative amount;
- repair of equipment;
- business travel expenses up to a set limit;
- rent expenses, etc.

Other expenses, which are not enumerated in this list, must be financed by profits after tax. A detailed analysis of the deductible and non-deductible expenses, the need for such control and its drawbacks is beyond the scope of this article. The main reason for this specific provision is that the state tries to restrict the growth of certain elements in the cost of production. Otherwise, with excessive money supply over goods supply the absence of such control will lead to new spiralling of prices and inflation. But at the same time, it is difficult to deny that another purpose of this tax regulation is to raise funds for public expenditures by increasing the taxable base in a time of a fast-growing budget deficit. For example, interest payments made by enterprises[29] are now deductible. However, deduction is limited to the discount rate of the Central Bank of Russia increased by three points. At the end of 1993 the Central Bank discount rate was increased considerably from 80 to 210 percent in order to bring it nearer to private commercial bank rates, which are established according to credit supply and demand. Nevertheless, commercial bank rates are still double the Central Bank discount rate. In a situation where the majority of enterprises is forced to take credit from commercial banks, this measure may be considered discriminatory, but it is justified to a certain degree by the vast shortage of money resources. Deductibility of interest payments at the rate of commercial banks would considerably reduce state tax revenues. This contradiction may not be easily solved in the present crisis situation.

Another example of peculiarities in the Russian tax system is the tax provisions with regard to the partial deductibility of wages. These provisions, which were adopted in the initial tax legislation, are the object of much criticism by Western observers and experts. In Western countries wages and salaries are deductible without limit. According to Russian legislation actual labour expenses not exceeding the normative amount established by the Government are fully deductible. Russian enterprises whose actual wages and salaries exceed this amount must pay additional tax on this excess. In 1992 the normative amount initially equalled four times the minimum monthly labour payment per employee, established and revised periodically, taking account of inflation. In 1992 the amount of actual labour expenses exceeding the normative amount was taxed at the basic profit tax rate of 32 percent. In 1993, enterprises whose actual labour expenses exceed double the normative amount paid tax on the sum of excess at the rate of 50 percent. If the sum of excess was within double the normative amount, the basic rate of 32 percent was applied.[30] In accordance with the President's Decree[31] in 1994 the normative amount was increased from four to six times the minimum monthly labour payment. At present the latter is 14,620 roubles and accordingly, the normative amount equals 87,720 roubles. This sum approximately corresponds to the average monthly wage (at the end of 1993 it equalled 93,000 roubles).[32] The excess amount will be taxed.

These tax provisions must be understood as the peculiarities of the transitional period, where wages are not yet formed

27. Generally speaking, the larger agricultural enterprises, the list of which is set by the Government of Russia.
28. The Statute concerning the composition of expenditures relating to the cost of production (work, services) was approved by Decree No. 552 of the Government of the Russian Federation of 5 August 1992. Until this date an analogous statute approved by the State Planning Committee of the USSR, the Ministry of Finance of the USSR, the State Price Committee of the USSR and the State Statistics Committee of the USSR, of 30 November 1990, was used.
29. Amendments concerning the interest payments were approved by Decree No. 3251-I of the Supreme Soviet of the Russian Federation of 10 July 1992 "Concerning the introduction of amendments to Degrees of the Supreme Soviet of the Russian Federation relating to issues of taxation".
30. Instruction No. 4 of the State Tax Service of the Russian Federation of 6 March 1992 "Concerning the Procedure for the calculation and payment to the budget of tax on the profits of enterprises and organizations, Art. 11.
31. President's Decree of the Russian Federation No. 2270 of 22 December 1993 "Concerning some changes in the taxation and interrelations between the budgets of the different levels", Art. 3.
32. Izvestiya, 22 December 1993.

© 1994 International Bureau of Fiscal Documentation

through a market mechanism of supply and demand. Enterprises tend to increase the cost of production including wages, in order to attract the skilled employees in conditions of low unemployment. Thus this tax measure was adopted to halt the process of wage inflation. It should be added that these tax provisions are not an essential characteristic of Russian tax reform but are only temporary measures in a crisis situation, which might be considered softer than freezing wages – a measure sometimes used by other countries with high levels of inflation. Until wages are formed on the basis of supply and demand, this artificial interference in the process of consumption and accumulation is justified from the economic point of view. Unfortunately, the adoption of the laws concerning privatization and free business does not mean the immediate creation of a labour market. It is likely that this will demand a long period. Certainly, it is clear that this most specific element of the Russian tax system will have discouraged the economic activity of foreign companies and particularly the process of technological transfer. Therefore, in 1992 tax law was amended to attract foreign capital investment so that foreign companies were granted the right to deduct wages and salaries in full from the tax base.

Fifthly, some provisions were added to the legislation, preventing a dual interpretation of the definition of the taxable base (either of VAT or tax on profits). Imprecise formulas in the initial legislation afforded taxpayers the opportunity to avoid taxation legally. Insufficient supply and shortages of finished goods and raw materials led to the widespread increase of primitive forms of distribution, such as barter trade and direct supplies of goods between enterprises.

Enterprises engaged in a very specific method of tax avoidance. Under private agreements between suppliers and buyers, the latter paid the supplier of goods at a reduced price, but the difference between the market price and the reduced price was subsequently transferred to the supplier's own funds. In this case the difference was previously non-taxable. In the transfer invoice the difference between these sums was not reflected as a purchase of goods, but rather as financial aid, for instance, or replenishing of social funds. The amendments prevented this unintended use of tax legislation and now these types of transfers are included in the taxable base. Additionally, when a direct exchange or sale of goods is carried out at prices which are not higher than the cost of production, the amount of the transaction (for tax purposes) will be determined on the basis of market prices. Thus, for the first time, an attempt is made in the tax legislation to create a mechanism comparable to the Western style transfer pricing mechanism in related party transactions.

Finally, some amendments overcome distortions in the economy under conditions of fast-growing inflation. It may seem strange, but enterprises contrived to receive gains from rapidly-changing prices. They tried to accumulate raw materials and finished goods in order to sell them later at higher prices. After this practice became widespread, an amendment was made to the calculation of VAT. Now the equivalent amount of tax paid to the suppliers of raw materials may be deducted from the amount of tax due to be paid by the purchaser of goods, but only if the raw materials are actually used in production. The equivalent amount of tax paid on raw materials accumulated in the warehouse is not deductible.

Understanding the contradictions in some amendments to the principle of taxation used in a market economy, Russian tax specialists realize that these measures are extraordinary, due to a crisis situation. When the Russian "unreal" market economy is transformed to an economy based on real competition and a developed labour, land and capital market, such measures will most likely be gradually removed. At the same time, it may be said that the implementation of a tax reform under such conditions of severe economic crisis may be considered as an original and peculiar contribution to tax law theory and practice.

IV. CONSTRAINTS OF THE TAX REFORM AND TRENDS IN MODIFICATION OF THE TAX SYSTEM

A. Difficulties in the implementation of the tax reform

The tax reform in Russia is moving in parallel with the fundamental changes in the economic basis, particularly in property relations. But insufficient speed in the privatization process and slow structural changes in the economy create difficulties in the implementation of tax reform.

During the transitional period policymakers have two main tasks, which to a certain degree are contradictory. The first task concerns the creation of a favourable tax climate for economic development, and investments and savings, mainly through a reduction in the tax burden. The second task is to enable the government to restrain negative tendencies in an economy which has the rudimentary characteristics of a centrally-planned economy. It also implies the reduction of the budget deficit. This task is very difficult to accomplish solely through the use of taxes. Taxes should be used in close cooperation with other economic instruments (credit, prices, etc.) in creating the real basis of a market economy. The creation of a favourable tax climate is being sought by the application of a wide range of tax incentives, which provides different tax treatments depending on the sector of the economy, the type of activity and investment, group of population, kinds of investors, etc. Some incentives are economically justified, such as those connected with the encouragement of small business, those promoting a competitive environment and those aiming at the encouragement of investment and savings. But the majority of tax incentives should be revised as their use leads to a less efficient allocation of resources; it also makes the tax system more complex and collection more expensive. In future, a detailed analysis should be made to define the efficiency of such tax incentives compared to losses in tax revenue. Furthermore, with the stabilization of the economy and the growth of internal sources of investment, uniformity in the treatment of domestic and foreign companies for tax purposes should be reached.

One of the main requirements of tax reform is its administrative feasibility. Russia has faced administrative difficulties in

© 1994 International Bureau of Fiscal Documentation

the implementation of tax reform due to the limited capacity of the tax administration. The State Tax Service was created in 1992 through a special law. The staff of the newly created tax administration was formed mainly from the officials of the Ministry of Finance and the local fiscal authorities. Several significant factors lie behind the administration's limited capacity:

- the increase in the number of taxpayers due to the adoption of laws allowing free enterprise;
- the introduction of VAT, demanding regular inspection of a growing number of tax declarations; and
- insufficient computer technology facilities.

A particularly critical situation occurred in 1993 when as a result of the new act "Concerning Individual Income Tax", the tax administration first faced difficulties in verification of individuals' declarations.[33] Due to the inability to cope with the growing flow of tax declarations, an amendment was adopted by Parliament establishing a base income which did not need to be declared.[34] Initially, the amount which was exempt from declaration was fixed at a rather high level, 200,000 roubles a year (by comparison, the average monthly wage at the end of 1992 equalled 10,000 roubles). It was increased twice – from 1 to 3 million roubles a year – due to inflation in 1993. The average monthly wage at the end of 1993 amounted to 93,000 roubles. This means that individuals with average or even above average income are outside the control of the tax administration. This illustrates the present incapacity of the tax administration to implement the law as regards verification of tax declarations of more individuals liable to pay income tax.

The problems concerning the efficiency of the tax administration could be solved by increasing staff members (especially at the local level) provided by the expansion of tax law education in Russian academies, institutes and universities. Currently, only a few higher education institutions prepare tax specialists.[35] Further training is also needed for a new profession of specialists already employed in financial and banking enterprises. Furthermore, computer technology should be introduced to promote efficiency in tax administration. Employees of the State Tax Service should no longer fulfil the triple function of tax inspector, tax collector and tax adviser. At the moment they are compelled to give advice. The services of the small number of private tax advisers are too expensive for the majority of taxpayers, either individuals or companies. In order to improve the implementation of tax legislation, legally binding advance rulings interpreting the tax law in cases brought to the tax officials should be issued. This would assist taxpayers in better understanding the law, and simultaneously relieve the tax administration of a significant burden. These measures would also ensure that full attention was paid to the levying and collection of taxes. Finally, no less important, is the simplification of tax legislation and accounting by reducing the number of specific taxes, special incentives, tax exemptions, etc. The implementation of tax legislation is further complicated by the existing problem of "fiscal federalism", defined as a struggle between federal and local governments over the degree of decentralization of their power over tax collection and expenditure. This problem is especially acute due to the complex budget system, including thousands of separate budgets, and due to the existing system of revenue distribution to different budgets.

The unity of the tax system is infringed by the incompetent actions of local governments, including local tax authorities. They deviate from the laws and the normative acts adopted by the Russian Government or change them unilaterally. In particular, in order to reduce their budget deficits, local governments adopt their own laws, according to which all federal taxes collected in their territories through local banks, should be passed to the local budgets. As a result, the federal budget deficit increases in spite of federal taxes being levied and even collected, because they are not in fact transferred to the federal budget. Moreover, numerous local taxes, contradicting federal tax legislation, have been introduced. Local authorities are entitled to levy only local taxes which are provided for by federal law. But in fact local governments levy taxes in addition to the list of local taxes defined by federal law in order to bolster the revenue basis of their local budgets. For example, some local authorities illegally levy tax on cars used for business purposes, tax on information and certificates given by local authorities, etc. Such actions lead to an uncontrolled growth in the total tax burden. Solutions to this problem have not yet been found, but will have to be found as soon as possible in order to prevent the destruction of the single tax system and to remove the threat to the continuity of tax reform.

Finally, one of the major constraints of the tax reform is the need to solve the complex of social problems. There is a flagrant contradiction between the economic and social aspects of the tax reform. The funds which are necessary for the social support of the population may be raised by increasing the tax burden. With the intensification of economic restructuring, price liberalization and increasing inflation, social problems are becoming more acute. In Russia the lowering of living standards is accompanied by substantial differentiation in the revenues of different groups. Under such conditions, a tax system aimed at defending the interests of low income groups maintains the features of a social justice system, and may be considered as backward, but necessary in the transitional period. Also, one of the main tasks of such a system is to avoid social tensions by using a rather low income tax rate for the majority of taxpayers and the application of numerous tax exemptions for different taxpayers. Many tax exemptions have a historical character (e.g. for veterans and invalids of World War II) and it is unlikely that these will be removed quickly. But in future, exemptions on income tax could be replaced by direct subsidies to individuals granted from the funds of the social programmes. As a market economy approaches the social demands on the tax system should be reduced.

An analysis of the implementation of tax reform shows that a first step towards the creation of a tax system compatible

33. These are analogous to tax returns in Western countries.
34. Individuals who received income within this minimum amount are not obliged to fill in a tax declaration.
35. The Financial Academy under the Government of Russia situated in Moscow is the main educational institution in the sphere of taxation. The Institute of taxation was created in 1992 within the framework of the Academy.

© 1994 International Bureau of Fiscal Documentation

with a market economy has been made. At the same time, it is clear that a tax system is being developed. In future, tax legislation should be consistent with the long-term goals of tax policy, including stability, fairness, certainty, economic neutrality and simplicity. But the approach to these fundamental principles of tax policy should be gradual as far as economic, political and social conditions permit.

B. Main trends in bringing the Russian tax system in line with the Western model

In order to move the Russian tax system towards a system based on standards generally accepted in a market economy a number of changes are necessary. First, in order to ensure the stability of the tax system in a market economy it is necessary that tax provisions defining, for instance, calculation of taxable profits be part of the tax laws. Now they are still defined in many cases by the instructions and special normative letters from the Ministry of Finance, which sometimes deviate from the framework of the law. This may lead to arbitrary decisions of the tax authorities and infringe the rights of taxpayers.

Secondly, the definition of profits for tax purposes should be based on Western accounting standards and should include the deduction of all reasonable and necessary expenses of earned income. Basically, this demand requires the removal of three main restrictions included in the present legislation with regard to the deductibility of labour payments, depreciation allowances and interest payments. To prevent distortion of the tax base, wages and salaries should be deductible without any limitation. Depreciation allowances are deductible from the taxable base, but the tax legislation provides relatively conservative depreciation rules for tax purposes, and depreciation allowances are calculated by using the straight-line method based on historical costs.

Furthermore, the useful lives of assets assumed in calculating depreciation allowances are presently too long to ensure timely recovery of capital invested. For example, the useful lives of different equipment range from six to 20 years and may even reach 30-40 years. Accordingly, depreciation rates are too low. This situation constrains the renovation of equipment and modernization of the technological process. This problem is aggravated by inflation, which reduces the real value of depreciation allowances. With regard to interest payments, any limits in the deductibility of these expenses established by the Government should be removed with the creation of a developed capital market. All of these measures, providing full deductibility of all reasonable expenses, would reduce the effective tax rates on the profits of enterprises. It is true that the statutory tax rates of the profits tax are lower in Russia than in Western countries. But unjustifiably long useful lives of depreciable assets, and the disallowances of deduction on some reasonable business expenses mentioned above, lead to an increase of the effective rate compared with the statutory one. A reduction in the tax burden is necessary to encourage both domestic and foreign investment needed for economic reform.

Thirdly, with the development of the market, the use of different tax rates applied to different types of activity, should be eliminated. Now, for example, the profits generated from intermediary transactions,[36] casinos and other gambling businesses considered to be excessively profitable is taxed at higher rates than profits generated from other business activities. Under conditions of great divergence between supply and demand of goods in favour of the latter, intermediaries now have more favourable conditions for earning income than producers of goods, and are being taxed at a higher rate. But as the consumer market becomes satiated, equal rates should be applied. This will promote the free flow of capital within the economy.

Fourthly, numerous and rapidly expanding tax incentives should be analysed and considerably reduced. The experience of Western countries confirms the arguments against tax incentives. They lead to a less efficient allocation of resources, and to compensate for losses in revenues, higher taxes have to be imposed on other sectors of the economy. Tax incentives do not on their own have an essential impact on the level and structure of investment. Radical changes in investment policy also depend to no small degree on credit and price policy. The implementation of tax reform in Russia showed that enterprises did not invest profits released from the reduction in taxation, but used them for consumption. The main reasons include the instability of the economy, excessively high bank interest rates, rapidly increasing prices of raw materials and equipment, and fast decreasing of depreciation funds due to inflation. These factors create obstacles to the development of small business, and to the attraction of foreign investors; both of these groups enjoy preferential tax treatment.

Additionally, tax incentives make the tax system more complex. The low capability of the tax administration does not permit the audit of all taxpayers having preferential tax treatment, thus facilitating tax avoidance. So the negative effects of tax incentives and losses in the state revenues might be eliminated by broadening the tax base by lower tax rates. Regarding exemptions from individual income tax which are granted to certain groups of taxpayers (such as World War II disabled persons and veterans, victims of the Chernobyl disaster, and parents and spouses of serving soldiers or state employees killed in the execution of their duties) may be in future substituted by subsidies from within the framework of the state social welfare programme.

Finally, it will be necessary to separate wage tax and dividend tax from individual income tax and profits tax, respectively, as is generally accepted in Western countries. The need for such separation is stipulated by the difference in nature of these taxes, in the kinds of taxpayers, and in the procedure of levying and payment to the tax collector. In addition, the success of the implementation of the tax reform will depend to a considerable degree on adequate changes in the economic structure which stimulate or constrain its course. The efficiency of the tax reform will be defined by the state's ability to halt the fast-growing inflation and the fall in output, and to create favourable conditions for the development of a competitive environment.

36. Transactions carried out by mediators – legal entities, providing circulation of goods from a producer to a customer.

© 1994 International Bureau of Fiscal Documentation

SINGAPORE

1994 BUDGET

Lee Fook Hong, MBA FCIS FAIA ACIArb

The 1994 Budget Speech was delivered by the Minister of Finance, Dr Richard Hu, in the Singapore Parliament on 23 February 1994. It comprises three parts: economic performance in 1993; the financial year 1994 budget; and the fiscal position and proposed changes.

The Minister reported that the Singapore economy grew by 9.9 percent in 1993 and that such growth resulted in a healthy budget surplus. The growth was broad-based, with all major sectors performing well and such growth was mainly due to buoyant activity in the stock market and foreign exchange trading.

On the economic outlook for 1994, the Minister said the external environment had improved, and growth would continue in Asia at a brisk pace as domestic consumption and investment boost demand, and Singapore would benefit from the improved prospects in the world. The Ministry of Trade and Industry has forecast 1994 growth to be 6.8 percent.

On longer-term issues in economic management, the Minister urged Singaporeans to prepare for the future. Having become a Newly Industrialized Economy and being on the threshold of the First League of Nations, Singapore is now at a turning point. In the new phase the role of the Singapore Government in economic management will be more important than the take-off stage. The Government will continue its involvement in the following areas:

- providing a conducive environment for economic growth and social stability;
- maximizing the employment potential of Singaporeans through a practical and vigorous education system;
- upgrading economic structure through selective direct investments in strategic projects; and
- ensuring that Singaporeans have relevant skills by providing up-to-date training and skills upgrading programmes.

In the second part of his speech, the Minister dealt with the Government's expenditure policy, which will continue to focus on areas that support and promote Singapore's economic growth. Government's role is to put the necessary infrastructure in place, provide a clean and safe environment, and train the people to the best of their potential.

The Financial Year 1994 budget spending will focus on education, sound economic infrastructure, affordable health care, good public housing and national security, while budgetary surpluses will build up the assets of Singaporeans through grants and purchasing quality shares such as Singapore Telecoms shares. A pension fund for public officials will also be set up.

In the third and final part of his speech, the Minister announced the proposed tax changes. This article highlights a number of those changes.

I. TAX CHANGES FOR COMPANIES[1]

A. Tax incentives to promote securities lending and borrowing

To facilitate the growth of international derivatives trading and arbitrage activities and the trading of regional securities in Singapore, the Asian Currency Unit ("ACU") and Approved Securities Companies ("ASC") schemes will be extended to include foreign securities lending and borrowing activities. With this extension, ACUs and ASCs will enjoy a concessionary rate of 10 percent on income derived from lending and borrowing foreign securities with another ACU, ASC or a non-resident person. Additionally, the fee income derived by approved fund managers from arranging securities lending and borrowing transactions on behalf of foreign investors will also enjoy this concessionary 10 percent tax rate. The securities lending fee, manufactured dividend[2] and interest paid by an ACU or ASC to a non-resident will also be exempt from tax. To qualify for the tax exemption, the non-resident must not have a permanent establishment in Singapore unless it is in the form of a bank or a branch of a bank.

With immediate effect, no stamp duty will be levied on documents executed under seal, and agreements in respect of such securities lending and borrowing transactions. These incentives will help attract more international financial institutions to use Singapore as a securities lending and borrowing centre.

B. Incentives to promote silver and platinum trading

Presently, ACUs enjoy a concessionary tax rate of 10 percent on income derived from trading in gold, but not other precious metals. As there is growing market interest in the trading of silver and platinum, income from spot and physical trading in silver and platinum with approved parties is also to be taxed at the concessionary rate of 10 percent.

1. Unless otherwise noted the changes will take effect from year of assessment 1995.
2. A dividend declared in respect of shares borrowed for use during a period of time; such shares are registered in the name of the borrower until they are returned to the lender who is the beneficial owner.

© 1994 International Bureau of Fiscal Documentation

C. Extension of incentives for transactions in non-Singapore dollar securities

Currently, ACUs and ASCs enjoy a 10 percent concessionary rate of tax on income, and exemption of contract note stamp duty when they transact in non-Singapore dollar securities on their own account or on behalf of non-residents with other ACUs, ASCs or non-residents. To further promote Singapore as a regional securities trading centre as well as a fund management centre, the 10 percent tax concession will be extended to ACU and ASC transactions with approved fund managers in respect of funds managed for foreign investors by such fund managers. The exemption of stamp duty will also be extended to such transactions with immediate effect.

D. Further incentive for Approved Secutiries Companies ("ASCs")[3]

Presently, the tax exemption scheme for syndicated offshore credit and underwriting facilities is only open to ACUs. To encourage non-bank financial institutions, such as securities companies, to expand their operations and conduct syndication business in Singapore so as to further enhance Singapore's position as a leading syndication centre in Asia, the tax exemption scheme will be extended to ASCs.

E. Extension of relief periods for tax incentives

Since the 1960s, a number of tax incentives have been introduced under the Economic Expansion Incentives (Relief from Income Tax) Act to promote the development of Singapore's manufacturing and services sectors; such incentives include expansion of established enterprises and service companies, export of services, warehousing and servicing.

Since these incentives provide for an initial tax relief period of five years or less, companies have not been encouraged to expand after expiration of the initial incentive period. To enhance these incentives, the initial incentive period will be extended to not more than ten years, and companies can thereafter apply for an extension of the tax relief period. The period for each extension will not exceed five years, subject to a maximum relief period of 20 years for each incentive.

F. Reduction of time limit to issue assessments

Currently, the Comptroller of Income Tax is empowered to raise assessments or additional assessments on taxpayers within 12 years after the year of assessment concerned. Accordingly, taxpayers are effectively required to retain their records of income and deductions for 13 years as the Comptroller has 12 years to make assessments, and tax is assessed on a preceding year basis. However, under the Companies Act, companies are required to retain their accounting and other records for seven years. The current 12-year statute of limitations to issue assessments for non-fraud cases will be reduced to six years so that accounting and other records relating to such assessments are to be retained for seven years. Where fraud or wilful default has been committed, assessment can still be raised at any time.

G. Corporate tax rate

The corporate tax rate will remain unchanged at 27 percent.

II. TAX CHANGES FOR INDIVIDUALS

A. Income tax rebate[4]

An across-the-board one-off rebate of 5 percent on individual income tax will be granted to individual taxpayers.

B. Rebates on service and conservancy and rental charges[5]

To offset the impact of Goods and Services Tax ("GST"), additional rebates will be granted on Housing & Development Board Service and Conservancy charges and rentals. The rebates will vary according to the type of flat.

C. Higher interest rate for the CPF retirement and special accounts[6]

The Central Provident Fund ("CPF") minimum sum is expected to be raised from $ 34,600 to $ 80,000 over the next ten years. Half of the CPF minimum sum is to be kept in the form of cash. To compensate individuals who are required to hold 50 percent of the minimum sum in cash, the Government will pay a higher interest rate on cash savings held in the CPF Retirement and Special Accounts (from 2.5 to 3.75 per annum).

D. CPF share ownership top-up scheme ("SOTUS")[7]

In addition to Singapore Telecom, the Government expects to privatize other major Government-owned companies and statutory boards. To help Singaporeans build up enough CPF savings to buy shares in Singapore Telecom, the Government will implement a second SOTUS to top-up CPF accounts of citizens aged 21 and over. The Government will pay $ 300 into the account of a CPF member, provided he or his employer contributes at least $ 750 during the 18-month period from 1 March 1994 to 31 August 1995. The qualifying period will be extended from six to 18 months, to make it easier for Singaporeans to meet their co-payment requirement. Members who pay in less than $ 750 will receive a prorated contribution from the Government.

E. Extension of claim period of procreation incentives[8]

Currently, the period within which the special and additional tax rebates can be absorbed is seven years. When GST was

3. The expansion of the scheme will take effect from 1 March 1994.
4. This is effective for year of assessment 1994, as announced in the previous year's Budget Speech.
5. These rebates will be additional to the GST offset rebates which take effect from 1 April 1994.
6. The increase in the interest rate will be effective from 1 July 1995.
7. The second SOTUS scheme will be implemented in 1994.
8. This change will take effect from year of assessment 1994.

© 1994 International Bureau of Fiscal Documentation

implemented on 1 April 1994, personal income tax rates were cut and a tax rebate of $ 700 granted. As a result, some taxpayers who were entitled to the special and additional tax rebates were not able to fully utilize the rebates within the seven-year claim period. To assist taxpayers to better enjoy the procreation incentives, the claim period for the special and additional tax rebates are extended from seven to nine years.

F. Tax changes to encourage Singaporeans to venture overseas

To encourage Singaporeans to venture abroad, with effect from year of assessment 1993, Singaporeans can choose to be non-residents for tax purposes if they have worked overseas for at least six months in any calendar year. As non-residents, they will not be taxed on their foreign income remitted to Singapore. In addition, these non-resident Singaporeans can claim special non-resident relief under ITA Section 40 on their Singapore-source income.

However, many Singaporeans working overseas who declare non-resident status for tax purposes are unable to enjoy the non-resident relief because Section 40 relief is based on the tax rates set out in Part B of the Second Schedule to the ITA, according to which the top rate is 55 percent on chargeable income in excess of S$ 100,000. To encourage Singaporeans to venture overseas, the tax rates used to compute non-resident relief will be reduced.

G. Tax deduction for voluntary contributions to the CPF

Employees are often reluctant to accept overseas postings as they are unable to enjoy a tax deduction for voluntary CPF contributions. Presently, a tax deduction is allowed for contributions by employees to the CPF which are obligatory by contract of employment, if they are Singapore residents. The tax deductibility for these contributions, as well as contributions to other approved pension and provident funds, will be capped at the compulsory CPF limit.

The employer's contributions in respect of ordinary wages will be exempt from tax, up to the statutory limit for compulsory CPF contributions by employers.

H. Earned income relief for taxable retirement benefits[9]

In 1993, the Minister announced that all retirement benefits, other than compulsory CPF, received from private employers will be taxable. These taxable retirement benefits can be paid out in several ways: as a lump sum, an annuity over five years or a life pension. There has been some uncertainty as to whether earned income relief can be claimed for all taxable retirement benefits. The Minister announced that as retirement benefits are earned, income relief will be allowed in respect of all taxable retirement benefits received by employees from their employers.

I. Payment of life and personal accident policy proceeds without probate or letter of administration[10]

Death benefits from a life insurance or a personal accident insurance policy are subject to estate duty. The Insurance Act (Chapter 142) currently allows up to $ 50,000 of death claims to be paid by insurance companies without having to wait for clearance from the Inland Revenue. This $ 50,000 is inadequate. To restore the adequacy of the financial relief, the $ 50,000 will be increased to $ 150,000.

J. Tax deduction for CPF contributions by the self-employed

Self-employed persons who contribute to the CPF are currently allowed to deduct contributions, inclusive of compulsory Medisave contributions, from their assessable income. The limit for such deduction is 18 percent of assessable income from self-employment, subject to a maximum of $ 12,960. As the employer's CPF contributions rate was increased to 18.5 percent with effect from 1 July 1993, the limit for the tax deduction will be raised to 18.5 percent of assessable income from self-employment, subject to a maximum of $ 13,320.

III. OTHER TAX CHANGES

A. Reduction in property tax rate[11]

The property tax rate for industrial, commercial and leased residential properties was reduced from 23 to 16 percent in 1990. To help reduce business costs and enhance Singapore's competitiveness in attracting foreign investment, the property tax rate will be reduced in stages to 12 percent over the next four to five years. As a first step, the property tax rate of 16 percent will be reduced across the board to 15 percent of annual value.

B. Duties on cigarettes, tobacco and liquor

There will be no increase in duties on cigarettes, tobacco or liquor.

C. Duties on motor vehicles[12]

Import duties on motor vehicles will be reduced to neutralize the effects of GST. With effect from 1 April 1994, import duties on cars, taxis and motorcycles will be 41 percent, 17 percent and 12 percent, respectively.

9. This change will take effect from year of assessment 1994.
10. This change will take effect from 1 April 1994.
11. The reduction will take effect from 1 July 1994.
12. This change will take effect from 1 April 1994.

© 1994 International Bureau of Fiscal Documentation

D. Duties on petrol[13]

To neutralize the effects of GST, excise duties on petrol will also be reduced. Duties on kerosene, lubricating oil, liquified petroleum gas and aviation spirits will be suspended.

IV. CONCLUSION

In concluding the Budget Speech, the Minister said he was confident that Singapore could prosper and grow together with its neighbours and trading partners, provided Singapore remained competitive and productive.

Post-Budget reaction indicates that there have been mixed feelings about the Budget. Most Members of Parliament accept the Budget as sound and prudent, whilst most businessmen regard it as disappointing and unexciting. As for the ordinary Singaporeans, they welcome the Budget as it provides more goodies to offset the GST which was introduced with effect from 1 April 1994.

The business community is disappointed that the corporate tax rate of 27 percent remains unchanged. Most businessmen expected the tax rate to be reduced by 1 or 2 percent. They feel somewhat let down by the Budget which they consider a "non-event" for business and which offers nothing much to benefit the business community. They are unhappy over the proposed increase in the employer's CPF contributions rate from 18.5 to 20 percent, as such increase will drive up business costs. The Government back-benches chided the businessmen for wanting more. As enough goodies had been given in 1993, businessmen should not expect more and more rebates and incentives, year after year.

Non-businessmen, however, feel that the Budget on the whole is fairly neutral and that it provides more rebates and incentives for the man-in-the-street and the less well-off Singaporeans. It is the "common-man's budget, and a people's budget" as it helps the ordinary people.

Although there are some incentives for the financial services sector, they seem to be very industry specific and exclusive. As such, the incentives do not benefit ordinary individuals or the business community at large. Smaller businesses with an annual turnover of less than $ 1 million will be affected. These small businesses, which are not registered with the Comptroller of Goods and Services Tax, will not be able to claim the input GST but will have to increase the employer's CPF contribution to 20 percent which will increase their cost of business operations.

However, the introduction of GST with effect from 1 April 1994 is timely because rising business costs can be offset by the additional revenue resulting from the positive growth in 1993 and 1994.

13. The revised duty rates will come into effect on 1 April 1994.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

PUBLIC INTERNATIONAL LAW ASPECTS OF SOME TRANSFER PRICING ISSUES

Lynette V. Eastmond

1993 Research Associate, International Fiscal Association

I. INTRODUCTION

Transfer Pricing is currently one of the more frequently discussed topics in international tax circles. This article is a modest contribution to the discussion of some of those aspects of transfer pricing which do not strictly concern the determination of an arm's length price. It is an attempt to place those aspects in a more general domestic and international legal framework with emphasis on the position of the multinational enterprise ("MNE") as taxpayer.[1] This approach has been taken since the view has sometimes been expressed that international tax practitioners suffer from an inability to distance themselves from the particular issues with which they are concerned and are therefore unable to place those issues in a broader legal context.[2]

A. Transfer pricing

A typical transfer pricing situation may occur where a parent company of State A receives goods or services from a subsidiary located in State B at a price considered to be greater than arm's length, resulting in a greater claim for deductible expenses and a decrease in declared taxable income in State A. The revenue authorities ("RAs") in State A may make an upward adjustment in order to reflect the newly recognized taxable income. Where State A makes this initial adjustment under its transfer pricing rules, the RAs of State B may make a corresponding adjustment in the case of the subsidiary in State B. Where a corresponding downward adjustment is not made, however, this may give rise to economic double taxation, the same income being taxed twice, but in the hands of different juridical persons.

Three factors give rise to the peculiarities associated with transfer pricing. Firstly, MNEs are structured in such a way that a parent company may have subsidiaries, sister companies and permanent establishments in more than one jurisdiction. Secondly, MNEs frequently enter into transactions across borders and are therefore simultaneously subject to the taxing jurisdiction of more than one state. Thirdly, the transactions under consideration take place between related parties as defined by the relevant tax legislation of the state reviewing the transaction. The question therefore naturally arises as to whether any given transaction has in fact been concluded at arm's length and whether the price in question reflects, as far as the RAs of the taxing state are concerned, the true price of the goods or services provided.

The preoccupation with transfer pricing has, however, focused primarily on the prevention of an initial adjustment in potential transfer pricing situations. This is understandable, but it would be imprudent to suggest that if states followed the arm's length criteria set out in the 1979 OECD transfer pricing Report[3] and endorsed in the 1984 Transfer Pricing Report,[4] corresponding adjustments would not be an area for concern. It is after all more often the case that legal disputes do not concern the majority of transactions entered into by persons, but rather concern hard cases which are not easily solved between the parties to the dispute. It is because of the international nature of transfer pricing that many important issues peculiarly relevant to public international law ("PIL") acquire a heightened significance, and it is PIL no less, which is required to provide some recourse for taxpayers through which these issues may be settled.

B. Public international law

Transfer pricing disputes potentially concern at least two states which may or may not have tax treaty obligations with each other. In addition, each state brings to any dispute its own domestic legal rules which must be accommodated within the framework of PIL. Issues which may arise concern the role of tax treaties, sovereignty, the taxing jurisdiction and the MNE as a subject of PIL. At least one commentator has lamented the fact that so little attention has in the past been paid to PIL as a focus of study in international tax matters.[5] Perhaps this stems from the fact that PIL is perceived as providing few clear answers to questions which arise in tax disputes, but the same may be said of domestic law whenever new issues arise which the legislative and judicial arms of the state have had little experience with. However, this does not

1. MNEs in this context are considered to be enterprises with operations in more than two states.
2. See Martha, R.S.J., *The Jurisdiction to Tax in International Tax Law* (Deventer: Kluwer Law and Taxation Publishers, 1989), at 1.
3. OECD, *Transfer Pricing and Multi-National Enterprises*, (Paris: OECD, 1979).
4. OECD, *Transfer Pricing and Multi-National Enterprises: Three Taxation Issues* (Paris: OECD, 1984).
5. See Martha *supra* note 2, at 11.

© 1994 International Bureau of Fiscal Documentation

prevent the state from developing and refining appropriate legal rules.

II. TRANSFER PRICING ISSUES

A. Recharacterization of transactions

One of the incidents of an initial adjustment under Article 9(1) may be the recharacterization of transactions. Here the RAs may consider that regardless of the commercial nature of a contract and the legal obligations created thereunder, such characterization is not appropriate for tax purposes. This in itself raises basic issues as to the right of the national of a state (outside any criminal activity) to contract with a person of another state in a manner suitable to itself. It has been suggested that the doctrine of freedom of contract has rather outlived its usefulness and is now outdated, this doctrine being characteristic of an epoch when the state endorsed a much more *laissez-faire* attitude towards its nationals; the essence of the concept being that if individuals are given the maximum freedom to pursue their economic interests, the result will enure to the benefit of the general good.[6] In modern times, however, the state has taken on a more regulatory function and through legislation and case law has indicated to its nationals that freedom of contract, in many situations, no longer serves state interests. It should not be surprising therefore that the revenue law should seek to make further inroads into an area which has been frequently traversed by other branches of the law.

The situation becomes potentially even more complex since the attitude towards recharacterization may vary from state to state. This divergence is generally seen as a reflection of the differing treatment of transactions by common law and continental civil law systems, and was considered in 1989 IFA discussions under the subject, "The disregard of a legal entity for tax purposes".[7] The flexibility which has been displayed by common law courts to disregard the transactions of taxpayers has been recognized as stemming from historical developments in the common law of the United Kingdom and those countries which derive their juridical system therefrom.[8] One analysis describes this divergence as arising from the fact that the common law system involves a limited number of statutes supplemented by a large volume of case law, whereas continental systems are based generally on a civil code which is prescriptive in a much more detailed manner than the common law system.[9]

Nevertheless, recharacterization of transactions remains a feature of transfer pricing under both common law and civil law systems.[10] One should note that the 1979 OECD Report declares, as one of the principles in determining arm's length price, that the legal effects of the actual transaction should not be disregarded unless the particular situation is exceptional.[11] It is interesting therefore that the US 1993 revised transfer pricing regulations provide that the RAs must now respect contractual arrangements between the relevant parties if the contractual terms are in keeping with the economic substance of the underlying transaction and the actual conduct of the parties.[12]

One of the most obvious forms of recharacterization is the recognition of a price considered to be the arm's length price as opposed to that agreed between the parties. The result is either the increase in profits or the decrease in losses in one jurisdiction and the corresponding decrease in profits or increase in losses in the other. Much more far reaching is the recharacterization of entire transactions. For example, where there are "package deals" between one part of the enterprise and another, there may be a transfer of goods in the form of plant and machinery along with intangible property such as know-how and patent rights. The value of these components seen as a whole may be perceived rather as akin to an investment in real estate (capital expenditure) as opposed to a deductible revenue expense. Such disregard of transactions may also arise in what are referred to as "round trip" transactions involving the licensing by a US corporation of an offshore company to manufacture a product and then the purchasing by the US corporation of substantially all of that product. In the past the IRS assumed the right to disregard the contract entered into with the offshore company.[13]

B. Classification of income after an initial adjustment

This is one aspect of recharacterization and the OECD Commentary expressly states that it is not concerned with secondary adjustments under Article 9(2). Pagan and Wilkie have expressed the view that the question of secondary adjustments is far too complex an area to be dealt with under this Article.[14] It has further been suggested that the object of a secondary profit adjustment is to have such sums taxed in line with the model conventions,[15] and some RAs have formulated methods by which that additional income is to be classified and recognized. The practice, however, varies from country to country.

1. No reclassification

In some states, such as the United Kingdom, there is no such provision with respect to reclassification. The general prac-

6. *Contract Conflict*, ed. P.M. North (North-Holland Publishing Company, 1982), at 111.
7. See "The Disregard of a legal entity for tax purposes", Vol. LXIVa, *Cahiers de Droit Fiscal International* (Deventer: Kluwer Law and Taxation Publishers, 1989), at 21.
8. Such as Australia, Canada, New Zealand and the United States.
9. Nobbes, C.W., "Harmonisation of Accounting Within the European Community: the Fourth Directive of Company Law", Vol. 15 *International Journal of Accounting* (Spring 1980), at 1-16.
10. Pagan and Wilkie suggest that there are potentially four different ways in which an initial adjustment may be made under TP provisions: (i) the transaction is respected and only the price is changed; (ii) the transaction is recategorized for purposes of determining what a fair price would be; (iii) the pricing adjustment is made in the form of a constructive dividend or regarded as a contribution to capital (iv) non-arm's length payments may be disallowed as deductions, or additional income may be required to be recognized under other provisions in the tax law. See Pagan, J.C. and Wilkie J.S., *Transfer Pricing Strategy in a Global Economy* (Amsterdam: IBFD Publications, 1993), at 60.
11. See *supra* note 3, at para. 23.
12. See Morrison, P., "New Section 482 Regs Abandon Commensurate-With-Income-Focus", 6 *Tax Notes International* (April 1993), at 857.
13. See *supra* note 10, at 61.
14. *Id.* at 64.
15. Vogel, K., *Vogel on Double Taxation Conventions* (Deventer: Kluwer Law and Taxation Publishers, 1991) at 452.

© 1994 International Bureau of Fiscal Documentation

tice appears to be that the RAs will adjust the UK company's taxable profit, and having made such an adjustment, will not require any increase in the transfer price to be paid to the UK taxpayer or any reduction to be refunded to it.[16] Similarly in the United States, in most cases the difference between the transaction price and the arm's length price is treated by the RAs as an adjustment to taxable profits without consequences for dividend or capital.[17] This also appears to be the case in Italy and Belgium.[18]

2. Hidden profit distribution

In some states a payment which is considered to be less than arm's length may be treated as a hidden profit distribution from the parent in State A to the subsidiary in State B, thereby conferring a benefit on the latter party. Such is the practice in Austria, where such a secondary adjustment will be made only where there is a deliberate deviation from the arm's length principle.[19]

3. Constructive dividend

Income may be classified as a constructive dividend where one member of the MNE is deemed to have conferred a benefit on the other. This approach may be taken with respect to loans where a deficiency in interest income arises from the fact that a loan made by the State A company to the State B company has been made for a consideration which is less than arm's length.[20]. In Germany, where the domestic taxpayer's taxable income is to be increased such increase is calculated by the market value of the benefit conferred on the shareholder, and the shareholder is treated as having made a constructive dividend distribution. This constructive dividend distribution is treated in the same manner as an ordinary dividend distribution.[21] Similarly, in Canada an excess payment made to a foreign parent may be treated as a dividend payment. The Canadian RAs are in practice willing to provide the taxpayer with the option of incurring the secondary tax adjustment or avoiding it by having the foreign person pay to the Canadian corporation the excess price.[22]

4. Interest

The situation as regards interest may arise in at least two contexts. Firstly, in commercial terms there may have been a loan made by the State A company to the State B company at a rate of interest which the RAs consider to be too low and an adjustment is made to reflect increased interest paid and income received. Secondly, there may be a pricing adjustment and the RAs may deem that the income remaining in the hands of the State B company constitutes a loan and that the State B company is deemed to have made interest payments to the State A company.

5. Contribution to capital

Income may be considered as a contribution to capital where there is a benefit conferred on a member of the MNE which is capable of being treated as an asset. In the case of a loan, where there is a lower than arm's length interest rate the RAs may consider the amount of interest income actually payable as a contribution to capital or it may treat the entire loan as such. This will raise the issue of the applicability of the thin capitalization rules of the particular state and it should be noted that the OECD Commentary does recognize the application of thin capitalization rules in this context.[23]

The haste with which the RAs may seek to recharacterize transactions and reclassify income is rooted essentially in the competing claims of states upon the wealth generated by taxpayers, especially when those taxpayers exist in the form of MNEs. The historical competition amongst states for the acquisition of territory is now fought at a more sophisticated level through a relatively recent upsurge in tax phenomena such as transfer pricing. This was clearly illustrated in an article by Philip D. Morrison concerning US transfer pricing policy where he states in his conclusion:[24]

> ... a central piece of the Clinton economic plan is the $ 45 billion (over four years) in increased revenues from foreign-controlled US corporations....[t]he fact also remains that Clinton and his closest advisors, as well as much of the American public, believe that there is a problem with foreign-controlled US corporations underpaying their income tax due chiefly to transfer pricing abuses.

These attitudes can not be considered to be purely political, and issues of sovereignty[25] and its seeming inviolable nature dominate. However, there are PIL lawyers who question the manner in which sovereignty is now viewed. Akehurst states that "it is doubtful whether any single word has caused so much intellectual confusion and international lawlessness".[26] After reviewing the development of the concept of sovereignty he states:

> When international lawyers say that a state is sovereign all that they really mean is that it is not a dependency of some other state. They do not mean that it is in any way above the law. Everyone knows that states are powerful, but the emphasis on sovereignty exaggerates their power and encourages them to abuse it; above all, it preserves the superstition that there is something in international co-operation as such which comes near to violating the intrinsic nature of a "sovereign state".

16. IBFD, *The Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Publications, 1993), chapter United Kingdom, at 20a.
17. *Id.* United States, at 16.
18. *Id.* Belgium, at 3; Italy, at 15.
19. *Id.* Austria, at 11.
20. See for example UK ICTA Sec. 209.
21. See *supra* note 16, Germany, at 21.
22. Information Circular No. 87-2, International Transfer Pricing and other international transactions (27 February 1987), at para. 49.
23. See *Model Tax Convention on Income and on Capital*, OECD Commentary on Art. 9 Concerning the Taxation of Associated Enterprises, para. 1(2) (Paris: OECD, 1992).
24. Morrison, P.D., "US Transfer Pricing Policy: Prospects for Continuing Controversy", *Intertax* (February 1993), at 74; see also Denhem, P.H. and Rhines, R.A., "German Transfer Pricing Rules and Practices", *Tax Planning International Review* (November 1993), at 3.
25. See *supra* note 2, at 23. Sovereignty connotes absoluteness, and therefore sovereign states are congruent counterparts, meaning that states can not legally co-exist for the purpose of law at the same time in the same space governing the same people (and regulating the same subject matter). It necessarily follows that for the concept of sovereignty to make sense at all, a body of principles must exist with the essential function to delimit time, space, people and matters over which sovereign states are supreme.
26. Akehurst, M., *A Modern Introduction to International Law*, 6th. ed. (London: George Allen & Unwin (Publishers) Ltd, 1987), at 15.

© 1994 International Bureau of Fiscal Documentation

Clearly, Akehurst's view is not necessarily the right view – whether or not it is the better view is debatable. It is another view which illustrates that PIL thinking on this matter remains controversial.

The jurisdiction to tax is considered one of the attributes of sovereignty.[27] Unlike other aspects of PIL the jurisdiction to tax appears to have very few limits and in a sense lacks definition. One school of thought suggests that limitations lie in a link between the state and the object of taxation.[28] However, there are those who argue that the limitation is that of enforcement and a minimum standard afforded foreigners.[29] In the transfer pricing context both schools of thought give the state of incorporation, the state of residence or the place where the taxpayer or source of income is physically located the right to tax the entity in the manner which it chooses, since it can claim a connection through nationality or territoriality and also may have the power to exercise enforcement jurisdiction. Thus an initial adjustment prescribed by domestic legislation seems justified.

With regard to corresponding adjustments, this leads one to consider the enforcement jurisdiction of states and their willingness to recognize the fiscal laws of other states.[30] It is true that one can discern a softening of attitude towards this rule, accelerated by the conclusion of tax treaties for the reciprocal enforcement of certain tax claims and the case law of certain states. However, in many states the rule is still firmly entrenched. It is therefore arguable that to seek a corresponding adjustment outside of treaty or legislation will amount to at least an indirect enforcement of the tax law of another state. Thus, it would be difficult for a taxpayer to argue for a corresponding adjustment or the recognition of the consistent treatment of a transaction or income without the support of legislation or treaty.

C. Article 9(2)

Article 9(2) of the OECD model convention is the tax treaty answer to the economic double taxation which may arise after an initial adjustment pursuant to Article 9(1); secondary adjustments are, however, not considered specifically.[31] This provision is reproduced in the UN model treaty with very little additional comment. Thus where there is a double taxation treaty between the two states in conformity with the OECD and UN models relief may be found under Article 9(2) of those models. With respect to corresponding adjustments it is interesting to take note of the number of countries which have actually included Article 9(2) in their double taxation treaties, those which have made reservations with respect to Article 9 and those which have domestic provisions concerning corresponding adjustments.[32]

The general practice of states as illustrated in the table raises the issue as to the usefulness of Article 9(2) in view of the fact that a significant number of treaties signed exclude it.[33] This reflects a marked divergence in attitude towards Article 9(2) and it will further become clear that even though the provision is included in treaties by some states, it is far from effective. For those states which do include a provision simi-

The Treaty and Domestic Practice of States

Country	Treaties contain article 9(2)*	Domestic practice	Reservation
Australia	yes	yes (where the initial adjustment is made by the RAs & it is fair & reasonable)	no
Austria	no (37)	no	no
Belgium	no (38)	no	yes, not to insert Art. 9(2)
Canada	yes	no (normally through CA procedure)	no
Denmark	no (27)	no	no
Finland	no (25)	no	yes, not to insert Art. 9(2)
France	no (55, 1 exception)	yes (case law holds TP can file claim to obtain adjustment)	yes (right to specify in its conventions that it will proceed to a correlative adjustment if justified)
Germany	no (52, 6 exceptions)	yes	no
Italy	no (40, 1 exception)	no	no
Netherlands	yes (almost all treaties after 1977)	yes (RAs may authorize adjustments)	no
Norway	no (2 exceptions)	no	yes (not to insert Art.9(2))
Sweden	yes	no	no
Switzerland	no (2 exceptions)	no	yes (not to insert Art. 9(2))
UK	no (52, 10 exceptions)	no (relief discretionary)	no
US	yes (11 exceptions)	yes (express provision)	no

* Table shows the general practice of states with indication of the number of treaties which do not include Article 9(2) and the exceptions to the general practice.

27. See *supra* note 2, at 59.
28. Brownlie, I., *Principles of Public International Law*, 4th ed. (Oxford: Clarendon Press, 1990), at 298.
29. Quereshi, "The Freedom of a State to Legislate in Fiscal Matters under General International Law", 41 *Bulletin for International Fiscal Documentation* (January 1987), at 14.
30. *HM The Queen of Holland (Married Woman) v. Drukker LR* [1928] 1 Ch. Div. 877.
31. See Baker, P., *Double Taxation Agreements and International Tax Law* (London: Sweet & Maxwell, 1991), at 156. The drafting of the provision is described as "astonishingly opaque."
32. See "Transfer Pricing in the absence of comparable market prices", Vol. LXXVIIa, *Cahiers de Droit Fiscal International*, (Deventer: Kluwer Law and Taxation Publishers); *The Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Publications, 1993); *Model Tax Convention on Income and on Capital* (Paris: OECD, 1992); Vogel *supra* note 12, at 453.
33. See *supra* note 31, at 159.

© 1994 International Bureau of Fiscal Documentation

lar to Article 9(2) of the models, the OECD Commentary is important.

Some of the issues raised by the Commentary are as follows:

- where there is a rewriting of transactions giving rise to economic double taxation, State B shall make an appropriate adjustment so as to relieve the double taxation;
- this adjustment becomes mandatory only in situations where State B considers that the initial adjustment made by State A is justified both in principle and amount;
- the method by which this adjustment may be carried out is left to bilateral negotiations;
- the purpose of the provision is not to deal with secondary adjustments where after a corresponding adjustment money representing the profits which have been taxed in State A are left in the hands of the State B enterprise;
- provision for secondary adjustments may be made under domestic legislation; and
- the mutual agreement procedure may be utilized.[34]

1. The mandatory nature of the corresponding adjustment

One of the more significant aspects of the Commentary is the fact that the corresponding adjustment, although couched in mandatory terms, is considered in effect discretionary since the RAs must be satisfied as to the initial adjustment both in terms of principle and amount. One would hope that in the interest of the taxpayer the RAs would consider the view adopted by the Dutch RAs and allow a corresponding adjustment even where the method can not be agreed upon (although the amount can be). The 1984 OECD Report discusses this issue and concludes that the RAs can not be expected to operate in a fashion which would amount to signing a blank cheque. The exception taken to an automatic corresponding adjustment by states seems justified since the initial adjustment may indeed be incorrect. However, at another level it may appear to be a rather simplistic view of the procedure. Certainly it must be the basis of any administrative action that that action be justified, otherwise Article 7(2) of the models can also be brought into question on similar grounds.

2. The method by which a corresponding adjustment is effected

The OECD Commentary does not make a recommendation as to how the adjustment should be made but suggests either re-opening the assessment of the enterprise in order to reduce its taxable profits or applying Article 23 of the models *mutatis mutandis*. Similarly the 1984 OECD Report, while not making specific recommendations with respect to how a corresponding adjustment should be effected, does suggest that such an adjustment may be made either by recalculating the profits using the relevant revised price or by leaving the calculation intact and granting the taxpayer relief against its own tax for the additional tax charged by the adjusting state.[35] It does not appear, however, that treaty practice has moved towards implementing these or similar provisions.

3. Methods of giving effect to corresponding adjustments through domestic legislation

Some states provide for the means of effecting a corresponding adjustment under their domestic legislation. For example, there is express provision in US law for appropriate correlative adjustments to be allowed any member of a group where it would affect its US tax liability. Further to this a domestic parent corporation may request permission from the RAs to receive from a foreign subsidiary, payment of all or part of the amount made under the initial adjustment without further tax consequences. A similar provision exists for domestic subsidiaries of foreign corporations.[36] In contrast, where the profits of an associated company have been adjusted under another state's transfer pricing rules, UK law does not require any corresponding adjustment to be made to the UK company's taxable profits, and the UK RAs are not bound to accept the amount of the other country's adjustment as being correct. Where however, the UK taxpayer requests an adjustment or relief from any consequent double taxation it may be allowed, depending on the circumstances of the case.[37]

III. TAX PLANNING

The reluctance to embrace Article 9(2) may be partly attributable to the fact that transfer pricing disputes are sometimes seen as a result of international tax planning schemes. States are concerned, sometimes justifiably, that MNEs are playing the domestic legislation of one state against the other and perhaps this is in part responsible for the shift in attitude over the years towards international tax planning. The traditional view is illustrated in the case of *IRC v. The Duke of Westminster*,[38] decided in the 1930s and concerning a domestic case of tax avoidance in the United Kingdom. In that case Lord Tomlin in an oft-quoted dictum stated:[39]

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

Even though that dictum is still considered to be good law it seems very much like a relic of those days when the phenomenon now described as global trading was still awaiting recognition. The case of *IRC v. Burmah Oil Co. Ltd.*[40] is perhaps more reflective of the current attitude towards tax planning. Lord Diplock in that case stated that the:[41]

34. One may be tempted to argue that Art. 9(2) raises more problems than it actually solves.
35. See *supra* note 4.
36. See *supra* note 16 United States, at 17.
37. See *supra* note 16 United Kingdom, at 20a.
38. 1936 AC 1.
39. This issue is discussed further in *Butterworths UK Tax Guide 1992-93*, ed. J. Tiley (London: Butterworths, 1992), at 7.
40. *Id.* at 10.
41. *Id.* at 32.

© 1994 International Bureau of Fiscal Documentation

> [*IRC* v. *Duke of Westminster* case] was about a simple transaction entered into between two real persons, each with a mind of his own ... The kinds of tax avoidance schemes which have occupied the attention of the courts in recent years, however involve inter-connected transactions between artificial persons, limited companies without minds of their own but directed by a single master mind.

This judicial observation sounds more in keeping with the way in which issues concerning transfer pricing are currently viewed, including the scope allowed the tax planning activities of MNEs which are viewed by some as abusing their somewhat privileged position of being able to shop around on a global scale. It is perhaps not surprising then that the following comment should have been made by the OECD Committee on Fiscal Affairs regarding corresponding adjustments:[42]

> The Committee took the view, moreover, that Article 9(2) did not in fact impose any obligation to match a corresponding adjustment where the original adjustment was made to correct the deliberate manipulation of a transfer price by the enterprise for the purpose of gaining a tax advantage.

The Committee's statement may provide some clue as to the general attitude of the RAs to the resolution of transfer pricing conflicts.

IV. SOLVING TRANSFER PRICING CONFLICTS

A. Treaty considerations

1. Mutual agreement procedure

Article 9(2) of the OECD model recognizes that there may be a need to have resort to the competent authority in determining an appropriate adjustment. Between treaty states with a provision similar to Article 25 of the OECD and UN models this procedure may be used in obtaining a corresponding adjustment, a refund or the payment of interest. Under this Article the competent authorities are not bound to come to any agreement. The competent authority procedure is essentially concerned with negotiation and may or may not include input from the taxpayer. The taxpayer's rights are limited to initiating the procedure. Indeed, the practical experience of MNEs suggests that the mutual agreement procedure is normally time consuming and uncertain in its results.[43]

2. Arbitration

The shortcomings of the competent authority procedure have contributed to a shift in focus to the utilization of a binding arbitration procedure.[44] The OECD Committee on Fiscal Affairs suggests that such a procedure would have a number of important advantages. One of the arguments canvassed against a binding arbitration procedure is the infringement of state sovereignty, but one should note the position of the Permanent International Court of Justice on this matter. It stated: "The court declines to see, in the conclusion of any treaty by which a state undertakes to perform or refrain from performing a particular act an abandonment of sovereignty ... [T]he right of entering into international engagements is an attribute of state sovereignty".[45] If a recourse to arbitration was mandatory in the absence of a settlement within a specific period, the taxpayer would be provided with the certainty of a decision and a reduction in delay. The Committee was also of the view that the arbitration proceedings themselves could be expected to be more expeditious.

Such a process which allowed the taxpayer a full right to present evidence and arguments would give it the opportunities excluded in its limited access to the competent authority procedure. In practice it has been suggested that arbitration decisions could be expected to be based less on a strict interpretation of national pricing rules and regulations and more on what the arbitrator considered to be a fair and equitable solution. Further, an arbitration system would avert the danger that the merits of a taxpayer's case would be ignored and its claim abandoned by the RAs on grounds of expediency. The EC Arbitration Convention is geared towards reconciliation of tax claims in transfer pricing. The Advisory Commission may be required to give an opinion, but the final decision is left with the competent authorities unless they fail to reach an agreement, in which case the opinion becomes binding. It should be noted, however, that even here MNEs are not proper parties to the proceedings.[46]

B. Public international law considerations

1. International tax tribunal

The idea is certainly not new, although it would not be unfair to suggest that little progress has been made in this area at the international level and the disadvantages resulting to the taxpayer remain. The view seems to be held that since states are the primary possessors of rights and duties under PIL, any rights to which the person may be entitled are derived from the state of which they are nationals. Thus individuals or enterprises may only be represented at the international level with the leave of the state. Brownlie notes that there is no rule that individuals can not have procedural capacity, but accepts that current thinking does not acknowledge the ability of enterprises to act independently of the state.[47] There are, however, other jurists who consider that the state is to be distrusted as a vehicle for maintaining the rights of individuals, so that PIL is seen as the best available moderator of human affairs. Thus we see a growing trend towards the recognition of individuals as subjects of international law where crimes of particular international significance are concerned. Since international law is continuing to develop it is possible that refinements may continue along these lines so that eventual-

42. See *supra* note 31, at 157. Baker draws readers' attention to the comment of the Committee on this matter and describes it as ominous, unwarranted and extremely dangerous "since it can only encourage the general tendency of RAs to assume that TP has been manipulated for the purpose of gaining a tax advantage..."
43. See *supra* note 4.
44. Arbitration clauses in recent double taxation treaties include the Germany–Sweden, Germany–France, US–Germany, US–Mexico and the US–Netherlands tax treaties.
45. Wimbledon case, PCIJ, Series A, No. 1, at 25.
46. See Killius, J, "The EC Arbitration Convention", *Intertax* (October 1990), at 437.
47. See *supra* note 28.

© 1994 International Bureau of Fiscal Documentation

ly the taxpayer may have direct access to international tribunals. It has been noted by von Glahn that the interest in human rights is characteristic of a modern disposition to enlarge the concept of what is of international interest or concern, it is not unreasonable to suggest that tax matters may develop in that direction.[48]

2. Abuse of right

PIL does not presently recognize an obligation to avoid double taxation,[49] but this is arguably attributable to the fact that this aspect of PIL requires further development. If we were to take an example from domestic law we see that it has recognized that individuals have a right to the enjoyment of their property, but this is coupled with a duty not to perform acts on that property so as to cause injury to neighbouring property. The sensible nature of this solution leads one to imagine that "civilized nations" would be anxious to develop the concept of fiscal duties amongst states under PIL.

Elements of this principle may be seen in the concept of abuse of right. The question which then arises is whether, given the appropriate circumstances, transfer pricing adjustments can be considered an abuse of right.[50] In PIL, abuse of right refers to a state exercising a right which prevents other states from enjoying their own rights or rights exercised for an end different from that for which the right was created, resulting in injury to the other state. The concept of abuse of right is not, however, clear.

Unfortunately, even amongst writers who accept the principle of the prohibition of the abuse of right, there is no agreement on the analysis of its significance and theoretical basis. The divergence of opinion results to some degree from the different forms in which the exercise of an existing right can cause injury to another state. The importance of the principle in international relations has certainly been questioned. Some commentators have objected to its lack of precision for practical use and others that it is lacking in value as an independent rule, concluding that it consists primarily of an application of other uncontested concepts such as good faith, reasonableness, good neighbourliness or equity.

There is some explicit recognition of an abuse of right found in the Convention adopted in 1982 by the Third United Nations Conference on the Law of the Sea in Article 300:[51]

> parties shall fulfil in good faith the obligations assumed under this Convention and shall exercise the rights, jurisdiction and freedoms recognized in this Convention in a manner which would not constitute an abuse of rights.

One can well imagine the difficulty in proving that an abuse of right has occurred. However, it has always been the view of judicial bodies that a right was nonetheless worth pursuing because of difficulties in adjudication. If a state will seek to exercise its taxing jurisdiction (which it has a right to do) in such a manner that it will deprive other states of revenue which is rightfully theirs, thereby causing injury to those states and their nationals, this may create a basis for judicial scrutiny. One would hope that double taxation concerning MNEs may be solved through a procedure other than negotiation; otherwise one can very well imagine that it will be the more powerful states which will emerge with the bigger tax share. However, with political leaders arguing that for their "fair share" of taxes (no longer a banner waved only by "developing countries"), unless these issues are going to be solved exclusively at the political level concepts such as an abuse of right may very well find a place in international tax law.

3. Treaties negotiated in good faith

It has been argued that in a sense treaty clauses providing for the application and implementation of the measures agreed upon good faith may be considered as involving the prohibition of any abuse of right which those treaties confer on the contracting parties. In this connection it should be noted that Article 26 of the Vienna Convention on the Law of Treaties declares that every treaty in force must be performed in good faith by the parties. Finally, where a double taxation treaty is concluded, the express object of which is to relieve double taxation of the taxpayer, it is arguable that when a state refuses a corresponding adjustment or refuses to deal adequately with any other matter which results in the double taxation of the taxpayer then there may be a breach of good faith, so that both states have an obligation to have the matter resolved.[52]

V. CONCLUSION

International tax law has considerable scope for development through PIL. The work of various bodies, most outstandingly the OECD, have assisted greatly in the harmonization of treaty practice. Treaties are, however, inadequate in determining all issues which may arise as seen specifically in the case of corresponding adjustments in transfer pricing. The provision in the model conventions is deficient and state practice is inconsistent. It is true that MNEs are powerful and are capable of engaging in sufficient lobbying to minimize the harmful effects of the current status quo. Certainty and consistency may only be developed where they are derived from PIL principles applicable to all MNEs and all states.

48. Von Glahn, G., *Law Among Nations: An Introduction to Public International Law*, 5th. ed. (New York: MacMillan Publishing Co., Inc., 1986), at 180.
49. See Martha *supra* note 2, at 141.
50. *Id.* at 86 where abuse of right is discussed in the context of legislative jurisdiction and unitary taxation.
51. UN Doc. A/CONF. 62/122.
52. See Killius *supra* note 46, at 438.

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

South Africa

EXPORT PROMOTION. 2ND EDITION.
Johannesburg, Coopers & Lybrand. 1993, pp. 126.
This guide covers primarily the incentives for export promotion provided by tax and customs legislation and particular export promotion measures for certain industries as part of the structural adjustment programme.
(B. 13.478)

THE WORLD OF INFORMATION: AFRICA
Review 1993/94. 17th Edition.
London, Kogan Page and Walden Publishing, 120 Pentonville Road, London N1 9JN, United Kingdom. 1993.
The Economic and Business Report, pp. 208, £. 35.-.
Annual information guide dealing with general topics concerning Africa along with a country-by-country description of the major events that have occurred in various countries.
(B. 13.481)

GLENDAY, Graham.
Perspectives on the computerization of tax systems in Sub-Saharan Africa.
Cambridge, Harvard University. 1993.
Taxation Research Series No. 9. pp. 29.
This paper examines experiences in Kenya, Lesotho, Malawi and Zambia in order to understand the successes and failures of the computerization of tax systems in sub-Saharan Africa. The author explores why computerization has proceeded more slowly than expected and pinpoints key ingredients for a successful computerization strategy.
(B. 13.482)

Ivory Coast

LA REGLEMENTATION FISCALE EN Côte d'Ivoire.
Abidjan, C2A Editions. 1994, pp. 250.
General Income Tax Regulation (updated till 1993) and Investment Code.
(B. 13.487)

ASIA & THE PACIFIC

Australia

HEIJ, Gitte.
Doing business with Indonesia. A tax guide for Australian investors.
Murdoch, Asia Research Centre on Social, Political and Economic Change, Murdoch University, Western Australia. 1993. Policy Paper No. 9, Volume I, pp. 68.
The aim of this publication is to inform Australians who do business in Indonesia or intend to do so. This book is Volume I (of two) on Indonesian Tax Law and deals mainly with corporate income tax and individual income tax. The double taxation treaty between Australia and Indonesia is dealt with, and an English version of the Indonesian Income Tax Law is appended. Volume II, Tax Administration and Compliance in Indonesia, gives information and guidelines regarding the tax administration system in Indonesia.
(B. 57.956)

1994 AUSTRALIAN MASTER TAX GUIDE.
From the EEC Tax Editors.
North Ryde, CCH Australia Limited. 1994, pp. 1800.
Guide to help taxpayers prepare their tax returns for 1993/94 income year and to provide information on the tax consequences flowing from decisions and transactions that taxpayers may face in the 1994/95 income year. This edition highlights the main legislative, judicial and administrative changes in tax law and practice which occurred during 1993. Special features include a depreciation table, personal tax calculator, provisional tax ready reckoner, 1994 tax calendar and checklists of deductible and non-deductible items and taxable and non-taxable items.
(B. 57.975)

VERTICAL FISCAL IMBALANCE AND the allocation of taxing powers. Proceedings from a workshop held at the Hyatt Hotel, Canberra, 4-5 November 1993. Edited by D.J. Collins.
Sydney, Australian Tax Research Foundation. 1993. Conference Series, No. 13, pp. 345.
(B. 57.959)

POPE, J.; FAYLE, R.; CHEN, D.L.
The compliance costs of employment-related taxation in Australia.
Sydney, Australian Tax Research Foundation. 1993. Research Study No. 19, pp. 192.
Study on the compliance costs of employers' pay-as-you-earn (PAYE), fringe benefits tax (FBT), prescribed payments tax system (PPS) and payroll tax 1989/1990 in Australia.
(B. 57.960)

DEUTSCH, R.L.; GATES, S.J.; GIBSON, M.M.;
HANLEY, P.J.; PAYNE, G.L.
Butterworths Australian Tax Handbook 1994.
North Ryde, Butterworths. 1994, pp. 2400.
Annual updated handbook covering all legislation in force as of 31 December 1993. The book includes the following subjects: Australian tax system, income tax, capital gains tax, deductions, fringe benefits tax, international taxation, tax accounting/administration, tax planning.
(B. 57.977)

Brunei Darussalam

BUSINESS PROFILE SERIES: BRUNEI Darussalam.
Hong Kong, The Hongkong and Shanghai Banking Corporation Limited. 1993, pp. 44.
Seventh edition of information booklet on the economic and investment climate in Brunei Darussalam, including tax issues, customs duties, foreign employment regulations, exchange controls, registration of companies, money and banking.
(B. 13.483)

China (People's Rep.)

TRETIAK, Lois Dougan; HOLZMANN, Katalin.
Operating joint ventures in China.
Hong Kong, EIU – The Economist Intelligence Unit, 10th Fl., Luk Kwok Centre, 72 Gloucester Road, Hong Kong. 1993, pp. 226. $ 595.
Research report on joint ventures in China. Chapters include: equity considerations, foreign exchange balancing, the venture site, investment incentives, labour, technology transfer, management and multiple ventures.
(B. 57.958)

COMMERCIAL LAWS & BUSINESS
Regulations of the People's Republic of China. Edited by Victor F.S. Sit. 5 Volumes.
Hong Kong, Tai Dao Publishing Limited, 113, Wanchai Road, Tak Lee Commercial Bldg., 13/F., Block D, Hong Kong. 1987.
Compilation of English translation of Chinese legal systems, including taxation. The laws and statutes are divided into the following sections: industry, agriculture, finance and banking, insurance, land, energy, taxation, financial management, commercial management, trade marks and advertisement control, economic contract, foreign investment

© 1994 International Bureau of Fiscal Documentation

and joint ventures, special economic zones, customs and tariffs, accountancy, lawyer and legal arbitration, measurements, standardization and quality controls, awards and protection of invention, labour welfare and organization, wages, individual and collective enterprises, statistics, and environmental protection. Each volume contains more than 500 pages.
(B. 57.978)

India

BHARGAVA, U.K.; BHARGAVA, Rakesh.
Income Tax Rules 1993.
Dehli, Taxmann Publications Ltd. 1993, pp. 525.
Includes amendments up to March 1993.
(B. 57.968)

HANDBOOK TO INCOME TAX ACT.
With master guide to Finance Act, 1993 & Income Tax Lexicon. Edited by George Koshi.
Delhi, Taxmann Publications Ltd. 1993, pp. 366.
A practice manual to law of income tax. This book explains the entire gamut of law using charts and tables.
(B. 57.967)

COMPANION VOLUME OF
notifications referred to in Income Tax Act.
Delhi, Taxmann Publications Ltd. 1993, pp. 100.
Text of relevant notifications referred to in Taxmann's Income Tax Act, 1993 edition.
(B. 57.966)

TAX REFORMS COMMITTEE.
Final Report, Part I.
New Delhi, Ministry of Finance. 1992, pp. 207.
This report covers issues in five broad areas and makes recommendations on these issues: 1) problems of direct taxes not considered in the Interim Report, namely, corporate profits tax including the taxation of foreign entities, problems relating to business taxation, the interest tax, taxation of agricultural income and gift tax; 2) further reform of the system of domestic indirect taxes, more details regarding the extension of modified value added tax (Modvat) and conversion of Modvat into VAT; 3) improvements in procedures, including appellate procedures; 4) problems of administration; 5) revenue auditing.
(B. 57.813)

DIRECT TAX LAWS MANUAL.
Volume II: The Income-Tax Rules, 1962 and the Wealth-Tax Rules, 1957 & Gift-Tax Rules, 1958. 1992 Edition. Edited by O.C. Tandon.
Allahabad, Law Publishers. 1992, pp. 610.
Texts of Income Tax, Wealth Tax and Gift Tax Rules as amended up to 20 May 1992.
(B. 57.969)

MATTA, Ali Mohammad.
Taxation of foreign investments in India.
New Delhi, Uppal Publishing House, 3 Ansari Road, Daryaganj, New Delhi-110002, India. 1991, pp. 412. US$ 46.
This book provides a critical evaluation of the tax policies of the Government. Chapter I contains an introduction to the problem of taxation of foreign investments in India. Chapter II discusses various factors responsible for attracting or repelling foreign investments. These include both tax and non-tax factors. Chapter III deals with the chargeability of income tax, residence status, scope of total income, etc. in so far as these concern foreign investors. The objectivity and profitability of such incentives are considered in chapter IV. A closing chapter contains detailed discussion of the tax incentives and a critical evaluation of the approach of tax administrator in implementing these provisions, double taxation issues of global importance and the importance and role of transnational corporations in the globalization of international resources.
(B. 57.970)

GUNASEKARAN, T.
MODVAT Manual 1993-94. 3rd Edition.
Bombay, Snow White Publications Ltd., Jer Mahal, 532, Kalbadevi Road, Bombay 400 002, India. 1993, pp. 539.
Reference manual for industries, Departmental Officers, advocates and consultants dealing with MODVAT – modified value added tax. There are new chapters on advance licence and MODVAT and a commentary on the Chelliah Committee's Report pertaining to MODVAT which give this third edition an added feature (with reference to case law).
(B. 57.971)

SRINIVASAN, K.
Guide to double taxation avoidance agreements. Edited by B.P. Bhargava.
New Delhi, VIDHI Publishing, 7/22B, Ansari Road, Darya Ganj, New Delhi 110 002, India. 1993, pp. 1073.
(B. 57.974)

Indonesia

HEIJ, Gitte.
Doing business with Indonesia. A tax guide for Australian investors.
Murdoch, Asia Research Centre on Social, Political and Economic Change, Murdoch University, Western Australia. 1993. Policy Paper No. 9, Volume I, pp. 68.
The aim of this publication is to inform Australians who do business in Indonesia or intend to do so. This book is Volume I (of two) on Indonesian Tax Law and deals mainly with corporate income tax and individual income tax. The double taxation treaty between Australia and Indonesia is dealt with, and an English version of the Indonesian Income Tax Law is appended. Volume II, Tax Administration and Compliance in Indonesia, gives information and guidelines regarding the tax administration system in Indonesia.
(B. 57.956)

HEIJ, Gitte.
Tax administration and compliance in Indonesia.
Murdoch, Asia Research Centre on Social, Political and Economic Change, Murdoch University, Western Australia. 1993. Policy Paper 9, Volume II, pp. 28.
Study on tax administration and compliance in Indonesia with emphasis on income tax.
(B. 57.955)

Japan

THE JAPANESE BUDGET IN BRIEF, 1993.
Tokyo, Ministry of Finance. 1993, pp. 135.
This edition contains a summary of the fiscal 1993 budget and a detailed review of the main items of government expenditure. This publication also outlines the Fiscal Investment and Loan Program (FILP) for the current term. A brief description of the Japanese budget system and the budget process are presented in Part II.
(B. 57.964)

Taiwan

GOVERNMENT FINANCE OF THE
Republic of China.
Taipei, Ministry of Finance. 1993, pp. 90.
This bilingual Chinese and English text provides figures describing the organization and functions of the Ministry of Finance and the activities relating to the treasury, taxation, banking, insurance and securities.
(B. 57.954)

EUROPE

FINE, Frank L.
Mergers and joint ventures in Europe. The law and policy of the EEC. 2nd Edition.
London, Graham & Trotman Limited. 1994, pp. 778. £ 125.-
The book examines the application of the EEC competition rules to changes in corporate structure and to all forms of permissible industrial cooperation. The book provides an in-depth analysis of the Merger Regulation and the Commission decisions during the first two years' operation of the Regulation.
(B. 113.591)

FINANCIAL REPORTING BY THE EUROPEAN
oil industry.
London, Arthur Andersen & Co. 1993, pp. 150.
This guide contains the results of a review of several oil company accounts published in Europe during the past year. It analyses what companies are currently doing and reviews levels of compliance with the recommendations of oil industry SORPs.
(B. 113.511)

© 1994 International Bureau of Fiscal Documentation

Austria

NEUE WETTBEWERBSFAKTOREN IN der Weiterbildung. Herausgegeben von Norbert Kailer und Hubert Regner.
Vienna, Linde Verlag Wien GmbH. 1993, 240 pp. 352.- S.
This book contains information on education and is not dealing with taxation. Items dealt with are: the increase involvement of clients in the development of measures to stimulate the education of adults, evaluation and studying the needs for further education of adults, the transparency of education. Various articles by practicians and scientists dealing with special topics and examples and training courses of companies in Germany, Austria and Switzerland.

Belgium

BEHAEGHE, I.; CAUWENBERGH, P.; CLAES,
S.; DEFOOR, W.; a.o.
Vennootschap en belastingen. Fiscaal jaaroverzicht 1993.
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 182.
Overview of modifications introduced in Belgian tax legislation in 1993.
(B. 113.484)

TILQUIN, Thierry.
Traité des fusions et scissions.
Deurne, Kluwer Editions Juridiques Belgique. 1993, pp. 657. 6450.- Bfrs.
Extensive monograph on all the legal aspects of national and cross-border mergers and divisions before and after the 1993 legislation.
(B. 113.311)

R-2265. ARRETE ROYAL D'EXECUTION du Code des impôts sur les revenus, 1992; Koninklijk besluit tot uitvoering van het Wetboek van de inkomstenbelasting, 1992. V-2265.
Brussels, Ministry of Finance. 1993, pp. 290.
Royal Decree implementing the consolidated Income Tax Code.
(B. 113.466)

VENNOOTSCHAP IN POCKET, 1994.
Diegem, CED Samsom. 1994, pp. 700.
Overview of legislation applicable to companies.
(B. 113.410)

Bulgaria

GONGALOVA, Eleana.
Investitionen in Bulgarien.
Vienna, Linde Verlag Wien. 1993, pp. 270, 740.- AS.
Investing in Bulgaria. The author describes the macro-economic development, the forms of doing business and the tax system in Bulgaria. The book also contains laws on foreign investment and privatization as well as statistical information.
(B. 113.529)

Czech Republic

INTERNATIONAL BANKING IN THE Czech Republic.
Prague, Price Waterhouse. 1993, pp. 47.
Overview of the banking environment in the Czech Republic. This brochure describes the legal, accounting and tax framework and outlines the requirements and procedures for setting up a bank.
(B. 113.506)

EEC

GEIE. ASPECTS PRATIQUES FRANCE ET autres pays de la Communauté.
Levallois, Editions Francis Lefebvre. 1993, Dossiers Européens Francis Lefebvre, pp. 250. 340.- Ffrs.
In-depth study of the European economic interest grouping.
(B. 113.329)

MEMENTO PRATIQUE FRANCIS Lefebvre:
Communauté Européenne 1994-1995.
Juridique, fiscal, social, comptable, financier. A jour au 1er septembre 1993. Paris, Editions Francis Lefebvre. 1993, pp. 1706. 592.- Ffrs.
Monograph on EC law covering the legal, tax, customs, social and accounting aspects. The French version of the Treaty of Rome and the most significant directives to date are appended.
(B. 113.411)

JURGENS, E.C.M.; VERMEEND, W.A.
Een onparlementair stelsel; Het Europees belastingrecht na Maastricht.
Deventer, Kluwer. 1993, pp. 47. 32.50 Dfl.
Booklet containing two speeches: one by E.C.M. Jurgens made on the occasion of his acceptance of a visiting professorship in Parliamentary Law at the RU in Maastricht on 27 May 1993. This speech deals with the aspects of control of policy and jurisdiction of the EC by national parliaments: constitutional problems, legitimacy in a pre-federal structure; lack of democracy and supplementary legitimazation; national options and cooperation between parliaments. The second speech, by W.A.Vermeend made on the occasion of his acceptance of the office of a visiting professor of European Tax Law at the RU in Maastricht on 27 May 1993, dealt with the harmonization of direct taxes and European tax law after "Maastricht".
(B. 113.439)

DOSSIER MAASTRICHT. VERDRAG betreffende de Europese Unie.
The Hague, SDU Uitgeverij. 1993, pp. 642. 119.- Dfl.
Official documents dealing with the Treaty of Maastricht. A reprint of the official text of the treaty and its explanatory memorandum as published in Tractatenblad, Stadsblad and Parliamentary Documents. The book is a source of information, from a Dutch point of view, on the steps leading up to the treaty's conclusion.
(B. 113.450)

TAKENS, J.W.; WAGENAAR, H.A.; WIT, J.P. de.
Douanememo.
Deventer, Kluwer. 1994, pp. 225, 42.- Dfl.
Customs memo providing summary on customs regulations within the EC as of 1 January 1994.
(B. 113.504)

COEN, M.; HÖLSCHEIDT, S.; PIEPER, S.U.
Europa '93. Auf dem Weg zur Europäischen Union. Festschrift für Prof. Dr. Dr. Albert Bleckmann zum 60. Geburtstag.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 332, 98.- DM.
Europe '93 on the way to the European Union. Compilation of essays on various European topics, such as exise duties within the internal market, tax harmonization, international private law and community law.
(B. 112.949)

France

GEIE. ASPECTS PRATIQUES FRANCE ET autres pays de la Communauté.
Levallois, Editions Francis Lefebvre. 1993, Dossiers Européens Francis Lefebvre, pp. 250. 340.- Ffrs.
In-depth study of the European economic interest grouping.
(B. 113.329)

CODE LOCAL DES IMPOTS.
Réglementation fiscale et para-fiscale, 1993.
Paris, Imprimerie Administrative. 1993, pp. 175.
Tax Code of the French overseas territory of Saint Pierre et Miquelon.
(B. 113.359)

KAMBER, A.; RICCI, G.; O'BRIEN, M.J.; JACOBS,R.C.
Sociétés de domicile et mesures en vue de contrer l'évasion fiscale en Suisse et en France. Base companies and anti-avoidance tax rules in the United Kingdom and the USA.
Zurich, Chambre Fiduciaire, Limmatquai 120, 8001 Zurich. 1990. Publication de la Chambre fiduciaire, Volume 91, pp. 117.
The authors describe the unilateral, bilateral and multilateral measures to fight tax avoidance resulting from the setting-up of offshore companies in Switzerland, France, the United Kingdom and the USA.
(B. 111.715)

PRATIQUE LAMY COMPTABLE 1994.
Paris, Lamy SA. 1993, pp. 924. 465.- Ffrs.
Complete guide to French accounting rules.
(B. 113.441)

Germany

BOVELETH, BRAMBRING, CLAASSEN, COEN, DORNFELD, u.a.
Handbuch der Bauinvestitionen und Immobilienkapitalanlagen. Stand: Oktober 1993.

© 1994 International Bureau of Fiscal Documentation

Heidelberg, C.F. Müller Juristischer Verlag, 1993.
Handbook of taxation of capital expenditure on building and investment in real property. Loose-leaf publication providing a detailed commentary on the various tax aspects of investment in houses and real property in Germany or participate in a fund investing mainly in immovable property. The book is updated regularly.
(B. 104.647)

75 JAHRE REICHSFINANZHOF –
Bundesfinanzhof. Festschrift. Herausgeber Der Präsident des Bundesfinanzhofs.
Bonn, Stollfuss Verlag. 1993, pp. 764.
398.- DM.
Compilation of essays, comments and critique on the 75 years of jurisdiction of the Supreme German Tax Court.
(B. 113.371)

SAUER, Otto.
Allgemeines Steuerrecht.
Hamburg, Steuer- und Wirtschaftsverlag. 1994, pp. 425. 39.80 DM.
General Tax Law. Explanation of the basic principles of German tax law.
(B. 113.515)

LANG, Joachim.
Entwurf eines Steuergesetzbuchs.
Bonn, Stollfuss Verlag. 1993, Schriftenreihe des Bundesministeriums der Finanzen, Heft 49, pp. 475.
Draft of a tax code. The author prepared a model tax code for East European countries, which covers all aspects of taxation and recent developments in tax law in a state in which the rule of law prevails. The book contains the text of the draft as well explanations of the most important provisions.
(B. 113.540)

SCHMIDT-TROJE, Jürgen.
Der Steuerprozess. Ratgeber für das finanzgerichtliche Verfahren.
Bonn, Stollfuss Verlag. 1993, pp. 200.
45.80 DM.
The tax trial. Guide explaining the principles, the risk and the necessary formalities of a proceeding in a German tax court. Statement of case, request for suspension, time limits, etc.
(B. 113.408)

EBERL, Christina.
Rechtsfragen der Bankgarantie im internationalen Wirtschaftsverkehr nach deutschem und schweizerischem Recht.
Baden-Baden, Nomos Verlagsgesellschaft. 1992.
Studien zum Bank- und Börsenrecht, No. 24, pp. 140. 46.- DM.
Legal questions with regard to bank guarantees in international business according to German and Swiss law: the bank guarantee in cross-border business; legal qualification; distinction between bank guarantee and suretyship; applicable law.
(B. 112.338)

KALABUCH, Jutta.
Der Stetigkeitsgrundsatz in der Einzelbilanz nach Handels- und Ertragsteuerrecht.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 441. 98.- DM.
The principle of continuity. The author discusses the application of the continuity principle in the single balance sheet under commercial and tax law.
(B. 113.416)

STEUERBERATER
Branchenhandbuch.
Gewerbliche und berufliche Besonderheiten zu Steuern – Wirtschaft – Recht.
Bonn, Stollfuss Verlag. 1993, 248.- DM.
Tax advisor's handbook. The authors describe specific aspects of various branches of industry for tax law purposes.
(B. 113.159)

KÖRPERSCHAFTSTEUER
Handausgabe 1993.
Körperschaftsteuergesetz mit Durchführungsverordnung, Richtlinien, Nebenbestimmungen und Rechtsprechung in Leitsätzen. Bearbeitet von Ewald Dötsch und Hans Singbartl. Ausgabe Februar 1994.
Bonn, Stollfuss Verlag. 1994, pp. 624.
65.80 DM.
German Corporate Income Tax Law 1991 of 11 March 1991 as last amended by the Anti-Abuse and Corrections Tax Act of 21 December 1993. Implementation Directive, administrative guidelines, related provisions and jurisprudence.
(B. 113.534)

HAMBITZER, Rolf.
Verdeckte Gewinnausschüttung. Verdeckte Einlage.
Hamburg, S+W Steuer- und Wirtschaftsverlag. 1993, pp. 204. 48.- DM.
Hidden profit distribution – hidden capital contribution. The author describes these terms as they appear in the recent German jurisprudence.
(B. 113.407)

DIE VERANLAGUNG ZUR
Körperschaftsteuer für 1993. 44. Auflage. Bearbeitet von Horst Eversberg.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 1519, 47.- DM.
1993 corporate tax assessment. Texts of laws including ordinances, guidelines and jurisprudence of the Supreme Tax Court.
(B. 113.571)

LOOSE, Matthias.
Rückstellungen für Umweltverbindlichkeiten.
Cologne, Verlag Dr. Otto Schmidt KG. 1993.
Der Rechts- und Steuerdienst, Kölner Schriftenreihe, Heft 78, pp. 191. 56.- DM.
Reserves for environment-related debts. The author discusses the problems arising from the creation of reserves for debt resulting from liability for environmental damage.
(B. 113.468)

STUHRMANN, Gerd.
Die neue Investitionsförderung in den neuen Bundesländern. 2. Auflage.
Cologne, Peter Deubner Verlag. 1994.
Steuer-Telex Sonderinformation, pp. 74.
38.80 DM.
Updated edition of a survey on all the tax incentives available within the five new Länder.
(B. 113.403)

ERTRAGSBESTEUERUNG. FESTSCHRIFT
für Ludwig Schmidt zum 65. Geburtstag. Herausgegeben von Arndt Raupach und Adalbert Uelner.
Munich, C.H. Beck'sche Verlagsbuchhandlung. 1993, pp. 912.
168.- DM.
Jubilee edition on the occasion of Ludwig Schmidt's 65th birthday: Taxation of income. Various authors contribute to the topic income taxes.
(B. 113.448)

DIE VERANLAGUNG ZUR
Gewerbesteuer
für 1993. 43. Auflage. Bearbeitet von Horst Eversberg.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 566. 36.- DM.
1993 business tax assessment. Annual updated guide containing the texts of the Business Tax Law, the regulatory ordinance to it, case law and other relevant material for the 1994 assessment year.
(B. 113.570)

VERANLAGUNGS HANDAUSGABEN
1993.
Sammelband. Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. Mit Richtlinien, Gesetzen, Durchführungsverordnungen und Nebenbestimmungen. Ausgabe Februar 1994.
Bonn, Stollfuss Verlag. 1994, pp. 2650, 169.- DM.
Extensive documentation of the Individual Income Tax Act, Corporate Income Tax Act, Business Tax Act, Value Added Tax Act and all administrative guidelines thereto.
(B. 113.607)

ROSE, Gerd.
Die Substanzsteuern. 9. Auflage.
Wiesbaden, Verlag Dr. Th. Gabler GmbH. 1993.
Betrieb und Steuer, 3. Buch, pp. 194.
Taxes on net worth. Introduction to German valuation law, net wealth tax, real estate tax, business tax on capital, inheritance and gift tax.
(B. 113.447)

WAGNER, Klaus-R.
Management buy-out.
Führungskräftebeteiligung/Arbeitnehmer-beteiligung.
Neuwied, Hermann Luchterhand Verlag. 1993, pp. 250. 68.- DM.
The book gives advices to entrepreneurs and managers about MBO strategies. Basic principles, model structures, former East Germany, law policy, corporate law and labour law aspects, participation of employees and

© 1994 International Bureau of Fiscal Documentation

management in the corporation, and related risks.
(B. 113.376)

LENNARDT, Jörg; STEFANOVIC, Milos.
Management buy-out. Vorbereitung und Umsetzung in den neuen Bundesländern. Ein Leitfaden.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 218, 78.- DM.
The book advices entrepreneurs and managers about MBO strategies with special reference to the situation in East Germany. Basic principles, model structures and samples, law, financing, policy, and special industries.
(B. 113.415)

WP-HANDBUCH DER
Unternehmensbesteuerung. 2. Auflage.
Düsseldorf, IDW Verlag. 1994, pp. 2832, 250.47 DM.
Auditor's handbook of corporate taxation. Various authors describe in 22 comprehensive chapters all topics of German corporate taxation. Basic principles of income taxation, balance sheet, taxation of business income and partnerships, income of leasing and rent, capital income and withholding taxes, wage tax, corporate income tax, business tax, foreign tax law, valuation, net worth tax, inheritance and gift taxes, VAT law, subsidies, employer provided security schemes, losses, organization, group taxation, examination for tax purposes, donations law, procedure, penalties, legal protection in tax law.
(B. 113.377)

FISCHER, Lutz.
Besteuerung internationaler Konzerne. Qualifikationskonflikte, Verluststrategien, Grenzüberschreitende Spaltung, Einbringung von Betriebsstätten, Rechtsschutz bei Treaty Overriding, Unternehmenssteuerreform.
Cologne, Verlag Dr. Otto Schmidt KG. 1993.
Forum der Internationalen Besteuerung, Band 3, pp. 139. 58.- DM.
Taxation of international groups. Various authors discuss the following topics: qualification conflicts, loss strategy, cross-border spin-off, transfer of permanent establishments, treaty overrides and legal protection.
(B. 113.469)

HAARMANN, Wilhelm.
Die beschränkte Steuerpflicht. Aktuelle Schwerpunkte in der Diskussion: Betriebsstätte, Grenzüberschreitende Betriebsaufspaltung, Diskriminierung, Treaty Shopping, Künstler und Sportler, Zinsabschlagsteuer, Verfahrensprobleme.
Cologne, Verlag Dr. Otto S chmidt KG. 1993.
Forum der Internationaler Besteuerung, Band 2, pp. 162. 68.- DM.
The following topics are discussed by various authors: procedural problems of non-residents, treaty shopping, permanent establishments, artists and professional sportsmen, cross-border spin-off, discrimination against non-residents, and withholding taxes on interest derived by non-residents.
(B. 113.470)

GRUBER, Thomas.
Der Bilanzansatz in der neueren BFH-Rechtsprechung.
Stuttgart, Schäffer Verlag. 1991.
Schriften zur Bilanz- und Steuerlehre, Band 7, pp. 272. 64.- DM.
The entry in the balance sheet under recent jurisprudence of the Federal Tax Court of Germany. The author discusses the application of general valuation principles by the higher German tax courts.
(B. 111.457)

BALS, B.
Steuer-Ratgeber zur Einkommen- und Lohnsteuer 1994.
Munich, Verlag Franz Rehm GmbH & Co KG., Einsteinstrasse 172, 81675 Munich, Germany. 1994, pp. 288. 41.80 DM.
Income tax/Wage tax 1994 – Guidebook. Compilation of all relevant laws and explanations to the amendments in 1994.
(B. 113.512)

EINKOMMENSTEUER HANDAUSGABE 1993.
Richtlinien mit Einkommensteuergesetz, Duchführungsverordnung, Nebenbestimmungen.
Bonn, Stollfuss Verlag. 1994, pp. 960. 59.80 DM.
Comprehensive compilation of all relevant laws, implementation provisions and administrative guidelines relevant for income tax assessment 1993.
(B. 113.530)

GEWERBESTEUER HANDAUSGABE 1993.
Richtlinien mit Gewerbesteuergesetz, Durchführungsverordnung, Nebenbestimmungen, BFH-Rechtsprechung in Leitsätzen. Bearbeitet von Dietmar Pauka.
Bonn, Stollfuss Verlag. 1994, pp. 239. 45.80 DM.
Comprehensive compilation of all relevant laws, implementation provisions, administrative guidelines and jurisprudence relevant for business tax assessment.
(B. 113.531)

RICHTER, Heinz; BOVELETH, Karl-Heinz.
Die neue steuerliche Förderung des Wohnungsbaus. 4. Auflage.
Cologne, Peter Deubner Verlag. 1994.
Steuer-Telex Sonderinformation, pp. 100.
The new tax incentives for dwelling-houses. The authors describe all important provisions with regard to dwelling construction as well as the relevant tax incentives and their effects.
(B. 113.442)

LOHNSTEUER HANDAUSGABE 1994.
Einkommensteuergesetz mit Durchführungsverordnungen, Richtlinien, Ergänzenden Hinweisen auf Verwaltungsanweisungen, rechtsprechung in Leitsätzen, Anhang mit ergänzenden Gesetzestexten. Bearbeitet von Robert Hanke.
Bonn, Stollfuss Verlag. 1994, pp. 1072, 77.- DM.
1994 Wage Tax Manual containing rulings, the Income Tax Ordinance, regulations, and jurisprudence of the German Supreme Tax Court.
(B. 113.535)

PAUS, Bernhard.
Erben, vererben und das Finanzamt. Steuerstrategien und -tips zur Verminderung der Einkommen-, Erbschaft- und Schenkungsteuer.
2. Auflage.
Planegg, WRS Verlag Wirtschaft Recht und Steuern, Postfach 1363, 82142 Planegg, Germany. 1993, pp. 116, 19.80 DM.
To inherit, to leave and the tax administration. Tax strategies to lower the burden of income, inheritance and gift taxes.
(B. 113.431)

ABC DES LOHNBÜROS. ARBEITSLOHN – Lohnsteuer – Sozialversicherung von A bis Z.
Bearbeitet von Wolfgang Schönfeld.
(Rechtsstand: 1. Januar 1994.)
Bonn, Stollfuss Verlag. 1994, pp. 440.
54.30 DM.
Explanation of the most relevant topics relating to wages, wage tax and social security.
(B. 113.462)

HAHN, Volker; KORTSCHAK, Hans-Peter.
Lehrbuch der Umsatzsteuer. 6. Auflage.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1993, pp. 444. 58.- DM.
Explanation of the German VAT law, including the European single market.
(B. 113.453)

DIE VERANLAGUNG ZUR UMSATZSTEUER
für 1993. 36. Auflage. Bearbeitet von Werner Widmann.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 1858, 65.- DM.
Annual guide containing the texts of the VAT Law, regulatory ordinance to it, case law and other relevant material for the 1994 tax assessment year.
(B. 113.572)

UMSATZSTEUER HANDAUSGABE 1993/94.
Bearbeitet von C. Forst, H. Treptow und M. Langer. Ausgabe Februar 1994.
Bonn, Stollfuss Verlag. 1994, pp. 815.
VAT handbook 1993/94.
(B. 113.608)

KUSSMANN, M.
Schenken, Erben, Steuern. 3. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 230. 37.80 DM.
Revised and updated third edition of book discussing tax-favourable devices for gifts and inheritances under general tax law, civil law and company law.
(B. 113.588)

SCHÖN, Wolfgang.
Die Auslegung europäischen Steuerrechts. Das harmonisierte Steuerrecht zwischen nationalem Zivilrecht und europäischem Gemeinschaftsrecht.
Cologne, Verlag Dr. Otto Schmidt. 1993.
Rechtsordnung und Steuerwesen, Band 20, pp. 84. 42.- DM.
The interpretation of European tax law. The harmonized tax law between national civil law and European community law. The author discusses the triangular relation between

© 1994 International Bureau of Fiscal Documentation

national civil law, national and international tax law and community law.
(B. 113.397)

GROSSFELD, Bernhard.
Unternehmens- und Anteilsbewertung im Gesellschaftsrecht. Zur Barabfindung ausscheidender Gesellschafter. 3. Auflage.
Cologne, Verlag Dr. Otto Schmidt KG. 1994, pp. 182. 92.- DM.
Valuation of enterprises and shares under corporation law. The author explains various topics, including methods for the valuation of enterprises and methods for the valuation of shares.
(B. 113.516)

WEHMEIER, Wolfgang.
Praxisübertragung in wirtschaftsprüfenden und steuerberatenden Berufen. 2. Auflage.
Bonn, Stollfuss Verlag. 1993, pp. 240, 52.80 DM.
Transfer of an auditor's or tax advisor's practice. A guide for professionals who intend to set up, sell or buy a tax advisor's or an auditor's practice in Germany.
(B. 113.399)

BERANEK, Axel.
Die steuerliche optimale Rechtsform der Unternehmung.
Hamburg, S+W Steuer- und Wirtschaftsverlag. 1993.
Betriebswirtschaft aktuell, Band 11, pp. 268. 78.- DM.
The author describes a computer-aided decision-making model to optimize the legal form of an enterprise for tax purposes. A special feature is that the software allows the particular risk rates of transactions to be taken into consideration.
(B. 113.406)

BESGEN, Dietmar; JÜNGST, Manfred.
ABC der Kündigung und anderer Formen der Beendigung des Arbeitsverhältnisses. 2. Auflage.
Bonn, Stollfuss Verlag. 1993, pp. 352. 53.80 DM.
ABC of dismissal and other kinds of termination of an employment contract. This guide explains the basic principles of a procedurally correct dismissal and contains a comprehensive list of reasons for termination.
(B. 113.398)

Ireland

JUDGE, Norman E.
Irish income tax 1993-94. Edited by Susan Keegan.
Dublin, Butterworth Ireland Ltd., 26 Upper Ormond Quay, Dublin 7, Ireland. 1993, pp. 2476. £ 70.-.
The book is primarily concerned with the system of income tax in the Republic of Ireland. This bound edition, which replaces the 1985 loose-leaf publication, will be published each autumn and will contain all the relevant provisions of the latest Finance Act.
(B. 113.461)

CAPITAL TAX ACTS 1993-94. STAMP duties, capital acquisitions tax, residential property tax, probate tax. Edited by Tom Boland and Alan Moore.
Dublin, Butterworth Ireland Ltd. 1993, pp. 601.
This handbook contains the Stamp Act 1891 (as consolidated to Finance Act 1993), the Capital Acquisitions Act 1976 (as consolidated to Finance Act 1993), the new Probate Tax legislation, and the Residential Property Tax legislation (as consolidated to Finance Act 1993) together with the related non-amending sections of the Finance Acts from 1892 to 1993, and the major statutory instruments for each tax. The book is a companion volume to Butterworth Ireland Tax Acts 1993-94 and Butterworth Ireland VAT Acts 1993-94.
(B. 113.505)

Italy

FICHERA, Franco.
Le agevolazioni fiscali.
Milan, CEDAM – Casa Editrice Dott. Antonio. 1992.
Il Diritto Tributario, Serie I, Volume LXXIX, pp. 323.
Analysis of the general theory of tax allowances and incentives, also with respect to constitutional and EC law.
(B. 113.541)

FRIZZERA, Bruno.
Guida pratica fiscale. Vol. 1. Imposte indirette.
Milan, Il Sole 24 Ore. 1994, pp. 216, 34,000 Lrs.
Practical handbook explaining all items of indirect taxation in Italy, including a section on local taxes. Updated to January 1994.
(B. 113.548)

Netherlands

FETERIS, M.W.C.
Fiscale administratieve sancties en het recht op een behoorlijk proces.
Deventer, Kluwer. 1993. Fiscale Monografieën, No. 66, pp. 814. 170.- Dfl.
Dissertation on fiscal and administrative fines and the right to a fair hearing, as provided for by the Convention for the Protection of Human Rights and Fundamental Freedom, Rome 1950, and by the International Convention on Civil and Political Rights, New York 1966. A special chapter is devoted to the conflict between the domestic law and treaty law.
(B. 113.432)

MODELRULINGS.
Rotterdam, Belastingdienst/Grote ondernemingen Rotterdam. 1993, pp. 25.
Models for rulings used by the tax administration. Directions for filing the corporate income tax form by the "ruling corporations".
(B. 113.449)

MICHIELSE, G.M.M.
Thin capitalisation in het fiscale recht. Afbakening van vreemd vermogen ten opzichte van eigen vermogen binnen concernverhoudingen.
Deventer, Kluwer, 1994. Fiscale Monografieën, No. 67, pp. 345. 97.50 Dfl.
Dissertation on thin capitalization in tax law. Discusses the business and civil law aspects of corporate financing, thin capitalization rules of EC member countries, debt and equity financing, limitation on interest deductions and the extent to which the EC law can protect taxpayers against double taxation.
(B. 113.477)

AARDEMA, E.
De directeur-grootaandeelhouder met zijn BV en de fiscus. 3rd Edition.
Deventer, Kluwer. 1993. Kluwer Bedrijfswijzers, No. 14, pp. 212. 59.50 Dfl.
Third revised and updated edition of monograph on the tax aspects of the director-shareholder of a limited liability company with reference to case law (updated as of 1 August 1993).
(B. 113.429)

BLOKLAND, Thomas.
Winst uit aanmerkelijk belang. De aanmerkelijk-belangregeling in de Wet op de inkomstenbelasting 1964. 2nd Edition.
Deventer, Kluwer. 1993. Fiscale Monografieën, No. 19, pp. 337. 99.- Dfl.
Revised edition of monograph describing the taxation of gains derived from sale of a substantial interest in a company under the Dutch Individual Income Tax Law of 1964.
(B. 113.435)

MEERING, A.; JONKER, E.N.; BUIS, W.; LOON, P.M.F. van; a.o.
Elseviers Belasting Almanak. 39th Edition.
Amsterdam, Bonaventura. 1994, pp. 448. 27.50 Dfl.
Annual edition of guide for filing 1993 individual income tax return and 1994 net wealth tax return.
(B. 113.482)

BAARD, C.B.
De particuliere belegger en de fiscus. 2nd Edition.
Deventer, Kluwer. 1993. Kluwer Belastingwijzers, No. 21, pp. 91. 34.- Dfl.
Fiscal consequences of the different forms of private investment in savings, bonds, shares, options, immovable property, life insurance and investment funds. Financing of investment is also dealt with.
(B. 113.437)

BROUWER, J.Th.L.
Het begrip levensverzekering in de inkomstenbelasting na de Brede herwaardering.
Deventer, Kluwer. 1993, pp. 250. 69.50 Dfl.
Dissertation dealing with the concept of life insurance as used in the income tax law after the "Brede herwaardering" legislation.
(B. 113.436)

VOLLEBERGH, H.R.J.
Energieheffing: melkkoe of krachtvoer? Gezocht: energieke energieheffingen.
Rotterdam, Erasmus University. 1992. Reprint No. 9206, pp. 8.

© 1994 International Bureau of Fiscal Documentation

Article considering the question of whether the energy tax in the agricultural sector should be imposed on cattle or on fodder and how this tax would attent the agricultural industry.
(B. 112.797)

KOUWENHOVEN, F.D.
BTW in kort bestek.
Deventer, Fed. 1993, pp. 144. 57.50 Dfl.
Handbook dealing with VAT (before and after 1992) for the daily use of accountants and tax advisers. With reference to case law.
(B. 113.426)

PLANTE-FAIL, M.
Toeristenbelasting.
Deventer, Fed. 1993, Serie Belastingminiaturen, No. 7, pp. 52. 35.50 Dfl.
Booklet describing the tourist tax which can be levied on tourists or on those offering tourist accommodations. This brochure is specially designed for the tourist industry and the local authorities.
(B. 113.492)

KOSTERS, E.B.G.
Parkeerbelastingen. Een klemmetje onder het gemeentegras?
Deventer, Fed. 1993. Serie Belastingminiaturen, No. 8, pp. 52. 35.50 Dfl.
Discussion of motor parking duties levied by local authorities, such as tax on parking, parking ticket, automobile wheel locks and towing.
(B. 113.491)

SONNEVELDT, F.; ZUIDERWIJK, J.C.L.
Internationale aspecten van schenkings- en successierecht.
Deventer, Fed. 1993. Fed Fiscale Brochures, pp. 272. 77.50 Dfl.
General view of Dutch succession law and international aspects of gift and succession duties. Attention is paid to the OECD Model Convention on Estates and Inheritances and on Gifts and a number of succession treaties between the Netherlands and other countries (Switzerland, Sweden, Finland, USA, Israel, UK). Includes a survey of the principles of succession law in Belgium, Germany, France, Luxembourg, Monaco, Netherlands Antilles, Spain, the United Kingdom and the USA.
(B. 113.445)

ARRESTEN LOKALE BELASTINGEN.
2nd Edition. Samengesteld door J.L.M. Govaarts-Renne.
Deventer, Fed. 1993, pp. 207. 44.50 Dfl.
Second edition of a collection of summaries of cases on local taxes, updated to 1 June 1993. Subjects dealt with are: property taxes, local benefits tax, construction sites tax, dog tax, commuter tax, tourist tax, local duties, "waterschap" duties and others.
(B. 113.425)

BORGHOLS, E.G.
Reinigingsheffingen.
Deventer, Fed. 1993. Serie Belastingminiaturen, No. 10, pp. 54. 35.50 Dfl.
General principles of the sanitory levy, levy on residual products and the new possibility of the sorting of waste and different systems of tariffs.
(B. 113.417)

BOSMA, S.
Baatbelasting en bouwgrondbelasting.
Deventer, Fed. 1993. Serie Belastingminiaturen, No. 11, pp. 58. 35.50 Dfl.
Description of the local benefit tax and building sites tax which are levied to finance expenditures for public welfare on the local level. The booklet explains the general principles of the levies and who is responsible for payment of the tax.
(B. 113.418)

BERG, P. van den.
Rioolrechten.
Deventer, Fed. 1993. Serie Belastingminiaturen, No. 9, pp. 52. 35.50 Dfl.
Brochure describing the sewer tax. It explains what a sewer tax is, who the taxpayers are, how to determine the tax amount and how taxpayers can appeal against assessment.
(B. 113.490)

ROMYN, M.
Internationaal belastingrecht. 4th Edition.
The Hague, M. Romyn. 1991, pp. 182. 59.- Dfl.
Fourth edition of international tax law in the Netherlands dealing with: double taxation agreements and unilateral regulations, including taxation of non-residents.
(B. 113.427)

WESTEN, G.W.B. van.
Fiscaal proces dossier. 6th Edition.
Arnhem, Gouda Quint BV. 1993, pp. 90.
Sixth revised edition of monograph on objection and appeal procedures, with detailed forms and examples.
(B. 113.421)

VOLLEBERGH, H.R.J.
Vervuilen schaadt, betalen baat. Het beginsel "de vervuiler betaalt" en publieke heffingen.
Rotterdam, Erasmus University. 1992. Reprint No. 9207, pp. 12.
Pollution is harmful and payment is profitable. An article dealing with problems of protecting the environment and the principle of "the polluter should pay".
(B. 112.798)

FISCAAL PENSIOENRECHT IN beweging. Verslag van het symposium gehouden te Maastricht op 5 november 1993.
Arnhem, Gouda Quint BV. 1994. Maastrichtse fiscale symposia No.3, pp. 89.
Speeches and debates held during the third Maastricht tax symposium on 5 November 1993 dealing with tax and legal aspects of pensions. Contributions: "De toekomst van het pensioenbegrip" by E. Lutjens; "De pensioen-BV" by J.Th.L. Brouwer; "Fiscale begeleiding van oudedagsvoorzieningen voor ondernemer en werknemer" by R.E.C.M. Niessen.
(B. 113.503)

BELASTING INDEX 1994.
The Hague, SDU Juridische & Fiscale Uitgeverij. 1994, pp. 150, 22.50 Dfl.
Overview of the taxes and social security premiums levied in the Netherlands in 1994, as well as legislative proposals and relevant references to the Parliamentary documents.
(B. 113.489)

DIETVORST, G.J.B.
De drie pijlers van toekomst-voorzieningen en belastingen.
Deventer, Kluwer. 1994, Fiscale Monografieën, No. 68, pp. 465.
Commercial edition of dissertation considering "the three pillars in future pension schemes and taxation", which are: legal old-age provisions established by the authorities, supplementary provisions related to a specific profession, and personal provisions undertaken by individuals. The author describes the fiscal aspects of these three pillars in the Netherlands and in other European countries and proposes a new integrated system for future pension schemes.
(B. 113.603)

VERMEEND, Willem; BALLEGOOIJEN, Kees van.
Belastingvoordelen en vrijstellingen van sociale premies voor werknemers en werkgevers volgens de wet Vermeend/Vreugdenhil. Belasting- en premievoordelen voor werknemersspaar-regelingen, winstdeling, werknemersaandelen en aandelenoptieregelingen.
Deventer, Kluwer. 1994.
Fiscaal Actueel, pp. 102. 25.- Dfl.
In the law of Vermeend/Vreugdenhil the following new regulations have been introduced: (1) save-as-you-earn regulations; (2) premium savings regulations; (3) profit sharing regulations; (4) option to purchase shares regulations. Apart from the introduction describing the conditions for participation and the four regulations, 50 questions and answers concerning premium saving and savings from gross-salary are included in this book.
(B. 113.513)

BLIJSWIJK, J.A.M. van; DIJKHUIZEN, F.J.; LENGKEEK, L.J.
Elseviers almanak voor de BTW 1994.
Handleiding voor de aangifte omzetbelasting. 13th Edition.
Amsterdam, Uitgeversmij. Bonaventura. 1994, pp. 400.
VAT Almanac 1994 giving information for filing VAT returns, intercommunity transactions and services, administrative procedure, exemptions for services.
(B. 113.522)

TAKENS, J.W.; WAGENAAR, H.A.; WIT, J.P. de.
Douanememo.
Deventer, Kluwer. 1994, pp. 225, 42.- Dfl.
Customs memo providing summary on customs regulations within the EC as of 1 January 1994.
(B. 113.504)

REEHUIS, W.H.M.; SLOB, E.E.
Parlementaire Geschiedenis van het Nieuwe Burgerlijk Wetboek. Invoering boeken 3, 5 en 6. Voortgang.
Deventer, Kluwer. 1993, pp. 828.
Bound volume in the serie Parliamentary History on the introduction of the New Civil Code, systematically arranged and annotated documents with respect to Books 3, 5 and 6 dealing with general property law, proprietory

© 1994 International Bureau of Fiscal Documentation

law and general contract law, respectively, which came into effect on 1 January 1992.
(B. 113.349)

Norway

JARØY, Jacob.
Norsk skattelovsamling for inntektsåret 1993; forskuddet 1994.
Skien, Jacob Jarøy (Eget Forlag). 1994, pp. 1032
Annual bound compilation of Norwegian tax laws concerning the filing of 1993 tax returns and 1994 advance payments. The laws relate to income and net wealth tax, petroleum tax, social security contributions, VAT, investment law, local income and net wealth tax, inheritance and gift tax, and assessment of collection of tax.
(B. 113.440)

Switzerland

EBERL, Christina.
Rechtsfragen der Bankgarantie im internationalen Wirtschaftsverkehr nach deutschem und schweizerischem Recht.
Baden-Baden, Nomos Verlagsgesellschaft. 1992.
Studien zum Bank- und Börsenrecht, No. 24, pp. 140. 46.- DM.
Legal questions with regard to bank guarantees in international business according to German and Swiss law: the bank guarantee in cross-border business; legal qualification; distinction between bank guarantee and suretyship; applicable law.
(B. 112.338)

GUIDE DU FUTUR CONTRIBUABLE.
La taxation de l'impôt sur le revenu.
Berne, Commission Intercantonale d'Information Fiscale. 1990, pp. 65.
Outline of the Swiss income tax system, including federal taxes, cantonal taxes and local taxes as well as addresses of the local tax authorities.
(B. 112.051)

LE SYSTEME FISCAL SUISSE.
Berne, Commission intercantonale d'Information Fiscale. 1991, pp. 68.
Outline of the Swiss tax system, including federal taxes, cantonal taxes, local taxes and a comparison of the tax burden.
(B. 112.050)

STOCKAR, Conrad.
Übersicht und Fallbeispiele zu den Stempelabgaben und zur Verrechnungssteuer. 2. Auflage.
Basel, Verlag für Recht und Gesellschaft AG. 1993, pp. 304.
Overview and case studies relating to stamp duties and the anticipatory tax, with examples.
(B. 113.305)

KAMBER, A.; RICCI, G.; O'BRIEN, M.J.; JACOBS,R.C.
Sociétés de domicile et mesures en vue de contrer l'évasion fiscale en Suisse et en France. Base companies and anti-avoidance tax rules in the United Kingdom and the USA.
Zurich, Chambre Fiduciaire, Limmatquai 120, 8001 Zurich. 1990. Publication de la Chambre fiduciaire, Volume 91, pp. 117.
The authors describe the unilateral, bilateral and multilateral measures to fight tax avoidance resulting from the setting-up of offshore companies in Switzerland, France, the United Kingdom and the USA.
(B. 111.715)

United Kingdom

HANCOCK, Dora.
An introduction to taxation.
London, Chapman & Hall, 2-6 Boundary Row, London SE1 8HN, England. 1994, pp. 364.
Textbook providing students with a thorough understanding of the principles of taxation. It combines a detailed conceptual framework with the necessary technical information to form a complete course. The book deals with the impact of the UK tax system, personal taxation, business taxation, capital gains tax, corporation tax, taxation of close companies and groups, VAT and inheritance tax.
(B. 113.360)

RAYNEY, Peter; ROWLAND, Moores.
The practical corporation tax manual 1994.
London, The Institute of Chartered Accountants in England and Wales. 1994, pp. 535, £. 34.50
The book deals with all corporation tax queries. It incorporates the current legislation, including the provisions of the Finance Bill 1994 and explains the principles of accounting for both current and deferred tax liabilities in company accounts with various examples.
(B. 113.602)

BUTTERWORTHS FINANCE BILL 1994
Handbook. The provisions relating to value added tax, air passenger duty, insurance premium tax, income tax, corporation tax, capital gains tax, oil taxation, stamp duty and inheritance tax. With commentary.
London, Butterworths. 1994, pp. 604.
(B. 113.510)

KAMBER, A.; RICCI, G.; O'BRIEN, M.J.; JACOBS,R.C.
Sociétés de domicile et mesures en vue de contrer l'évasion fiscale en Suisse et en France. Base companies and anti-avoidance tax rules in the United Kingdom and the USA.
Zurich, Chambre Fiduciaire, Limmatquai 120, 8001 Zurich. 1990. Publication de la Chambre fiduciaire, Volume 91, pp. 117.
The authors describe the unilateral, bilateral and multilateral measures to fight tax avoidance resulting from the setting up of offshore companies in Switzerland, France, the United Kingdom and the USA.
(B. 111.715)

INTERNATIONAL

COOPERS & LYBRAND.
International transfer pricing.
Bicester, CCH Editions Limited. 1993, pp. 175.
Handbook on how the theory of transfer pricing is put into practice. Guidance through the methods used by multinational corporations to construct workable, secure and defensible positions.
(B. 113.471)

HORWATH INTERNATIONAL.
International tax planning – Real estate transactions.
North Ryde, CCH Australia Limited. 1993.
This manual outlines the tax position of a foreign investor wishing to acquire real estate in a number of countries of special interest to foreign real estate investment. Particular emphasis is given to different ways of structuring the most tax-efficient vehicle for foreign real estate ownership as well as to tax planning strategies for the most effective way of eventual disposal of the investment.
(B. 113.486)

STEINMO, Sven.
Taxation and democracy. Swedish, British, and American approaches to financing the modern state.
New Haven, Yale University Press. 1993, pp. 280.
The book examines the structure, politics and historic development of tax policies in several countries. Comparing three quite different political democracies, Sweden, Britain and the USA, the book provides a powerful account of the ways these democracies have managed to finance their welfare programmes despite widespread public resistance to tax. The author argues that the different political structures of these countries produce varying tax systems and, by extension, differing social policy regimes.
(B. 113.532)

MORISHIMA, MICHIO.
Capital & Credit. A new formulation of general equilibrium theory.
Cambridge, Cambridge University Press. 1992, pp. 212. $ 18.95.
The book provides a synthesis of growth theory and monetary theory.
(B. 113.590)

Developing countries

PAGE, Sheila; DAVENPORT, Michael; HEWITT, Adrian.
The GATT Uruguay Round: effects on developing countries.
London, Overseas Development Institute. 1991, pp. 64.
(B. 57.973)

LATIN AMERICA

Mexico

IVA-ISR. ENLACE DEL acreditamiento y la deducibilidad 1992.
Guadalajara, Indetec. 1992, pp. 91.

© 1994 International Bureau of Fiscal Documentation

VAT-Income tax. Linkage of the credit and deductibility.
(B. 18.786)

FORMULACION DE PAPELES DE trabajo en la auditoria del IVA (Guia basica del curso).
Guadalajara, Indetec. 1993, pp. 227.
The drafting of working papers in auditing VAT. A basic guide to the course material.
(B. 18.785)

EL REGIMEN JURIDICO DE LA concesion en Mexico.
Guadalajara, Indetec. 1993, pp. 266.
Legal regime on administrative concessions in Mexico.
(B. 18.794)

EL ANALISIS ESTRATEGICO EN LA administracion de ingresos de las entidades federativas de Mexico.
Guadalajara, Indetec. 1993, pp. 256.
Strategical analysis in the administration of revenues of Mexican federative entities.
(B. 18.809)

JURISPRUDENCIA Y PRECEDENTES de tribunales en materia de auditoria fiscal.
Guadalajara, Indetec. 1993, pp. 245.
Jurisprudence and precedents of courts on tax auditing issues.
(B. 18.793)

NORTH AMERICA

Canada

BEECHY, Thomas H.
Guide to accounting for income taxes.
Scarborough, Carswell Thomson Professional Publishing. 1992, CND$ 115.-
Guide for preparing financial statements understand and applying comprehensive tax allocation. Includes chapters on: intra-period income tax allocation; explaining deferred income taxes; accounting for timing differences; accounting for losses; accounting for losses when timing differences exist; case studies; investment credits; international standards and disclosure of effective tax rate variation.
(B. 113.472)

TAX FACTS 1993-94. PREPARED BY KPMG Peat Marwick Thorne.
Scarborough, Carswell Thomson Professional Publishing. 1993, pp. 101.
Quick reference tax guide on corporate and individual income tax rates (both federal and provincial) and related tax matters as of 30 September 1993.
(B. 113.474)

USA

AMERICAN FEDERAL TAX REPORTS.
Second series. Volume 71.
New York, RIA – Research Institute of America Inc. 1993, pp. 2250.
The volume contains unabridged federal and state court decisions under the federal tax laws.
(B. 113.488)

WRIGHT, Deloris R.
Understanding the new U.S. Transfer Pricing Rules.
Chicago, CCH Commerce Clearing House, Inc. 1993, pp. 136.
The book takes a close look at Code Section 482, the principal source of the IRS's authority in transfer pricing, and examines the latest temporary regulations which provide for harsh penalties for abuses.
(B. 113.526)

KAMBER, A.; RICCI, G.; O'BRIEN, M.J.; JACOBS, R.C.
Sociétés de domicile et mesures en vue de contrer l'évasion fiscale en Suisse et en France. Base companies and anti-avoidance tax rules in the United Kingdom and the USA.
Zurich, Chambre Fiduciaire, Limmatquai 120, 8001 Zurich. 1990. Publication de la Chambre fiduciaire, Volume 91, pp. 117.
The authors describe the unilateral, bilateral and multilateral measures to fight tax avoidance resulting from the setting-up of offshore companies in Switzerland, France, the United Kingdom and the USA.
(B. 111.715)

Saint Pierre et Miquelon

CODE LOCAL DES IMPOTS.
Réglementation fiscale et para-fiscale, 1993.
Paris, Imprimerie Administrative. 1993, pp. 175.
Tax Code of the French overseas territory of Saint Pierre et Miquelon.
(B. 113.359)

Loose-leaf Services

Received between 1 and 31 March 1994

AFRICA

FIDAFRICA
release 1
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 3 and 5
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX – LAW AND PRACTICE
- Rulings and guidelines
  releases 145 and 146
- Fringe benefits
  release 35

Butterworths, North Ryde.

SUPERANNUATION AND RETIREMENT BENEFITS IN AUSTRALIA
Brown – Edstein
release 29
Butterworths, North Ryde.

AUSTRIA

DIE KÖRPERSCHAFTSTEUER
release 4
Wirtschaftsverlag Anton Orac, Vienna.

BELGIUM

MODELES FISCAUX
release 37
CED Samsom, Diegem.

IMPORT – EXPORT. GUNSTREGELINGEN EN PROCEDURES IN DE BTW- EN DOUANEREGLEMENTERING
Brassine – Koedijk – Marckx, etc.
release 14
Kluwer Rechtswetenschappen, Deurne.

L'INDICATEUR FISCAL
release 90
CED Samsom, Diegem.

VENNOOTSCHAP EN BELASTINGEN
release 22
Kluwer Rechtswetenschappen, Deurne.

CANADA

GLOBAL INVESTMENT IN CANADA
release 102
Prentice-Hall of Canada Ltd., Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
release 875
Prentice-Hall of Canada Ltd., Scarborough.

© 1994 International Bureau of Fiscal Documentation

DENMARK

SKATTEBESTEMMELSER
- Moms
  release 2
- Skattenyt - Kronologisk
  releases 6 and 7
- Skattebestemmelser - Systematisk
  release 3

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 341

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – FISCAL
release 1
Editions Francis Lefebvre, Levallois-Perret.

JURIS CLASSEUR – CODE FISCAL
release 249
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – FISCALITE IMMOBILIERE
release 83
Editions Techniques, Paris.

GERMANY

BONNER HANDBUCH GMBH
Brandmüller - Küffner
release 27
Stollfuss verlag, Bonn.

DAS EINKOMMENSTEUERRECHT. KOMMENTAR ZUM EINKOMMENSTEUERGESETZ
Littmann - Bitz - Meincke.
release 18
Verlag Schäffer & Co., Stuttgart.

HANDBUCH DER EINFÜHRNEBENABGABEN
release 19
Von der Linnepe Verlagsgesellschaft, Hagen.

STEUERGESETZE
I, release 107
Verlag C.H. Beck, Munich.

NAMIBIA

JUTA'S TAX SERVICE – LEGISLATION SECTION – NAMIBIA
release 7
Juta & Co., Kenwyn, South Africa.

NETHERLANDS

BELASTINGWETTEN (De Belastingggids)
release 163
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
- Loonbelasting
  releases 152
- Omzetbelasting 1968 (BTW/1978)
  releases 89 and 90

Noorduijn BV., Arnhem.

CURSUS BELASTINGRECHT
Mobach
releases 212 and 213
Gouda Quint/D. Brouwer, Arnhem.

FISCALE WETTEN
release 210
Fed, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Algemene wetgeving inzake douane
  release 1
- Belastingheffing bij invoer
  release 452
- Tarief van invoerrechten
  releases 107 and 108
- Gecombineerde nomenclatuur
  releases 85, 86 and 87

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 369 and 370
Kluwer, Deventer.

KLUWERS TARIEVENBOEK
releases 433 and 434
Kluwer, Deventer.

NEDERLANDSE WETBOEKEN
release 242
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
releases 142 and 143
Gouda Quint/D. Brouwer, Arnhem.

PRAKTIJKBOEK SOCIALE VERZEKERINGEN
release 7
SDU, The Hague.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  releases 74 and 75
- Coord. SV/Premieheffing
  releases 25 a nd 26
- Heffing over uitkeringen en loon
  releases 47 and 48

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEF-RECHTELIJKE WETTEN
releases 294 and 295
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  releases 231-234
- Inkomstenbelasting 1964
  releases 894-900
- Investeringsregelingen
  releases 162-164
- Invorderingswet
  release 56
- Loonbelasting
  release 571-573
- Omzetbelasting
  releases 247 and 248
- Successiewet 1956
  releases 171 and 172
- Vennootschapsbelasting
  release 321
- Vermogensbelasting 1969
  releases 157 and 158

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, releases 1 and 2
B, releases 1-4
Norsk Skattebetalerforening, Oslo.

PERU

CODIGO TRIBUTARIO
releases 1 and 2
Editorial Economica y Finanzas, Lima.

IMPUESTO A LA RENTA
release 68
Editorial Economica y Finanzas, Lima.

IMPUESTO A LAS VENTAS
release 75
Editorial Economica y Finanzas, Lima.

SOUTH AFRICA

JUTA'S TAX SERVICE – LEGISLATION SECTION – SOUTH AFRICA
release 54
Juta & Co., Ltd., Kenwyn.

UNITED KINGDOM

SIMON'S TAXES
release 197
Butterworths, London.

SIMON'S TAX INTELLIGENCE
releases 7-12
Butterworths, London.

VALUE ADDED TAX – DE VOIL
release 223
Butterworths, Sevenoaks.

U.S.A.

UNITED STATES TAX REPORTER
releases 8-11
RIA – Research Institute of America Inc., New York.

TAX TREATIES – REPORT BULLETIN
releases 1 and 2
Warren Gorham Lamont, Boston.

TAX IDEAS – REPORT BULLETIN
release 1
Warren Gorham Lamont, Boston.

U.S. TAXATION OF INTERNATIONAL OPERATIONS
releases 1-5
Warren Gorham Lamont, Boston.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Australia:
Ann O'Connell:
Capital Gains Tax Amendments 176

Abe. I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Implementing Regulations for the New Income Tax Law 250

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Hong Kong:
Ian Harris:
Budget Bonanza 257

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shoma and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Israel:
Taxation of Corporations 141

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

New Zealand:
Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Qatar:
Finbarr Sexton:
Taxation regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

Switzerland:
Wiliam Bush:
Low Tax Opportunities 183

United States:
Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41, 200, 260

IV. CONFERENCE DIARY 55, 81, 137, 207, 267

V. BIBLIOGRAPHY
- Books 45, 103, 150, 201, 261
- Loose-leaf services 49, 107, 154, 205, 266
- List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 8/9 AUGUST/SEPTEMBER 1994

INTRODUCTION 371
Prof. Avv. Pietro Adonnino

INTERPRETATION OF DOUBLE TAXATION CONVENTIONS IN CANADA: AN UPDATE 374
Jacques Sasseville

The national report for Canada prepared for the 1993 IFA Congress gave an account of how Canadian courts previously interpreted tax conventions. This article provides an update on the information contained in that report, by focusing on some recent cases.

THE ONTARIO FAIR TAX COMMISSION: TAX REFORM IN ACTION 380
Robert Couzin

The Fair Tax Commission, constituted in 1991 to examine provincial taxation, rendered its report in 1993. This article, written by a vice-chair of the Commission, offers a thought-provoking glimpse into the process of tax reform.

THE DIVISION OF CANADIAN TAXING POWERS: A TUG OF WAR, WITH TAXPAYERS IN THE MIDDLE 392
Blair P. Dwyer and Katherine A. Thiessen

Canada is a federal state, with legislative authority divided between a federal government, ten provincial governments and two territories. Each province has created a third level of government for cities, towns and villages within the province. The federal nature of Canada reflects a nation with a strong regional texture rooted in diverse regional histories and economies, and this federal dynamic is reflected in the Canadian tax system. This article offers a comprehensive overview of the interaction between the various levels of government.

HIGHLIGHTS OF THE 1994 CANADIAN BUDGET 402
Stephen S. Ruby

On 22 February 1994 the Federal Budget was tabled in the House of Commons. Several areas of the Budget were subject to significant amendment by the Budget – this article focuses on four of these areas, i.e. divisive corporate reorganizations, foreign affiliates, debt restructuring and financial institutions. Further draft legislation was released by the Department of Finance on 23 June concerning divisive reorganizations and foreign affiliates.

ACQUIRING, HOLDING AND FINANCING CANADIAN CORPORATIONS 419
Allan R. Lanthier

This article addresses some of the Canadian income tax issues which should be considered in the context of a non-resident acquiring, holding and financing Canadian corporations. The rules establishing liability for Canadian tax, the forms of business organization and the choice of conducting business operations in a branch rather than a Canadian subsidiary are first discussed. This is followed by an analysis of a number of planning alternatives.

TAXATION OF FOREIGN AFFILIATES 430
Ingrid Sapona

This article focuses on the taxation of income flowing to Canadian corporations from activities of foreign corporations in which they own an interest. The article first outlines Canada's current tax treatment of foreign affiliates, then the Auditor General's Report and recommendations of the Public Accounts Committee are discussed. The final section discusses changes in the 1994 Budget.

CROSS-BORDER REORGANIZATIONS INVOLVING CANADIAN CORPORATIONS 442
James S. Hausman and Kathleen V. Penny

With the increased global integration of national economies there is likely to be an even greater tendency for business enterprises based in one country to have interests in another country. This article deals with some Canadian tax considerations arising from corporate reorganizations where there are elements of the transaction both inside and outside Canada, with the focus being on Canadian corporations which are part of a foreign-controlled corporate group.

© 1994 International Bureau of Fiscal Documentation

STRUCTURING INTERNATIONAL JOINT VENTURES: CANADIAN TAX ISSUES TO CONSIDER 448
Gary J. Webb

The tax strategies involved in structuring foreign joint ventures have, as their objects, the same objects identified when commencing to carry on any business activities inside or outside Canada. Before being able to set tax strategies, the parties must be fully aware of the Canadian tax regime applicable to any international business structuring. This article reviews basic Canadian principles to bear in mind when structuring international joint ventures and examines a few forms.

TRANSFER PRICING: CURRENT CANADIAN PERSPECTIVE 457
Nathan Boidman

This article looks at various aspects of transfer pricing in Canada, including the nature of the arm's length principle, the current status of APAs in Canada and a brief review of the parameters of Canadian transfer pricing law including a recent anti-avoidance proposal regarding offshore transshipment companies.

THE CONDUIT REGULATIONS: CANADIAN INVESTORS BEWARE! 469
Marianne Burge

The US government's preoccupation with treaty shopping is putting an end to a tradition of investing in the United States via a Dutch holding company, and Canadian investors are reviewing their options. Investors need to be aware of a small piece of legislation in OBRA'93, i.e. Section 7701(1). This article takes a look at that provision and offers a persuasive argument for limiting the scope of the regulations.

BIBLIOGRAPHY
- Books 476
- Loose-leaf services 480

CONFERENCE DIARY 483

CUMULATIVE INDEX 482

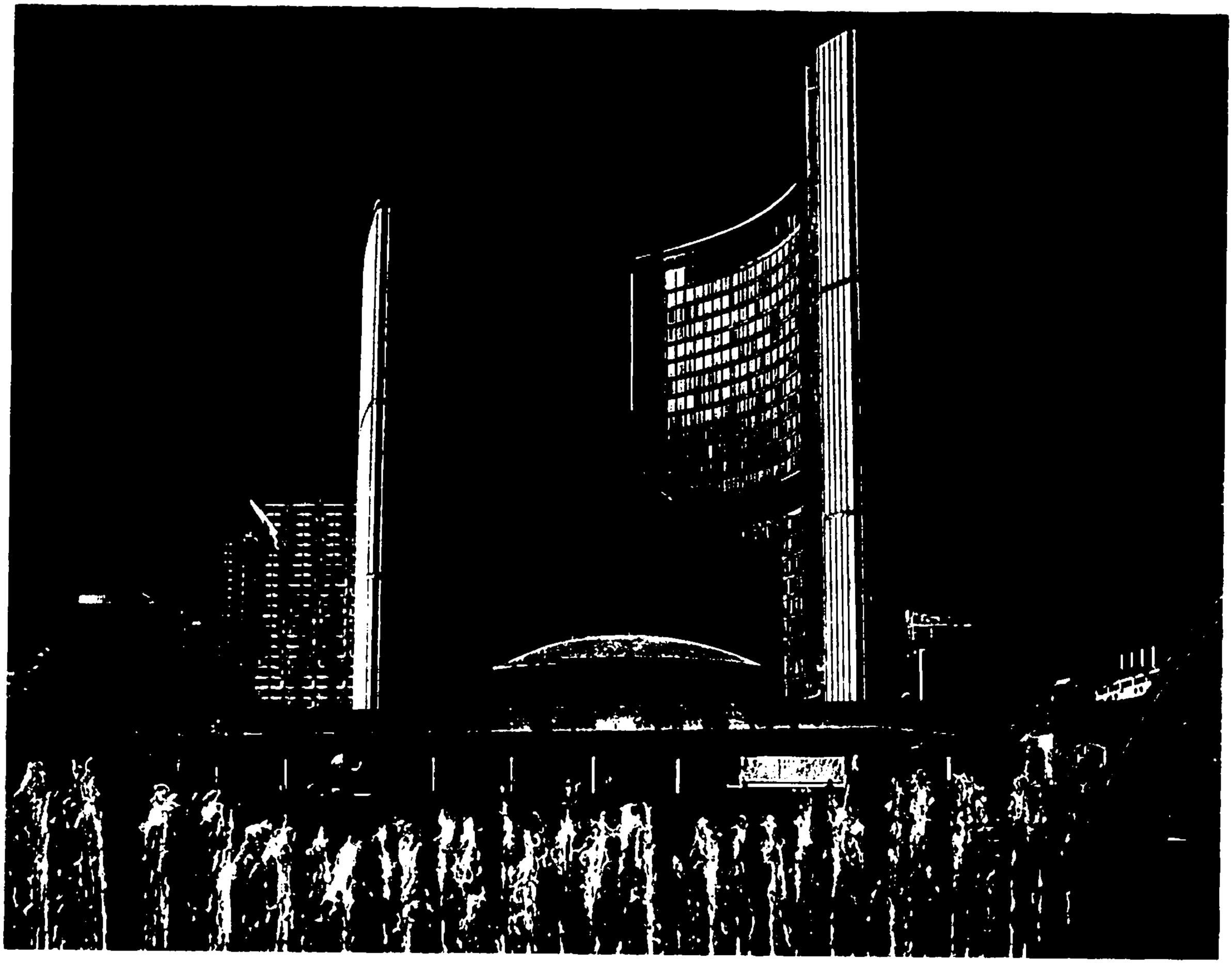
DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

INTRODUCTION
1994 IFA CONGRESS IN TORONTO

Prof. Avv. Pietro Adonnino



This year the annual IFA Congress is again being hosted by Canada, in Toronto, after being held in Montreal in 1982. The IFA Congresses in Canada appear to have a kinship with those held in Italy. The 1982 Montreal Congress was followed by the Venice Congress, and the 1994 Toronto Congress follows the 1993 Florence Congress. The success of the Montreal Congress was a prelude to the success of the Venice Congress, and the success of the Florence Congress surely will prelude the success of this Congress.

The city of Toronto is situated in one of the most beautiful areas of Canada, and it offers countless opportunities to appreciate its modern arts as well as its multicultural activities and sports facilities.

I would like to mention at the outset that selecting Canada as a venue for the annual Congress seems particularly appropriate as this country has always shown considerable interest in issues of international taxation. The Canadian IFA branch has also made significant contributions to IFA's scientific pursuits.

I look forward to a consolidation in Toronto of the encouraging signs evident in Florence concerning the further expansion of IFA, in terms of the number of countries represented at the Congress, the total number of participants and the scientific level of the contributions.

The four-day scientific programme, which was inaugurated during the Cancun Congress, will again be followed this year. The procedural changes to the Working Sessions of the two main subjects – introduced on a trial basis during the Florence Congress – proved so successful that they will be

© 1994 International Bureau of Fiscal Documentation

observed again in Toronto. I sincerely hope that these procedures will be adopted for future IFA Congresses.

In recent years IFA has not only increased its worldwide presence but has also considerably increased the scientific quality of subjects addressed, their discussion and conclusions. IFA, which is active in 45 countries and anticipating further expansion, is considered the most highly qualified international organization with comprehensive knowledge in international tax. IFA's outstanding reputation is also made evident by the large number of participants from the tax administrations of major countries as well as from other international organizations that deal with international tax issues.

This is my first IFA Congress as your President. The goals set forth above must be pursued with vigour so that IFA's influence will broaden, and the conclusions of the Congresses will be highly considered by national and international authorities entrusted with seeking vital solutions to problems related to international tax.

Two subjects of major importance and topicality will be addressed during the Toronto Congress.

The first subject concerns the deductibility of interest and other financing expenses in computing income. This is a major issue in international tax since conflicting rules in various countries come into play with the result that income may be routed from one country to another. The main aspects of the topic to be addressed are the deduction of interest paid to non-residents, the deduction of interest incurred by residents to earn foreign-source income and the deduction of interest by non-residents.

The second subject submitted for consideration is the national and international tax consequences of demergers and other similar transactions. Demergers are increasingly utilized for corporate re-organizations and the main issue connected with such transactions is that of ensuring that no capital gains tax consequences arise at the level of the companies and their shareholders, by carrying the existing tax base over to the successor company.

Rules governing domestic and cross-border demergers vary considerably from one country to another. Some countries have special rules for purely domestic demergers, others allow deferral on a case-by-case basis and still others prohibit any type of tax-free demerger. One example of the critical attention devoted to cross-border transactions is the EU merger directive which includes demergers. The scope of the directive is broad enough to safeguard corporate interests and to avoid revenue losses for one of the countries involved.

No regulations exist for EU international demergers with the exception of a few instances where such transactions may be covered by domestic legislation. It may be necessary to suggest that double tax treaties include specific provisions to cover this type of transaction. These subjects are obviously of particular interest when one considers the global trend towards international transactions.

To round off the programme five well-selected topics will be discussed during the seminars. Seminar A considers the harmonization of tax under the North American Free Trade Agreement. Seminar B will focus on secondary adjustments and related aspects of transfer pricing in transactions between entities that are part of multinational enterprises. The ways in which domestic anti-avoidance rules affect double tax treaties form the basis of Seminar C. Seminar D considers the tax implications of corporate transactions which have taken place during the last year. Finally, Seminar E will examine the current OECD work programme and will consider how Article 10 of the OECD Model Convention – which implies a classical corporate tax system – will apply in cases where one or both of the treaty partners have adopted a full or partial integration system.

In addition to the comprehensive scientific programme, the Toronto Congress also promises a fascinating social programme which includes a reception at the Royal Ontario Museum, a ballet performance and the Gala Closing Banquet. For sports enthusiasts, don't miss the baseball game between the World Champion Toronto Blue Jays and the California Angels. I hope to meet many of you during the course of these events.

I wish everyone a warm welcome to the 1994 Congress!

© 1994 International Bureau of Fiscal Documentation

SUBJECTS AND SEMINARS OF THE 1994 CONGRESS

SUBJECT I
Deductibility of interest and other financing charges in computing income
General reporter:
Prof. Brian J. Arnold (Canada)
Discussion Leader:
Prof. Paul McDaniel (United States)

TEMA I
Deducibilidad de los intereses y otros gastos financieros en la determinación de la renta
Ponente General:
Prof. Brian J. Arnold (Canadá)
Presidente de Debates:
Prof. Paul McDaniel (Estados Unidos)

SUJET I
Déductibilité fiscale des intérêts et autres charges financières
Rapporteur Général:
Prof. Brian J. Arnold (Canada)
Modérateur:
Prof. Paul McDaniel (Etats-Unis)

THEMA I
Die Abzugsfähigkeit von Zinsen und anderen Finanzierungskosten bei der Berechnung des Einkommens
Generalberichterstatter:
Prof. Brian J. Arnold (Kanada)
Diskussionsleiter:
Prof. Paul McDaniel (Vereinigten Staaten)

SUBJECT II
National and international tax consequences of demergers
General Reporter:
Prof. Dr Albert J. Rädler (Germany)
Discussion Leader:
Prof. Lieven Denys (Belgium)

TEMA II
Consecuencias tributarias, nacionales e internacionales, de la escisión de empresas
Ponente General:
Prof. Dr Albert J. Rädler (Alemania)
Presidente de Debates:
Prof. Lieven Denys (Bélgica)

SUJET II
Conséquences fiscales au niveau national et international des scissions et opérations similaires
Rapporteur Général:
Prof. Dr Albert J. Rädler (Allemagne)
Modérateur:
Prof. Lieven Denys (Belgique)

THEMA II
Nationale und internationale Besteuerungsfolgen der Spaltung von Unternehmen
Generalberichterstatter:
Prof. Dr Albert J. Rädler (Deutschland)
Diskussionsleiter:
Prof. Lieven Denys (Belgien)

SEMINAR A
Harmonization of tax under the North American Free Trade Agreement
Chairman:
W. Gordon Williamson C.A. (Canada)

SEMINARIO A
Armonización fiscal conforme al Tratado Trilateral de Libre Comercio de Norte America
Presidente:
W. Gordon Williamson C.A. (Canadá)

SEMINAIRE A
Harmonisation fiscale dans l'Association de Libre Echange Nord-Américaine
Président:
W. Gordon Williamson C.A. (Canada)

SEMINAR A
Steuerharmonisierung im Zeichen des Nordamerikanischen Freihandelsabkommens
Vorsitzender:
W. Gordon Williamson C.A. (Kanada)

SEMINAR B
Secondary adjustments and related aspects of transfer pricing corrections
Chairman:
Shirley Peterson (United States)

SEMINARIO B
Ajustes secundarios y aspectos relacionados con las correcciones de los precios de transferencia
Presidente:
Shirley Peterson (Estados Unidos)

SEMINAIRE B
Ajustements corrélatifs secondaires et problèmes connexes
Président:
Shirley Peterson (Etats-Unis)

SEMINAR B
Folgeanpassungen und damit verbundene Aspekte bei der Berichtigung von Verrechnungspreisen
Vorsitzender:
Shirley Peterson (Vereinigten Staaten)

SEMINAR C
How domestic anti-avoidance rules affect double taxation conventions
Chairman:
David A. Ward Q.C. (Canada)

SEMINARIO C
Influencia de las normas internas sobre la elusión fiscal en los tratados de doble imposición
Presidente:
David A. Ward Q.C. (Canadá)

SEMINAIRE C
Conventions de double imposition et dispositions de droit interne destinées à lutter contre l'évasion
Président:
David A. Ward Q.C. (Canada)

SEMINAR C
Wie inländische Regelungen gegen die Steuerumgehung die Doppelbesteuerungsabkommen beeinflussen
Vorsitzender:
David A. Ward Q.C. (Kanada)

SEMINAR D
Recent international transactions of interest
Chairman:
David R. Tillinghast (United States)
Co-Chairman:
J. David B. Oliver (United Kingdom)

SEMINARIO D
Recientes transacciones internacionales de interés
Presidente:
David R. Tillinghast (Estados Unidos)
Adjunto al Presidente:
J. David B. Oliver (Reino Unido)

SEMINAIRE D
Opérations internationales marquantes au cours de la période récente
Président:
David R. Tillinghast (Etats-Unis)
Président adjoint:
J. David B. Oliver (Royaume-Uni)

SEMINAR D
Neueste internationale Transaktionen von Bedeutung
Vorsitzender:
David R. Tillinghast (Vereinigten Staaten)
Co-Vorsitzender:
J. David B. Oliver (Vereinigtes Königreich)

SEMINAR E
The OECD Model Treaty – 1994 and beyond
Chairman:
Prof. Dr Klaus Vogel (Germany)

SEMINARIO E
El Modelo del Tratado de la OCDE – 1994 y después
Presidente:
Prof. Dr Klaus Vogel (Alemania)

SEMINAIRE E
La Convention modèle de l'OCDE – 1994 et au-delà
Président:
Prof. Dr Klaus Vogel (Allemagne)

SEMINAR E
Das OECD-Musterabkommen – 1994 und darüber hinaus
Vorsitzender:
Prof. Dr Klaus Vogel (Deutschland)

© 1994 International Bureau of Fiscal Documentation

INTERPRETATION OF DOUBLE TAXATION CONVENTIONS IN CANADA: AN UPDATE

Jacques Sasseville

Department of Justice, Canada. The views expressed in this article are solely those of the author and should not be attributed in any way to the Department of Justice of Canada.

In their national report on the interpretation of double taxation conventions which was prepared for the 1993 IFA Congress in Florence,[1] Jean-Marc Déry and David Ward gave an excellent account of how Canadian courts had previously interpreted tax conventions. This article is intended to provide an update on the information contained in that report; it does so by focusing on some recent cases, decided after the report was written, where Canadian courts have dealt with the interpretation of tax conventions.

I. *HINCKLEY V. MNR*: USE OF THE OECD MODEL TAX CONVENTION IN INTERPRETING TAX CONVENTIONS

In their national report, Déry and Ward had indicated that there was no Canadian jurisprudence where the courts had referred to the Commentary on the OECD Model Tax Convention.

There is now confirmation by Canadian courts that the Commentary is relevant for the purposes of the interpretation of Canadian tax conventions. The first reported case in which this was expressly recognized is that of *Hinckley v. MNR*,[2] a decision of the Tax Court of Canada.

In *Hinckley*, the taxpayer, allegedly a resident of the United Kingdom, had been hired by a Canadian employment agency to work as a structural engineer for a corporate client of that agency. He was paid weekly by the employment agency on the basis of hours of work recorded on time sheets signed by a representative of the client. He was supervised, had regular hours of work and executed his work in the same way as permanent employees of the client.

The taxpayer argued that, as a resident of the United Kingdom, he was exempt from Canadian tax on his remuneration under Article XIV (Professional Services) of the Canada–UK Tax Convention[3] because he did not have a "fixed base" in Canada.

The Tax Court judge held otherwise. In doing so, she referred to the Commentary of the OECD Model Tax Convention in the following words:

> On the substance of the matter, the Appellant relied on the application of Article 14 of the Convention. The Convention has followed nearly word for word the Model Convention for avoidance of double taxation with respect to taxes on income and on capital, adopted by the Organization for Economic Cooperation and Development (OECD) on April 11, 1977. With respect to the Model Convention, the OECD fiscal committee has also prepared and published a commentary on each article, the Commentary.
>
> In *Sun Life Assurance Co. of Canada v. Pearson*[4] (H.M. Inspector of Taxes), Mr Justice Fox says at page 331:
>
> > "We should add that it is common ground that we are entitled to consider the Commentary in determining the construction of the Treaty (see Fothergill v. Monarch Airlines Ltd. [1981] AC 251 at page 280)."

The judge then referred to paragraphs 3 and 4 of the Commentary on Article 14, which provide that the provisions of Article 7 and the Commentary thereon can be used as guidance for interpreting and applying Article 14 and that these two articles are based on the same principles. Noting that the Commentary on Article 7 referred to that on Article 5 for the interpretation of the concept of permanent establishment, the judge then quoted paragraphs 5 and 6 of the Commentary on the latter article and concluded that, if the taxpayer had been providing activities of an independent character, she would have found that he had a fixed base in Canada as his place of business "had a definite degree of permanency and was not of a purely temporary nature" (these are almost exactly the same words as those found in the first sentence of paragraph 6 of the Commentary on Article 5).

The judge, however, did not consider that the taxpayer had derived income from activities of an independent character but, rather, from an employment. In order to do so, she had to deal with a decision of the Federal Court[5] in which it had been held, with respect to Canadian unemployment insurance legislation, that there was not, legally, a contractual relationship between a worker and the client of an employment agency and, furthermore, that the contract between the agency and the worker could not be considered to be a contract of employment as the services were rendered to a third party. The judge, however, was able to dismiss that last conclusion on the basis of a more recent non-tax decision of the Supreme

1. Jean-Marc Déry and David Ward, "National Report for Canada", *Cahiers de droit fiscal international*, Vol. LXXVIIIa (Deventer: Kluwer, 1993), at 259-289.
2. 91 DTC 1336 (decision dated 23 October 1991).
3. That article of the Canada–UK Tax Convention is identical, in all material respects, to Art. 14 of OECD Model Tax Convention.
4. [1986] BTC 282 (decision of the UK Court of Appeal). Déry and Ward had accurately foreseen that this case would be considered as authority for the adoption, in Canada, of the practice of referring to the OECD Commentary in interpreting tax conventions; see their national report (cited in note 1), at 274.
5. *T.E.G. International Ltd. v. MNR* (unreported decision dated 21 October 1976).

© 1994 International Bureau of Fiscal Documentation

Court[6] (Canada's highest court) in which it was found that the relationship between a worker and an employment agency is legally one of employment. Having so decided, the Tax Court concluded that Mr Hinckley was therefore taxable in Canada, as provided for in paragraph 1 of Article XV[7] of the Canada–UK Tax Convention.

While *Hinckley* is primarily interesting for its recognition of the principle that the Commentary of the OECD Model Tax Convention is relevant for the purposes of interpreting bilateral tax conventions, another interesting aspect of the case is that the Court held that the meaning of the term "employment", for the purposes of Article XV of the Canada–UK Tax Convention, could be interpreted on the basis of other court decisions relating to non-tax legislation. In so doing, the Court relied expressly on Section 3 of the Income Tax Convention Interpretation Act ("ITCIA"),[8] which provides essentially the same rule as paragraph 2 of Article 3 of the OECD Model Tax Convention.[9]

The decision in *Hinckley* can therefore be seen as supporting the view that, for the purposes of paragraph 2 of Article 3 of the OECD Model Tax Convention, the internal law meaning of a term that is not defined in the Convention is not necessarily the meaning given by a definition of this term to be found in the relevant tax law, but can be a meaning derived from a case law interpretation of the term, even if that interpretation has been adopted in relation to a law other than the relevant tax law, as long as (as was the case in *Hinckley*) that meaning is applicable for the purposes of that tax law.

This position, however, is to be contrasted to that adopted in a more recent decision by the Federal Court of Appeal (a higher court). In *Qing Gang K. Li v. MNR*,[10] a decision that is discussed more fully below, the Federal Court of Appeal had to interpret Article 19 of the Canada–China Tax Convention, which is similar to Article 20 (Students) of the OECD Model Tax Convention. After quoting paragraph 2 of Article 3 of the Convention (which is identical to the same paragraph of the OECD Model Tax Convention), the Court made the following comments:[11]

> The Income Tax Act, R.S.C. 1952, c. 148, as amended, does not define the word "visiting". Thus, in deciding whether in the taxation year 1990 the Applicant was a visitor resident in Canada, resort must be had to the ordinary meaning of the word interpreted in context of Article 19 and the Agreement as a whole.

This excerpt could arguably be interpreted to suggest that recourse to the meaning that an undefined term of a convention has under the domestic law of the Contracting State applying the Convention is only possible if the term is defined in the applicable tax law.[12] Such an interpretation of paragraph 2 of Article 3 would clearly conflict with that adopted in *Hinckley* and would seem unduly restrictive given the approach adopted by the Supreme Court in *The Queen v. Melford Developments Inc.*,[13] where it was decided that "deeming provisions" found in the Income Tax Act – which cannot be said to be definitions – are applicable for purposes of determining the domestic law meaning of a term pursuant to paragraph 2 of Article 3.[14]

It is also interesting to contrast the approach adopted in *Hinckley* to the following comment made by Prof. Vogel and Dr Prokish in their general report on the interpretation of double taxation conventions prepared for the 1993 IFA Congress:[15]

> Secondly, the clause in the model [paragraph 2 of Article 3] only refers to the law of those taxes that are covered by the convention. Hence if a term is only defined in private law or in the provisions of a tax law that is not covered by the convention, references to domestic law are excluded.

Paragraph 2 of Article 3 of the OECD Model Tax Convention refers to the meaning which a term not defined in the Convention has "under the law [...] concerning the taxes to which the Convention applies". The word "law" is, of course, sufficiently broad to cover both the legislation and the jurisprudence of a Contracting State. Also, the phrase "the law concerning the taxes" should not be read as "the laws *under which the taxes are imposed*" but rather as "the law (i.e. including legislation and case law) *that is relevant to the taxes*".[16] In Canada, as in many other countries, tax law does not exist *in vacuum*; it is applied on the basis of the legal relations established under other branches of the law, in particular civil law.[17] Thus, private law may well "concern" the taxes to which the Convention applies. For the purposes of paragraph 2 of Article 3, it is therefore appropriate to refer to the meaning that a term not defined in a tax convention has under private law if such meaning is relevant for purposes of

6. *Public Service Alliance of Canada v. The Queen and Econosult*, cited by the Court as 123 N.R. part 3, at 161.
7. That paragraph of the Canada–UK Tax Convention was also identical, in all material respects, to para. 1 of Art. 15 of OECD Model Tax Convention.
8. R.S.C. 1985, c. I-4.
9. As noted by Déry and Ward (*supra* note 1, at 264), Sec. 3 of the ITCIA was enacted to nullify the effect of the decision of the Supreme Court in *The Queen v. Melford Developments Inc.*, 82 DTC 6281, where it was decided that, for the purposes of para. 2 of Art. 3 of the Canada–Germany Tax Convention, the meaning to be given to terms undefined in the Convention was the meaning these terms had under the Income Tax Act as it read at the time of signature of the Convention (the "static" approach) rather than at the time when the convention was applied (the "ambulatory" approach). As far as Canadian taxation is concerned, therefore, taxpayers cannot technically rely on para. 2 of Art. 3 of Canada's tax conventions as Sec. 3 of the ITCIA prevails over that paragraph. This does not have practical consequences, however, to the extent that Sec. 3 ITCIA provides essentially the same rule as the tax conventions, albeit with the important clarification that it is the ambulatory approach, as opposed to the static one, that must be applied in interpreting undefined terms of the convention by reference to their meaning for the purposes of the Income Tax Act.
10. 94 DTC 6059 (decision dated 5 November 1993).
11. At 6062.
12. It should be noted, however, that in *Qing Gang K. Li*, it does not appear that any domestic law interpretation of the term under consideration was put forward by either party. For that reason, the Court's comments on the condition for the application of para. 2 of Art. 3 may have been made in a rather cursory way.
13. *Supra* note 10.
14. Déry and Ward, *supra* note 1, at 280, note 26.
15. "General report", *Cahiers de droit fiscal international*, Vol. LXXVIIIa (Deventer: Kluwer, 1993), at 55-85.
16. The ITCIA is somewhat clearer in that respect since it uses the phrase "meaning it has for the purposes of the Income Tax Act".
17. One of the clearest statements of that principle in Canadian jurisprudence is found in the following excerpt from the decision of Mr Justice Décary in *The Queen v. Lagueux & Frères Inc.* 74 DTC 6569 (F.C.T.D.) at 6572:
"In my opinion fiscal law is an accessory system, which applies only to the effects produced by contracts. Once the nature of the contracts is determined by the civil law, the Income Tax Act comes into effect, but only then, to place fiscal consequences on those contracts."

© 1994 International Bureau of Fiscal Documentation

the applicable tax law. It is interesting to note that the Court followed this approach in *Hinckley* even though the Income Tax Act included a definition of the term "employment",[18] arguably on the basis that this definition of a general nature had itself to be interpreted on the basis of the civil law.

Another aspect of the interpretation given to the term "employment" in *Hinckley* that is worth noting is that of its relevance with respect to situations described as "international hiring-out of labour".

Since the employment agency referred to in *Hinckley* was a resident of Canada, the case dealt with a "national" rather than "international" hiring-out of labour. This is why the taxpayer, in order to be exempt from Canadian taxation on the basis of the Canada–UK Tax Convention, could not rely, as is usually the case in situations of international hiring-out of labour, on the exemption of paragraph 2 of Article XV (Dependent Personal Services) and had to rely instead on Article XIV (Professional Services) in his attempt to avoid Canadian tax. The decision of the Tax Court, however, could be seen as supporting the argument that in a situation involving an employment agency, the contract of employment is between that agency and the worker. By contrast, paragraph 8 of the Commentary on Article 15 of the OECD Model Tax Convention, which deals with situations of international hiring-out of labour, provides as follows:

> To prevent such abuse, in situations of this type, the term "employer" should be interpreted in the context of paragraph 2. In this respect, it should be noted that the term "employer" is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these functions are to a large extent exercised by the user. In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user.

To the extent that paragraph 8 suggests that, in a situation of international hiring-out of labour, it could be considered that the worker is employed by the client of the employment agency rather than by the employment agency itself, this could be seen as contrary to the position adopted by the Court in *Hinckley*.

It should be noted, however, that the issue that was dealt with in *Hinckley* was that of the distinction between employment and independent personal services and not that of whether the employer could have been considered to be the client of the employment agency.[19] Also, the wording of paragraph 8 makes it clear that the situation of international hiring-out of labour referred to in that paragraph is a case of abuse of the provisions of Article 15. Regardless of the interpretation of the term "employer" in Canadian domestic law, there would be good legal grounds to deny the taxpayer the benefits of paragraph 2 of Article 15 if the purpose of the interposition of a non-resident employment agency were to secure the exemption from source taxation provided for in that paragraph.[20]

II. *QING GANG K. LI V. THE QUEEN*: USE OF DECISIONS RELATING TO OTHER TAX CONVENTIONS

Although Canadian jurisprudence had already recognized[21] that the interpretation given to a provision of a Canadian tax convention by the courts of the other Contracting State would be relevant in interpreting that provision in Canada, there was no indication as to whether the interpretation by courts of other countries of similar provisions of tax conventions to which Canada was not a party would carry any weight in Canada.

The Federal Court of Appeal recently decided, in *Qing Gang K. Li v. The Queen*,[22] that this should be the case.

As already noted, that case dealt with the application of Article 19 (Students) of the Canada–China Tax Convention. The taxpayer who had received, in 1990, a scholarship from a Canadian university, claimed that the amount so received was exempt from Canadian tax under that article, which is similar to Article 20 of the OECD Model Tax Convention except for the fact that, unlike the latter article, it applies regardless of the source of the amount paid to the taxpayer.

The evidence revealed that the taxpayer, a Chinese citizen who was a resident of China before his arrival in Canada, had entered Canada in 1984 on a one year visa for the purposes of pursuing university studies. The taxpayers's visa was renewed every year thereafter. In 1987, the taxpayer married a Canadian citizen and established a family home in Canada. A few days after his marriage, he applied for landed immigrant status, which was granted in 1990.

The issue was whether the taxpayer could be considered, when the scholarship was received, to have been "present [in Canada] solely for the purposes of his education or training" so as to be able to avail himself of the exemption provided for under Article 19 of the Convention.

The Federal Court of Appeal rejected the taxpayer's appeal on the basis that the presence referred to in Article 19 is a temporary one and that the taxpayer, having applied in 1987

18. Subsec. 248(1) of the Income Tax Act provides the following definition of employment:
248(1) In this Act [...],
"employment" means the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign) and "servant" or "employee" means a person holding such a position.
19. The fourth sentence of para. 8, reproduced above, refers to a special interpretation of the term "employer" "*in the context of paragraph 2*" of Art. 15. To the extent that the context of para. 2 would require a special meaning of the term "employer", the general rule of para. 2 of Art. 3, on the basis of which *Hinckley* was decided, would become inapplicable.
20. See, in this respect, D. Ward "Abuse of Tax Treaties" in H. Alpert and K. van Raad ed., *Essays on International Taxation* (Deventer: Kluwer Law and Taxation Publishers, 1993), at 397. See also the recent landmark decision of the Supreme Court of Canada in *Antosko et al. v. The Queen* 94 DTC 6314, where the Court implicitly recognized that its interpretative role is different where a transaction is a "sham or *an abuse of the provisions of the Act*" [emphasis added].
21. *Canadian Pacific Limited v. The Queen*, 76 DTC 6120 (F.C.T.D.) (cf. Déry and Ward, *supra* note 1, at 276).
22. *Supra* note 12.

© 1994 International Bureau of Fiscal Documentation

for landed immigrant status, could no longer claim that he was temporarily present in Canada.

In finding so, the Federal Court of Appeal quoted the following part of the decision of the Tax Court of Canada from which the taxpayer was appealing:[23]

> There is no Canadian decision on that specific question. However, a review of the administrative rulings and court decisions pursuant to the other international tax treaties based on the OECD model in *Edwardes-Ker International Tax Treaties* shows that this Article on student income applies to individuals who are temporarily present in the other Contracting States. The various tax treaties in relation to student income use the expression "visit" or "is temporarily present" and the rulings and court decisions speak of transient persons and sojourners.

The Federal Court of Appeal expressly confirmed that it was appropriate to refer, as the Tax Court judge had done, to decisions of other OECD courts relating to similar provisions of other tax conventions. It did so in the following words:[24]

> The Agreement is one of many that Canada has entered into with foreign States and is patterned on the Model Convention for the avoidance of Double taxation with respect to taxes on Income and on Capital which was adopted by the Organization for Economic Co-operation and Development (OECD) on April 11, 1977. As a result, the decision of Courts in OECD States as to the meaning of the various articles in similar provisions of their governing conventions could be of assistance in deciding the meaning of the words in the Agreement. .

III. *COBLENZ V. THE QUEEN*: REFERENCE TO A TECHNICAL EXPLANATION OF THE CONVENTION PREPARED BY A TREATY PARTNER

Paragraph 2(b) of Article 31 of the Vienna Convention on the Law of Treaties provides that for the purpose of the interpretation of a treaty, the context of that treaty includes:

> any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

As an example of an instrument that would be covered by that provision, Déry and Ward referred to the US Technical Explanation of the Canada–US Tax Convention, which was endorsed by the Canadian Minister of Finance as a true reflection of the understandings reached during the negotiations.[25]

The recent decision of the Tax Court of Canada in *Coblenz v. The Queen*[26] has confirmed that view.

In that case, the taxpayer, a citizen of the United States who was resident of Canada, had received a lump-sum payment on the winding-up of the pension plan of his US employer.

For US tax purposes, he made an election under Section 402 of the Internal Revenue Code, which had the effect of allowing him to deduct the amount of the payment from his "taxable income" (as this term is defined in Section 63(a) of the Internal Revenue Code) but required him to add to his US tax payable for the year an amount generally corresponding to the present value of the tax that he would have paid on the lump-sum amount if he had averaged it over ten years. As noted by the Court, the effect of the election by the taxpayer was therefore that the lump-sum payment was taxed under a different system.

The taxpayer argued that the lump-sum payment was exempt from Canadian tax under the last part of paragraph 1 of Article XVIII (Pensions) of the Canada–US Tax Convention, which reads as follows:

> Pensions and annuities arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State, *but the amount of any such pension that would be excluded from taxable income in the first-mentioned State if the recipient were a resident thereof shall be exempt from taxation in that other State* [emphasis added].

As the technical effect of the election made by the taxpayer, which was available to residents and citizens of the United States, was to exclude the amount of the lump-sum payment from his taxable income and to submit that payment to an averaging tax system, the taxpayer claimed that the conditions for the exemption had been met.

In finding against the taxpayer, the Court adopted the Crown's argument that the part of the above-mentioned US Technical Explanation of the Canada–US Tax Convention that dealt with paragraph 1 of Article 18 of the Convention was an instrument referred to paragraph 2(b) of Article 31 of the Vienna Convention on the Law of Treaties.

The Court then quoted the following example from the technical explanation:

> Thus, if a $ 10,000 pension payment arising in a Contracting State is paid to a resident of the other Contracting State and $ 5,000 of such payment would be excluded from taxable income as a return of capital in the first-mentioned State if the recipient were a resident of the first-mentioned State, the State of residence shall exempt from tax $ 5,000 of the payment. Only $ 5,000 would be so exempt even if the first-mentioned State would also grant a *personal allowance* as a deduction from gross income if the recipient were a resident thereof. [emphasis added by the Court]

Deciding that it had to interpret the interpretative tool, the Court considered the meaning of the phrase "personal allowance" found in the Technical Explanation. Noting that there was no evidence that the election was available to a trust or estate,[27] the Court found that it had to apply Canadian law in order to interpret that phrase. Referring to various exemptions, available in Canada before 1988 that had commonly been referred to as "personal allowances" and noting that these were not available to estates or trusts, the Court concluded that making the election amounted to a "personal allowance" as described in the above quoted example found in the Technical Explanation. It therefore found that, as such,

23. At 6062.
24. *Id.*
25. *Supra* note 1, at 271.
26. 94 DTC 1364.
27. Although this is not clearly stated in the decision, the reference to the availability of the election to a trust or estate seems to have been based on the assumption that if a legal person, as opposed to a physical person, had been entitled to that election, the election could not have been properly characterized as a "personal" allowance.

© 1994 International Bureau of Fiscal Documentation

the election did not result in an exemption from taxable income to which paragraph 1 of Article 18 of the Convention applied.

The taxpayer has appealed from that decision.

Since the US Technical Explanation to the Canada–US Tax Convention has been endorsed by Canada, it seems to properly fall within the scope of paragraph 2(b) of Article 31 of the Vienna Convention (as was found in *Coblenz*). It is interesting to note that in *Utah Mines Limited v. The Queen*,[28] the Federal Court of Appeal has gone one step further by referring to the US Presidential message to the US Senate (which was not formally endorsed by Canada) in interpreting a provision of the Canada–US Tax Convention.

IV. *THE QUEEN V. CROWN FOREST INDUSTRIES LIMITED*: REFERENCE TO THE WORDING OF ARTICLE 4 OF THE OECD MODEL TAX CONVENTION

The recent decision of the Federal Court of Appeal in *The Queen v. Crown Forest Industries Limited*[29] provides an interesting, and somewhat surprising, example of the use of the OECD Model Tax Convention for purposes of interpreting a tax convention.

That case concerned the application of Article XII (Royalties) of the Canada–US Tax Convention. Essentially, the issue was whether the company (Norsk) that received the royalties from Canada was a resident of the United States within the meaning of Article IV (Residence) of the Convention.

According to the evidence, Norsk was incorporated in the Bahamas. Its only office and place of business was in the United States so that its place of management could be said to be in that country. Its income was totally derived from its shipping business and, as such, was exempt from US tax under Section 883(a)(i) of the Internal Revenue Code, which provides an exemption applicable to such income on condition of reciprocity.

The relevant part of paragraph 1 of Article IV of the Canada–US Tax Convention reads as follows:

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature but in the case of an estate or trust...

This paragraph is similar to paragraph 1 of Article 4 of the OECD Model Tax Convention, except for the absence of the following sentence found at the end of the latter paragraph:

> But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

In deciding the issue, the Court relied on the following findings of fact made by the Trial Judge:

- Norsk, a foreign corporation, was liable to tax in the United States in the same manner as a domestic corporation on its income effectively connected with the conduct of a US trade or business;
- under US law, in determining whether the income of a foreign corporation is effectively connected with the conduct of a US trade or business, various factors are considered including the head office location, the place of management, the extent of the activity in the United States, the employment of individuals, the use of resources and the continuity of the conduct of business over a period of time; the place of management of the corporation, while a principal factor, is not a factor which, in itself, would be determinative of the issue;
- Norsk's income was effectively connected with a trade or business actively conducted in the United States because its place of management was located in that country.

On the basis of these findings, the Federal Court of Appeal found, one of the three judges dissenting, that Norsk was a resident of the United States under paragraph 1 of Article IV of the Convention since it was liable to tax in the United States by reason of its place of effective management being situated therein. Norsk was therefore entitled, pursuant to Article XII of that Convention, to a reduction of the rate of withholding tax applicable to the royalties that it had received from Canada.

While that decision of the Federal Court of Appeal raises a number of interesting issues, the following aspects are particularly relevant in respect of the OECD Model Tax Convention.

First, the Court held that the phrase "liable to tax by reason of its ... place of management", found in paragraph 1 of Article 4, referred not only to cases where the taxpayer's liability to tax was based "directly" on its place of effective management, but also where it was based "indirectly" on that factor. The Court's reasoning could be described as follows: the taxpayer was liable to tax in the United States by reason of having income effectively connected with a US trade or business; since his income was found to be effectively connected with a US trade or business primarily because its place of effective management was located in that country, it could therefore be considered to have been liable to tax "by reason of" its place of effective management.

Second, the Court drew a negative inference from the fact that the phrase "place of management" had been included in the Convention as one of the criteria for tax liability. In replying to the Crown's argument that the phrase "place of management" had been included in the paragraph simply because it was a standard provision of the OECD Model Tax Convention and not in order to cover cases such as that of the taxpayer, the Court stated that if that submission were correct, the phrase would be superfluous in the context of the Con-

28. 92 DTC 6194. See Déry and Ward, *supra* note 1, at 276 (note 73).
29. 94 DTC 6108.

© 1994 International Bureau of Fiscal Documentation

vention since neither country imposed taxes solely on the basis of a corporation's place of management.[30]

Third, the Court also drew a negative inference from the absence, in paragraph 1 of Article IV of the Convention, of the second sentence of paragraph 1 of Article 4 of the OECD Model Tax Convention (quoted above). The Court rejected the Crown's argument that the definition of "resident of a Contracting State" in Article 4 was intended to apply only to taxpayers who were liable to tax in that State on their worldwide income. Noting that if that had been intended, such a result could have been "achieved simply by stipulating that only domestic corporations subject to tax on 100 percent of their worldwide income are residents for the purposes of the Convention", the Court noted the absence of the second sentence of paragraph 1 of the Model Tax Convention and made the following comment:

> Absent evidence of a contrary intent, I think it reasonable to conclude, firstly; that the drafters of the Convention were well aware of the OECD clause and, secondly, that its omission from this Convention was intentional. The omission of this clause indicates that it was not the intention of the drafters to make liability to tax on a worldwide basis a necessary condition for resident status under the Convention.[31]

Apart from the fact that this decision challenges the assumption, usually made when interpreting tax conventions, that a "resident" of a Contracting State is a person subject to worldwide taxation in that State,[32] it also suggests that the use of the OECD Model Tax Convention for purposes of the negotiation of tax convention might involve a particular risk, i.e. that a negative inference be drawn from the fact that particular parts of the Model are omitted, or included, in that convention.

The Supreme Court has granted leave to appeal that decision of the Federal Court of Appeal.

V. CONCLUSION

One common feature of the decisions analysed in this article is that they all seem to indicate that the Canadian courts do not feel easily constrained when it comes to deciding which sources can be used for purposes of interpreting the provisions of Canadian tax conventions. Not only have they accepted the relevance of the OECD Model Tax Convention and of its Commentary, but also that of the decisions of courts of other OECD countries on similar provision, of technical notes prepared by a treaty partner and, when applying the interpretative rule of paragraph 2 of Article 3 of the OECD Model Tax Convention, of Canadian court decisions relating to non-tax laws.

It is somewhat unfortunate, however, that, when relying on these sources, the courts have generally not attempted (*Coblenz* being one exception) to do so by reference to the framework of the interpretative rules found in Article 31 and 32 of the Vienna Convention on the Law of Treaties, to which Canada has acceded on 14 October 1970.

It must be recognized, however, that the proper articulation of these rules with respect to tax conventions presents a number of difficulties. First of all, while paragraph 4 of Article 31 can be seen as recognizing the priority of the interpretative rule of paragraph 2 of Article 3 of the OECD Model Tax Convention, the exact scope of that priority is unclear.

Also, there are doubts as to whether and how the OECD Model Tax Convention and its Commentary fall within the framework of Articles 31 and 32. In a recent article,[33] Prof. H. Ault has expressed doubts as to whether the Commentary was covered by any of the categories referred to in Articles 31 and 32. While it would seem possible to argue that the Recommendations adopted by the OECD Council, on which all Member countries are represented by their ambassador, can constitute an agreement within the meaning of paragraphs 2(a) or 3(a) of Article 31 and/or an instrument within the meaning of paragraph 2(b) of that Article and, also, that the Commentary might be considered to be a codification of practices followed by the Member countries in their application of the tax conventions negotiated on the basis of the OECD Model, so as to come within the scope of paragraph 3(b) of the same Article, this is an issue that clearly deserves further consideration.

It is also relevant to note that while Canada has acceded to the Vienna Convention on the Law of Treaties, it has not incorporated the provisions of that Convention in its domestic law.[34] This was not considered necessary as the Vienna Convention was considered to be a codification of already existing public international law.[35] While Canadian courts have often referred to the interpretative rules of the Vienna Convention when interpreting tax conventions, it is not entirely clear what is the relationship between these rules and other, potentially different, interpretative rules provided by Canadian legislation or jurisprudence which may be applicable to tax conventions by reason of their incorporation in Canadian law.

The Supreme Court may use the opportunity offered to it by the *Crown Forest* case to deal with these issues related to the interpretation of tax conventions.

30. Under Canadian jurisprudence, a corporation is generally resident where its place of management is located. Since, however, the place of management is, in that context, part of the concept of residence which is already included in the list of criteria referred to in para. 1 of Art. 4, it can effectively be said that the reference to place of management in that list is not required to cover corporations managed in Canada.

31. It is interesting to contrast that opinion with para. 8 of the Commentary on Art. 4 of the OECD Model Tax Convention, which suggests that the addition of the relevant sentence (which did not exist in the 1963 Draft Convention) had a more limited purpose, i.e. to address the case of some diplomats and, possibly, some conduit companies.

32. Paras. 3 and 4 of the Commentary on Art. 4 of the Model Tax Convention refer to "comprehensive liability to tax" or "full tax liability".

33. H. Ault, "The Role of the OECD Commentary in the Interpretation of Tax Treaties", *Intertax* (April 1994), at 144.

34. Under Canadian constitutional law, treaties are not, as such, part of the domestic law and must therefore be incorporated in that law through legislation. In the case of a tax convention, this is done through the adoption, by the Canadian Parliament, of a short implementation act to which the text of the convention is annexed.

35. Déry and Ward, *supra* note 1, at 260.

© 1994 International Bureau of Fiscal Documentation

THE ONTARIO FAIR TAX COMMISSION: TAX REFORM IN ACTION

Robert Couzin

Robert Couzin is Jurist, Société Juridique Internationale, Paris (correspondent firm of Stikeman, Elliott). He was President of the Canadian Branch of IFA 1992-93; Vice-chair, Fair Tax Commission of Ontario, 1991-93 and Governor, Canadian Tax Foundation, 1987-90.

The Nation should have a tax system which looks like someone designed it on purpose

William E. Simon, U.S. Treasury,
Blueprints for Basic Tax Reform, 1977

Every sermon needs a text. This witty and trenchant comment by William Simon serves my purpose. Its exegesis requires one to ask questions such as: "designed by whom?" and "for what purpose?" The reflections that follow do not answer those questions, but will place them in a particular context. They are based on my recent experience as a member of a provincial tax reform commission in Canada.[1] My hope is that others can learn from the Ontario exercise, and avoid its pitfalls.

I. THE CONTEXT AND HISTORY OF CANADIAN TAXATION

A. The constitutional framework

Canada is a federal state. The areas of provincial jurisdiction are substantial, on any measure. Decisions made in the 19th century regarding the division of powers between the two levels of government have had a not necessarily predictable effect on public finance and fiscal policy.

In particular, many of the most expensive and extensive areas of government operations in the latter part of the 20th century have fallen to the provinces. Health care, education and social welfare are essentially provincial responsibilities. The federal government has relinquished only a portion of the taxing jurisdiction required to fund these expenditures. It also provides direct transfers to the lower level of government through a bevy of complex revenue sharing arrangements.

The provinces, with their substantial spending responsibilities, have naturally sought an important role in policy formation within their areas of jurisdiction. The often Byzantine inter-provincial and federal-provincial negotiations have not been entirely successful. There are occasional breakthroughs, providing unified, if not always frictionless, national programmes, such as universal health insurance. In other cases, there is a kind of enforced unanimity, an intrusion of reality on the dreams of provincial policy makers. This seems to be the situation in the realm of tax policy.

B. The political framework

As in other federal states, one is often regaled with the spectacle of provincial and federal governments of different political stripes. Indeed, even when the same party is in power at both levels, there may be quite palpable differences in policy. Such federal-provincial asynchronicity was of some relevance in the creation of the Fair Tax Commission, and will often have an influence on tax reform exercises in a federal state.

In the particular circumstances, the Province of Ontario had elected, for the first time, the New Democratic Party ("NDP"), a self-styled "social democratic" party, while the Progressive Conservatives held power at the federal level. The provincial election was the impetus for the tax reform exercise. As a new government, and a first-time government, the NDP had substantial election promises to deal with, including enactment of a corporate minimum tax and reintroduction of succession duties, and an impatient and exuberant body of supporters. Whether or not it is fair cynically to accuse the government of appointing the Fair Tax Commission instead of meeting the expectations it created, there is no doubt that both the creation of the commission, the crafting of its mandate and its constitution were directly related to the political exigencies of the election.

C. The financial framework

Canada was in recession. Ontario, the industrial heartland, was particularly hard hit. Three aspects of the economic situation were relevant to the work of the commission. I imagine that similar factors are at work in any tax reform process.

The fiscal position was grave. Canadian provinces can run annual deficits, and borrow abroad. Ontario, the richest province, was embarking on both these courses to an

1. The commission was labelled the "Fair Tax Commission". It was created early in 1991 and reported in late 1993. References hereafter to the "Commission Report" are to the volume *Fair Taxation in a Changing World* (Toronto: University of Toronto Press, 1993), also available in French, *Une Fiscalité Equitable dans un Monde en Perpétuel Changement* (page references are to the English language version).

© 1994 International Bureau of Fiscal Documentation

unprecedented extent. The new government faced rising welfare and other social costs (unemployment insurance itself is a federal responsibility). In its first budget, it forecast an unheard of provincial deficit of over C$ 10 billion. The Fair Tax Commission was presented with a bleak short-term financial situation. This was not the moment for creative spending, through tax credits or incentives, for tax cuts or even for technical reform which might lower government revenues.

The employment situation in the province was bleak. The popular and the official view was that "structural" unemployment and permanent job losses were very high. The government, and many experts, argued that a "restructuring" of the economy was necessary, to attract and retain high value-added jobs. The tax system is always a tempting policy instrument.

Canada had recently started down the road of free trade with the United States, pursuant to the 1989 Free Trade Agreement. This fact had both economic and political importance. The tax policy options were, clearly, constrained by the policies of the other signatory to that agreement, with an economy ten times the size of Canada's. The NDP had campaigned against the Agreement.

D. The taxation framework

A tax reform commission has to start with the tax system as it is. Ontario has three main sources of tax revenue: income, sales and property tax.

Canada imposes income tax on individuals and corporations at both the federal and the provincial levels. The federal government collects the personal income tax on behalf of all provinces except Québec, and the corporate income tax on behalf of the provinces other than Québec, Ontario and Alberta. Such a collection agreement strictly limits provincial flexibility as regards tax policy. Aside from a few special low income credits, and surtaxes, they are limited to adjusting the basic rate. This arrangement was an obvious and critical constraint on provincial tax reform, although, as we shall see, not properly recognized as such.

In fact, there is even greater uniformity and coordination than this degree of cooperation might suggest. For example, even though three important provinces (representing most of the population) do not participate in the joint collection of corporate income tax, practical constraints have prevented the provincial systems from straying very far from the federal model. There are some important exceptions, such as Québec research and development incentives, but these are quite focused and designed not to disturb the overall harmony of the system.

All provinces but Alberta impose a retail sales tax on roughly, although not exactly, the same base. Until 1987, the federal government imposed a manufacturer's level sales tax, which was roundly criticized for its economic inefficiency, distortions, discrimination against exports and administrative archaism. The federal sales tax was replaced by a goods and services tax ("GST"), a form of value-added tax. Unfortunately, it proved impossible at that time to bring the provinces into a national sales tax system, and so Canada was saddled with two levels of distinct commodity taxes. In addition, the federal government imposes customs duties and certain excise taxes.

The third important source of provincial tax revenues is the property tax, imposed on real (immovable) property at the local municipal level under the authority of provincial legislation. This tax base was, in some respects, the most politically charged of those dealt with by the Fair Tax Commission. Being wholly provincial, highly visible and difficult to justify on policy grounds, the property tax was fair game for critics. As well, the province had passed through a series of unsuccessful attempts to reform the valuation base for the tax, which was generally regarded as unfair and arbitrary.

Finally, it should be noted that there is one tax Canada does not have: wealth tax. There is not and never has been an annual net wealth tax. There were both federal and provincial death duties, repealed by the federal government in 1971 with the introduction of capital gains taxation, and phased out by the provinces in the years following that major tax reform. The absence of a tax is as important as the existence of a tax in assessing the dynamics of tax reform.

E. The tax reform framework

While Canada overhauled its income tax system in 1948, the first major post-war examination of taxes was commenced in the 1960s with the appointment of a federal royal commission on taxation. Its findings, the Carter Report, are certainly the single most important Canadian contribution to tax policy analysis. The government of the day was not entirely faithful to the report, but sweeping changes were made with a new income tax statute in 1971. The major structural change was the taxation of capital gains, on realization and also on deemed realization, including death. The income tax system was overhauled in many other respects, and the new structure was of daunting complexity. This was a tax reform based upon the report of an independent commission which provided a highly sophisticated and careful analysis of both the principles and the practice of taxation, with considerable research and support.

The next identifiable tax reform occurred in 1987. Partly a response to changes in the US tax system, and a general *Zeitgeist* of OECD reforms, the government sought to reduce income tax rates and broaden the tax base. The reform package had three elements: income tax reform, sales tax reform and a system of tax transfers to cushion the effects of value-added taxation on low-income Canadians. The process was quite different from 1971. There was no royal commission, and essentially no public consultation, aside from the usual discussion of detail after the package was announced. This was a reform accomplished from within the Department of Finance.

© 1994 International Bureau of Fiscal Documentation

II. THE FAIR TAX COMMISSION PROCESS

Such is the context in which the Ontario government determined in 1991 to establish a commission to examine provincial taxation, for the first time since 1967.[2] While all of the foregoing elements were important in the work of the commission, not all were properly understood, or at least adequately taken into account, by those who constituted it. For example, while the significance of provincial revenues and expenditures means that provincial fiscal policy is, in theory, quite important, the practical constraints which have operated in the past do not disappear merely because the government of the day is of a different political persuasion. Thus, the room for manoeuvre of the Fair Tax Commission was extremely restricted, something soon discovered by most participants in the process. Similarly, the provincial budgetary situation presented a major constraint on the commission, and especially on those of its members and staff who would normally have favoured an increased role for government in fiscal planning, social engineering or what have you.

More generally, if there is a single thesis in these remarks, it is that tax reform bodies must be either fish or foul, providing external, impartial, apolitical expert advice, or making the hard political and social choices. The failure, as I perceive it, of the Fair Tax Commission is largely attributable to the fact that it was neither. Tax policy should be established by governments based upon a careful and subtle amalgam of political judgment and expert understanding. The Fair Tax Commission was not a committee of experts. Nor could it or should it supplant the elected officials. The balance of these notes is, essentially, devoted to explaining how this unenviable position came about. Paradoxically, we sailed between Scylla and Charybdus, and ran aground on both.

A. The mandate

The commission was established by an Order in council of the provincial government,[3] but the traditional format of a "royal commission" was studiously avoided. In retrospect, this seems largely a matter of form. At the time, the government expressed concern that royal commissions are seen as techniques for burying rather than resolving issues, and they generally report only as their mandate expires. The Minister preferred a more active persona for his commission, and was looking for ongoing and prompt advice. Another critical aspect of the commission's mandate was the focus on "fairness". Not only was the word inserted in the commission's name, it also runs through the official mandate. Thus, the Order in council stated that the commission should advise and report to the Minister "on the design and implementation of a more equitable tax system in Ontario" and, in particular, examine:

- the distribution of the tax burden,
- options for ensuring that corporations "pay an appropriate share" of that burden,
- distribution of tax powers between the levels of government,
- effectiveness and fairness of using the tax system to deliver economic incentives,
- any other matters referred by the Minister.

The last-mentioned item was not devoid of meaning. It was intended that the commission should serve as a sounding board for the Minister on various issues.

The focus on "fairness" could be viewed as an attempt to enhance this particular normative judgment in the formulation of tax policy. That is, perhaps the government was seeking to redress a perceived under-emphasis on equity issues in the formulation of tax policy, as against criteria of neutrality, simplicity, etc. The other, less charitable, interpretation is that the drafters of the Order in council (a) were playing to public perceptions that taxes could be fair but they were not fair because previous governments and unnamed special interest groups had prevented that, and (b) themselves misconceived the meaning of "fairness" in tax policy, and did not understand the complexity of the issues.

It is, of course, legitimate for a government to impose its will on tax reform, both the result and the process. However, the emphasis on an emotionally-charged word such as "fairness" was a hindrance. A great deal of commission time was spent, quite unproductively, trying to figure out what we meant by "fair". In the normal course, equity issues would have emerged along with other evaluative criteria, to be dealt with as required. That, naturally, happened in our process as well, but the fairness focus was a distraction.

The commission's mandate knew no bounds as to the scope of reform. As we quickly found, and as some commissioners immediately predicted, certain aspects of the investigation were not capable of meaningful resolution. In particular, while there may be some merit in pointing out problems in the federal tax system to the federal government, one would not expect a provincial government to spend the time (three years) and money (about C$ 9 million) that were invested in the Fair Tax Commission solely or primarily for that purpose. One would, rather, expect such a commission to focus on matters which the province can effectively deal with and reform, having regard to both constitutional and practical constraints. Yet, the breadth of the mandate, not only in the terms of the Order in council but also in specific questions posed by the Minister required the commission to devote a substantial portion of its time to research and debate which could only lead to pious and ineffective policy prescriptions to the federal government.

Tax reform exercises at the sub-national level should, unless they are blessed with unlimited resources, focus on provincial matters. This is not to say that the context of the federal tax system can be ignored. The principles of federal taxation are key in the reform of provincial legislation, and federal-provincial relations in the development and implementation of tax policy and tax systems are certainly a legitimate subject for a provincial commission.

2. Committee on Taxation (the Smith Committee), *Report*, 3 vols. (Toronto: Queen's Printer for Ontario, 1967).
3. O.C./Décret 2835/90, am. 184/91. Reprinted in the Commission Report, at 915-18.

© 1994 International Bureau of Fiscal Documentation

B. "Balance"

I believe that misguided attempts to achieve "balance" among various groups and along various scales impeded the tax reform process.

The commissioners themselves were an unusual lot.[4] Gender balance was perfect, but that external requirement had no adverse impact. Other restrictions were less benign. The choice of individuals from the "left" and the "right", business and labour, the tax professions and tax academia, the social sector, etc. appears to have reflected an attempt by the government (a) to include all these constituencies in the tax reform process, and (b) to achieve a reform package which had the implicit backing of these diverse groups in society.

The first of these two goals is a cross between participatory democracy and public relations: people were supposed to participate in the process because they were represented on the commission, or to feel as if they had participated because they were so represented. It is doubtful much was achieved in this regard. For example, my "constituency", tax professionals in private practice (and, I suppose, economic liberals, if anyone in government knew enough about me to discern that particular leaning), was hardly assuaged by a reform process it saw as dominated by "socialists" merely because one of the ten commissioners was a co-opted tax lawyer.

The second goal is what one commissioner derisively called "élite accommodation": getting opinion leaders from various constituencies to hammer out a "deal" on taxation. I saw this as an honest but misguided attempt to apply labour negotiation tactics to what is essentially a technical and political exercise.

None of these criticisms matter if the use of such criteria for choosing commissioners is not harmful. I think it was. This is not in any way to detract from the ability or acumen of the commissioners as individuals. It is merely an observation that a different selection criterion would probably have led to a better and more useful result.

C. The sources of commission input

A great deal of attention had been given by political advisors to the Minister, before the commission was appointed, to how it might function. As previously noted, for various reasons the government wanted a model which could be readily distinguished from the traditional royal commission. They also wished to involve as many people as possible in the tax reform exercise. Thus, the Fair Tax Commission was born with an unusual and in some respects unwieldy and inefficient design.

The commissioners themselves were, in theory, the top of the pyramid. They would, of course, debate the large issues, and approve the final report to the Minister. The chair of the commission, although not officially vested with any particular powers or obligations, had de facto control of the process. Two vice-chairs were appointed. Since they seemed to have no administrative or other roles different from the remaining commissioners, I presume this was a cosmetic device to enhance the appearance of "balance" and also provide an aura of professionalism: the vice-chairs were both tax "experts", one supposedly from the right (me) and the other from the left (a university law professor). In practice, the vice-chairs, and the commissioners as a whole, had a rather less commanding role than one might have expected. The power of the chair to set the agenda and control the process was very great. I attribute this in part to her enthusiasm and readiness to devote considerable time and energy to the commission, and in part to her close relation to the NDP government and the commission staff.

Any commission, and particularly a commission which is not generously endowed with technical experts, relies heavily on its staff. Their nomination is a delicate and contentious subject. This commission's staff lacked the collective expertise commensurate with the task. Unfortunately, it is difficult to make such a criticism without its being taken quite personally. However, as I said in my dissenting comments, the personal abilities and devotion of the individuals were unquestioned; unfortunately, a combination of factors prevented the commission from having the kind of staff it really needed. First, there was a political element. Clearly, the senior staff were loaded towards NDP supporters and sympathizers. That, of course, is not or need not constitute an adverse judgment of quality. It does limit the pool of people available and, since Canadian tax policy experts seemed for the most part to be of the "wrong" political persuasion, cut us off from most of the universe of available talent. Second, the senior staff member, the director, was chosen not by the commissioners but by the government, and the remaining staff were chosen by the director with input from the chair. Given the qualities of the director who, while not a tax policy expert was a man of considerable talent, this did not necessarily mean that the staff would be poorly chosen. However, it did lead to friction and, certainly from the point of view of some commissioners, a staff different from the one they would have liked.

The Minister, at the outset, determined that semi-autonomous "working groups" would be constituted each to deal with a specific, focused tax policy question. This, in my view, was a bad decision, from numerous perspectives. Those who feel that there is any cohesion to tax policy analysis would find it both unusual and unproductive to ask of such a group, for example, to make recommendations regarding the introduction of a corporate minimum tax, the tax treatment of women, or taxation and poverty. After all, is not the issue of minimum taxation intimately tied to the workings and reform of the corporate tax system? How can one look at the tax treatment of women without dealing more generally with questions

4. Biographies were not included in the Commission Report. The chair was an economist, and a popular columnist on personal finances, with expertise in pension matters; one vice-chair was a law professor, with well-known and public left-of-centre views; I was the other vice-chair; the remaining commissioners included a representative of the labour movement, a small business person, the retired president of a Canadian subsidiary of a US multinational enterprise, a former federal tax policy officer now employed by a major accounting firm, a local politician with particular interest in child poverty and education matters, a university professor of social policy and a representative from Northern Ontario involved with the co-operative movement. These capsules are likely unfair to the participants, but provide some flavour for the mixture.

© 1994 International Bureau of Fiscal Documentation

such as the definition of the tax unit? The tax treatment of the economically underprivileged crosses almost all lines of tax policy development, including the difficult issue of tax mix. Moreover, the creation of these working groups was not merely an idle distraction. I described them as "semi-autonomous" because, frankly, I am not sure anyone ever quite figured out what was their status. The members of these groups (much more numerous than the commissioners) were chosen along similar criteria of "balance", representing various interest groups (another serious fallacy: why should any tax issue affecting a particular sector be settled by the participants in that sector, since the effect is to increase or decrease the taxes on everyone else?). While the groups reported directly to the Minister ("through" the chair of the commission, whatever that means), they were staffed by commission employees, used commission research facilities and, certainly in the mind of the public and the press, represented the commission. Thus, it was difficult to distinguish their recommendations from interim reports of the commission, even though the commissioners had no say in the working groups' deliberations. (This turned out to be a relatively minor problem, since balance was so successfully achieved that the groups could rarely agree on anything at all.) The working groups were a serious drain on commission resources. Nothing much could be done for the first 18 months, as efforts were devoted to supporting the working groups.

The concept, from the Minister's point of view, was that the working groups would be one source of input into our work, outside of our own internal deliberations and the work of commission staff. Another source was public consultation. Initially, an ambitious programme of consultation was devised, including not only hearings around the province, but also the creation of community groups (in a fit of populist fervour called "tax forces") to debate the issues. The consultation process was ultimately scaled back somewhat due to financial constraints. More to the point, I believe very little came out of it. It could be that, as I was prone to believe, tax policy is not the kind of issue on which uninformed public debate is very useful. This is not because citizens are stupid or lazy. But their concerns regarding taxation are not deeply shrouded secrets which require public meetings to unveil. The problem in tax policy is not discovering what bothers people, but figuring out what to do about it. The commission devoted far too little of its admittedly meagre resources to public education, which could have raised the level of the consultation process. Personally, I cannot think of a single idea which came from that process that had a significant impact on the report. Cynically, I felt that in large measure the political elements in the commission, the government and the staff wanted public participation to create a warm feeling that "something was being done".

The final source of information for the commission was research to be carried out by hired consultants. Initially, there was some difficulty in the process of awarding research contracts. Some commissioners seemed to press for "balance" here too, and the result was some unusable research which wasted commission (and public) funds. Relatively quickly, however, even the most politicized participants realized that good research would be valuable regardless of the gender or political beliefs of the researcher. Nonetheless, the research product was somewhat disappointing. I am not sure why that happened. Perhaps it is a general comment on the research industry, the academics who ply their trade to supplement their income and do not expect and are not expected to produce much in the way of original thinking or work. Perhaps it was related to the commission's own lack of focus. In any event, the research product is certainly not comparable to, say, the volumes produced for the Carter Commission[5] in the 1960s. Moreover, the commission itself had great difficulty integrating such research as there was in its deliberations.

One notable exception to this criticism of the research product is the effort of the staff to create inter-departmental information bases. Much to our frustration, we discovered, what others already knew, that the kind of information any serious tax reform process needs was spread about in various unconnected data bases and government departments. A great deal of work went into combining some of this information, overcoming both technical and territorial barriers, and even (heaven forbid) getting cooperation from federal government departments to combine some information from the two levels of government. The work was certainly incomplete, and contained several flaws, but there is no doubt that such assault on compartmentalized and territorial thinking and operations within government is a worthwhile endeavour, and a very real accomplishment to be sought by this kind of commission.

D. Financial constraints

Government commissions often seem expensive to the public, and they are. The Fair Tax Commission budget was originally set at about C$ 9 million. The commission suffered some budget cuts during its term, as part of a wave of government belt-tightening. On the other hand, there were costs one could have associated with the commission but which were borne elsewhere in government. In any event, and however measured, the amount spent was not insignificant.

On the other hand, for those on the inside, the budget never seems to be enough. In this particular case, the mandate and structure of the commission required support for a number of working groups, a substantial outside research programme, a province-wide public consultation programme and, of course, the usual expenses of equipment, staff and supplies, over three years of anticipated life.

In the end, hard choices had to be made. Nothing could be done about some costs, so pressure built on others. The consultation programme was cut back, and other measures taken to stay within budget. It is fair to ask, as a message to future commissions, how much money such an exercise should cost.

A truly thorough study of the entire scope of taxation, the apparent but unrealistic mandate of the commission, would cost more than we had. The type of staff retained on a full-time basis would have been different: more seasoned, experi-

5. Royal Commission on Taxation, *Report* (Carter Report), 3 vols. (Ottawa: Queen's Printer, 1966).

© 1994 International Bureau of Fiscal Documentation

enced and expensive professionals. The research programme would have been even more expensive. In particular, such a commission should obtain serious, detailed and new empirical evidence of the phenomena with which it is dealing. In the case of the Fair Tax Commission, cost as well as time pressure prevented any serious empirical work. Almost all the research was in the form of surveys of the literature and so-called "think pieces", syntheses based on available information.

On the other hand, I believe that the budget was adequate for the work the commission should have done. If we did not need to support working groups, and only consulted the public as actually required for our work (rather than consulting them to make them feel consulted), I believe the necessary empirical research could have been commissioned, the proper staff hired and a useful report produced. A top-level commission, perceived by the academic community as such, can extract a surprising amount of relatively inexpensive advice. Considerable consultation can be obtained for next to nothing, and indeed the commission did use some techniques to access this information base, although not enough.

III. THE FAIR TAX COMMISSION RESULT

Lawyers are notorious for getting bogged down in questions of process at the expense of substance. An apparently flawed process which yields a creative and helpful product should probably be judged a success. On the other hand, a streamlined and well-designed process is of little use if the resulting recommendations lead nowhere. The proper tests of my criticisms of the commission's process are whether (a) the report and recommendations were, in the end, worth the time and money, and (b) if not, whether the defects I have alleged contributed to that failure.

A. The federal-provincial problem

I have already noted that the promoters of the commission, as well as some of its members and staff, did not immediately perceive or, if they did, failed to appreciate the gravity of the limitation on its work implied by the Canadian constitutional arrangement. In some cases, issues arising from provincial taxation in a federal system were, in and by themselves, reasonable questions to debate. For example, the commission majority did recommend, subject to several explicit dissents, the reintroduction of succession duties. However, the majority qualified that recommendation by limiting it to a suggestion that such a tax be adopted at the national level only. Clearly, it was proper for the commission to consider wealth taxation as a provincial matter, even though the final result was a suggestion that it should only be approached federally. Other examples, however, illustrate the futility of a large portion of the commission's work.

Given the realities imposed by the collection agreement with the federal government regarding personal income tax, and the practical constraints imposed on policy relating to corporate taxation, the commission would have been wise to limit quite severely its inquiries in these areas. Consider the subject of women and taxation. The Minister specifically listed this as a matter to be dealt with by a separate working group, and the commission was required by political realities and the views of several of its members to devote a separate chapter, a portion of its research efforts and considerable commission time to the issue. Gender bias in the tax system is, undoubtedly, an important matter. There are some very difficult questions as to how taxation should be judged from this perspective: is rigid equality of treatment the goal, or do factual differences in the situations of men and women require differential treatment in order that the system be judged fair? In traditional terms, that question is one of which factors are included in assessing horizontal equity. The implications of these general questions in terms of the technical tax provisions are very complex. I have no doubt that this is a legitimate and important subject for tax policy analysis. The issue, however, is whether it was a legitimate and important subject for the commission. I argued (unsuccessfully) that it was not, because of the federal-provincial dimension.

Even if Ontario were to pull out of the collection agreement and impose its own, distinct personal income tax (a subject debated at some length by the commission, leading to a recommendation against that course of action),[6] it would be unthinkable to adopt a different tax unit.[7] Thus, research commissioned on this issue, and commission discussion of it (which was mercifully short) was, frankly, a waste of time. Aside from understanding the starting point, which in Canada is the individual, with no provision for joint returns, there was no reason why a provincial commission should exert itself to study something over which it has no possible control. Almost all the issues relating specifically to women and taxation took the same course. While the definition of the tax unit issue was quickly resolved, there was much more discussion of the treatment of alimony and child support. In Canada, such payments are generally deductible to the payer (usually a man) and taxable to the recipient (usually a woman). Commissioners insisted on debating at length whether a fairer system would not be the reverse, with no deduction and no taxation, as is the case in some other countries. This is not an easy issue. There is a critical and thorny empirical question, whether courts and legal advisors properly factor taxation into the awards and agreements. If so, the implicit tax subsidy, arising from the fact that the payer is more likely to be in a higher tax bracket than the recipient, should in theory be benefiting women. There is also an equity question: why is there a tax subsidy at all, which benefits divorced or separated heterosexual couples, but no one else? And there are many technical or implementation issues, including not only the problems of transition, but the international dimension, given the number of cross-border payments which are made to and from the United States. These are interesting and important questions, but the commission

6. Commission Report, at 253.
7. Although perhaps superfluous, the commission expressly recommended that there be no change to the unit of taxation: Commission Report, recommendation 14 at 267.

© 1994 International Bureau of Fiscal Documentation

should not have spent any time on them. It was self-evident that, whatever the answer, Ontario could not possibly have a different rule than the federal government and the other provinces. Thus, all the commission's work on the issue could only possibly lead, as it did, to a plea to the federal government to change the rules.[8]

A careful reading of the commission's recommendations reveals the seriousness of this type of error. There are too many suggestions to the federal government.[9] On occasion, as in the example of succession duties, the subject was appropriate and the resulting decision that the matter should be left to the national level was a real decision. But for the most part, it was obvious from the beginning that the most which could come from the examination of the particular area was such a suggestion to another government. This happened because of two process flaws: the breadth of the mandate from the Minister, and the political requirements imposed on the commission by government and by some commissioners, that certain matters simply had to be dealt with, even if the result was certain to be an impotent plea to the federal government. Moreover, because in many cases the commission knew, as it debated the issue, that it had no power to do anything about it, the analysis and underlying support for its positions was superficial. Why bother with serious research, for example, on advance corporation tax systems if one knows that the province could never enact one on its own? Thus, not only does the report make too many suggestions to someone else, it also makes them without adequate support or analysis to have any impact.

B. The political problem

Some commissioners were openly partisan, and many were proud to belong to a commission with a difference: a tax reform body appointed by a social democratic government. They felt that there was an implicit mandate, or perhaps they properly read this into the explicit mandate, to change the direction of taxation towards the goals of the NDP platform. This had some effect on the report.

First, as previously noted, there was some initial adverse impact on the quality of the research programme. The commission research sub-committee approved, over some objections, certain proposals whose sole redeeming feature was either the political or philosophical bent of the researcher, or the unorthodox nature of the proposal. This was a poor expenditure of public funds. The research product in these cases was of no use to the commission.

Political views also led the commission into dead-end debates. In many cases, these were again reflections of the federal-provincial difficulty. It was unthinkable to some that the commission not examine burning issues such as gender equality, aboriginal rights and taxation of capital income, even though there was little the commission was likely to say of any value about any of these matters.

The political dimension played itself out in the recommendations as well. Some commissioners always favoured reintroduction of succession duties, from before their involvement in the commission's work until after it ended. Others were equally convinced of the contrary view. Unfortunately, the élite accommodation model, rather than leading to accommodation, led to polarization. Those who might have wavered on such an issue were driven to the more predictable position. Many issues were not approached as technical or tax policy matters, but as political tenets. All recommendations were adopted, or rejected, by formal votes, thereby reflecting not a consensus borne of serious thinking and debate, but rather the personal (or in some cases special interest group) views of ten particular individuals.

The government itself was careful not to interfere with the commission. Its influence, two examples of which will be referred to below, was more in the nature of damage control. I compliment the Minister and his staff for not attempting to change the course of commission debate (or, if they did, for being so subtle about it that I did not notice).

One revealing episode involved corporate minimum tax. The introduction of such a tax at the provincial level was part of the NDP election platform. Some commissioners believed in the "fairness" of this measure as a matter of faith, and others honestly felt it had a place in a well-functioning corporate tax system. However, after lengthy debate, a majority consensus coalesced against the tax, essentially on the basis that the "problem" it intended to address would be better and more properly dealt with by limiting the use of tax expenditure measures at the provincial level.[10] The commission recommended that no such tax be enacted. When the vote was held, there was great consternation expressed by the chair and the director, among others. This defeat was, evidently, unexpected and not in someone's game plan. I surmise that there was concern that, in so deciding, the commission was creating a potential embarrassment for the government. The government has since introduced a corporate minimum tax, admitting that this is contrary to the recommendation of its own Fair Tax Commission. That, of course, is the prerogative of government.

A second episode is perhaps more curious and reveals the subtle and indirect role government may have played in shaping the Commission Report. The chair, the director and sev-

8. Commission Report, recommendation 16, at 276. I dissented on this point not because I disagree with the theory, but because I was concerned about the empirical evidence, and the lack of consideration of the technical problems. Commission Report, Commissioners' Personal Comments, at 1044.

9. Including, for example: ask federal government to enforce strict rules on personal benefits conferred by corporations (recommendation 9); changes to pension and retirement assistance (recommendations 26 and 27); corporate imputation system (recommendation 28); capital gains taxation (recommendations 29 and 30); succession duties (recommendation 32); minimize interprovincial corporate tax competition (recommendation 36). In addition, there are a number of recommendations which are conditional on successful negotiation of changes to the federal-provincial collection agreement (recommendations 11, 12, 13, 19, 21, 22, 23, 24, 25, 31), and a number of suggestions that various matters be negotiated with the federal government.

10. There is a three-page discussion of various models of corporate minimum tax in the Commission Report, at 435 ff. A Working Group delivered a lengthy, but inconclusive report on the subject. There was a formal commission vote which rejected the tax. Nonetheless, there is no actual recommendation on the subject, as it was felt too sensitive. Instead, the text (at 437) concludes unequivocally that such a tax is not the best method of dealing with the "problem" of low-tax-paying or non-tax-paying corporations.

© 1994 International Bureau of Fiscal Documentation

eral commissioners favoured reintroduction of succession duties. At a critical meeting, that camp carried the day, and a majority vote was passed in favour of such reintroduction. Moreover, while there was a great deal of concern about moving ahead without the cooperation of the federal government, a majority also voted that, even if no national tax could be devised, the province should nonetheless proceed alone. That is not the recommendation which appears in the report. At a subsequent meeting, the issue was reopened, at the initiative of the staff. Those who had opposed the initial resolution were taken by surprise. Why should the staff, who had favoured it, ask us to reconsider? One theory is that the government may have felt it would be embarrassed by a recommendation to proceed unilaterally since it might have already decided, on the basis of expert advice from its own internal staff, that this was not feasible or advisable.

C. The research

One measure of the success or failure of a tax reform commission is the value of the "oeuvre", what is left behind. That could be a body of research or data which will advance substantially the improvement of tax policy in future, or it could be a report containing substantive recommendations which create the basis for a step forward in the design of the provincial tax system. I would have been content if the process yielded nothing more than a clear and careful analysis of what taxation is all about, a recognition of the constraints on purposeless creativity, and a heightened awareness of tax and fiscal policy issues. While I may be a tough marker, I would not grade the exercise very high on any of these standards.

The research work, as previously noted, was disappointing. It is unlikely that an informed reader of the published research studies will find much of real value. This is not to say that none of those studies merit reading. Some are stimulating, well written and even thought-provoking. But none take us beyond what can be found in academic journals and university publications. The tax policy professionals will not find any break-throughs. The general public will not find much good reading.

Another important potential product would have been new and revealing data or empirical information regarding taxation, such as the measurement of the underground economy, the incidence of corporate or payroll taxes, the distributional effect of tax policy initiatives, etc. While there were clear advances in tying together existing data, there was no original research which substantially advanced our knowledge in these areas.

This is a harsh judgment. If other jurisdictions embark on similar paths to tax reform, they should understand why the Fair Tax Commission did not produce what it might have done. Some of the problems have been described in the consideration of process. But the deeper reason may be that academia, and government departments, are better organized and more efficient now than they used to be. Market discipline has, to some extent, had an effect. If there are subjects of real interest, there is likely to be a body of researchers chasing after that subject, and after the necessary grant support to subsidize the pursuit. It is not self-evident that organized hunts, like tax commissions, will produce an original or supplementary body of knowledge. If there are things which are knowable, and worth knowing, we probably already know them or there are good reasons why we do not. The focus of government attention, and money, might be expected to create a cohesive body of information which academic market forces do not. However, if the Fair Tax Commission can be cited as evidence, it is a testament to the efficiency of this particular market.

D. The report and recommendations

I would describe the report as a relatively successful, but not first class description of the tax policy issues facing the Province of Ontario and other developed economies and societies at the close of the 20th century, but short on serious proposals. Its organization is mildly unorthodox (which is good), but such unorthodoxy is not necessarily in the service of any definable goal. The analysis or presentation of the basic issues of tax policy is, in most cases, rudimentary. More damning, in many areas the accumulated knowledge of prior research and reflection, or indeed the commission's own research and reflection, is not successfully integrated. While it might strike an intelligent but uninitiated reader as interesting, even provocative, one could have achieved that result by reprinting the Carter Report. The reader with any serious background in the area (including, for example, academic students of tax policy and policy-makers within government) would certainly be surprised by the unsuccessful attempts to reinvent a number of wheels. Thus, as an overall assessment, unless it incited either the media or the politicians to a thoughtful examination of the issues, the report itself could not have a serious impact on public debate, save through its recommendations.

The report contains 135 recommendations. Numbers are misleading, as a single idea can be turned into several distinct recommendations, and some of the so-called recommendations are really more in the nature of observations than suggestions for action. The recommendations are organized according to the chapters of the report into various subject categories, rather than following the simpler categorization by tax base. It is not possible in these notes to examine critically the particular recommendations, or even to catalogue them. However, the flavour of the result can, perhaps, be gleaned by focusing on certain elements of the ensemble.

1. Federal-provincial matters

As noted on several occasions already, the federal-provincial dimension asserted itself forcefully in the commission's deliberations, and constrained considerably the scope of the result. Thus, among the "process" recommendations, most do no more than seek to reinforce the provincial hand in dealing with the federal government.

The only substantive recommendation in this regard was the suggestion that Ontario accept an already existing proposal,

© 1994 International Bureau of Fiscal Documentation

contained in a federal discussion paper, to shift the provincial personal income tax from a "tax-on-tax" calculation (i.e. provincial tax is now a percentage of the federal tax) to a "tax-on-income" basis (i.e. provincial tax would be a percentage of the federally defined income base).[11] Such a change would present both advantages and disadvantages. The positives are usually said to lie in some increased flexibility in setting the effective progressive rate structure, and greater transparency, permitting taxpayers to see where their taxes actually go. The main negative is some increase in the already daunting complexity of tax filing. An irony here is that the commission had requested, paid for and received an extensive report on that proposal from an eminent expert in the field, which concluded that it was not worth pursuing, and even issued a press release indicating its own disappointment with the federal position. There is some wiggling in the report to suggest that the particular recommendations address the previously identified weaknesses.[12] The reality seems to be political. Some commissioners were unhappy with changes to the progressive rate structure wrought by the (Progressive Conservative) federal government since 1987, and sought flexibility for the (NDP) provincial government to create additional tax brackets, and raise rates at the top. As I noted in my dissenting comments,[13] there is no reason to believe that such enhanced flexibility will lead, over time (and with different governments in power) to any predictable result. Therefore, the only proper reason to permit a differential rate structure in a particular province is if circumstances there differ from the national average. That case was not made out.

2. Special interest issues

Special interest groups must have been disappointed by the treatment of their pet issues. Under the heading "Equality of Women and Men" there are only three recommendations: to retain the individual as the tax unit (a matter over which Ontario has no control), to eliminate the provincial piece of a credit to married couples (but only if the province gains greater control over personal income tax through renegotiation of the collection agreement with the federal government) and to suggest to the federal government a change to the treatment of child support and alimony.[14]

Aboriginal rights merited a single recommendation, that Ontario should declare itself prepared to negotiate harmonization accords with aboriginal governments.[15] This is based on the hypotheses that aboriginal groups will obtain certain rights of self-government and exercise them by asserting a jurisdiction to tax.

In the environmental area, there is a general preference expressed for tax-based instruments over regulation,[16] and for increased reliance on user fees.[17] There is a somewhat vague carbon tax proposal.[18] Unfortunately, creativity was stymied by the complexity of the issues, and the lack of solid empirical data.

3. Social policy

Some commissioners had a burning interest in social policy. There were lengthy discussions of how we, as a tax commission, could delimit our jurisdiction of inquiry to avoid becoming a social policy commission. After all, if the tax system grants various deductions and credits with a view to implementing social rather than fiscal goals, it is impossible intelligently and comprehensively to examine those measures while ignoring the rest of the government's (or governments') social spending. The Fair Tax Commission had not, however, been asked to review the province's social programmes as such. Clearly, a tax commission should consider the efficiency and the effects of social policy measures buried in the tax system. While that is, generally, what we did, it proved impossible to draw a clean distinction in all cases. One message here for other tax commissions is to clarify the scope of the mandate in connection with social policy.

The commission found no solution to the so-called "welfare wall", the high effective tax rate suffered by individuals who earn some income while receiving social benefits, due to the claw-back of those benefits, partly under the income tax regime but mainly due to the rules determining social assistance benefits. The problem proved intractable, partly because the welfare system itself was outside our mandate, and so while we did necessarily delve into it, we did not delve far enough. Of course, it may well be that there is no good answer anyway (which would appear to be the conclusion to be drawn from the experience in other jurisdictions).

Thus, in the end, the recommendations in this regard amounted to tinkering with existing ad hoc credits[19] (premised on the province getting greater control of its personal tax system), but no serious attempt to integrate social spending and income taxation. There are also a number of conditional recommendations, which depend upon hypothetical changes to the federal-provincial collection agreement. Some of these imply social policy decisions which were arguably beyond our mandate.[20]

4. Pensions

Two surprising proposals were brought to the commission by the staff, promoted by the chair, concerning the tax treatment of pensions. In Canada, private employer-sponsored registered pension schemes are common, and receive tax assistance through limited deductibility of contributions (employer and employee) and deferral of tax on the accumulating income in the plan. In addition, individuals may establish private pension schemes to supplement employer-sponsored plans, or to provide equivalent benefits in the case of self-

11. Recommendation 11, Commission Report, at 254.
12. Commission Report, at 254, footnote 1.
13. Commission Report, at 1042-43.
14. Recommendations 14-16, Commission Report, ch. 14.
15. Recommendation 125, Commission Report, ch. 34.
16. Recommendations 63, 68, Commission Report, at 559, 574.
17. Commission Report, ch. 26.
18. Recommendations 64, 65, Commission Report, at 563-66.
19. Recommendations 17, 18, Commission Report, at 296-306.
20. Recommendations 19-24, Commission Report, at 306-324.

© 1994 International Bureau of Fiscal Documentation

employment. All these schemes are integrated in a complex but equitable system.[21]

This, once again, is purely a federal matter. Even if it had a separate personal income tax system, the prospect of different pension rules solely within Ontario is unthinkable (and, of course, was not recommended). Moreover, unlike, for example, the tax treatment of alimony, where one might expect federal officials to at least be sympathetic to any well-supported arguments raised by the commission, it is highly unlikely that the federal Department of Finance would give the recommendations regarding pensions more than passing and bemused attention. The federal scheme was only recently revised, and both the level of tax assistance and its form were carefully considered. Nor is there any serious discussion in the text of the Commission Report which could serve as a justification for re-examining the issues.

The substance of the proposals seems to reflect merely personal views, rather than any reasoned tax policy, and ignores many years of technical debate within tax policy circles. The first recommendation would turn the deduction for pension contributions to a tax credit.[22] Generally, tax expenditures, government largesse delivered through the tax system, should be in the form of a credit rather than a deduction where progressive rates apply. In this way, taxpayers with higher incomes do not receive larger grants.[23] However, there are particular reasons why pension contributions are treated as deductions rather than credits. Some are technical (e.g. how does one deal with the taxation of the ulterior receipts, which will be taxed under the progressive rates?). None of these issues is mentioned in the report. There is also a policy question, whether the retirement system is really a tax expenditure, or rather an aspect of the tax treatment of savings. The report contains only a passing reference to the possibility contention that the tax treatment of retirement savings is essentially a kind of expenditure taxation, with a reference to that proposition as framed by the Carter Commission, but dismisses this notion in favour of the tax expenditure conclusion without any explanation.[24]

The other recommendation is eccentric, and reflects a particular social view held by its proponents. Since the public pension system (i.e. the public welfare system) provides only a certain level of support, and since different individuals save different amounts through company and personal pensions (in particular there appears to be a statistical difference between retirement savings by men and women, which is hardly surprising given the composition of the labour force), the majority of commissioners decided that the dollar level of deductible contributions should be reduced, and they even determined the precise level to which they should be reduced.[25] This is pure social policy, not tax policy.

5. "Get the rich"

NDP supporters who were hoping for an assault on business and the wealthy were certainly disappointed. There are only three recommendations regarding the treatment of capital income (dividends and capital gains – nothing at all on interest), all of which are recommendations to the federal government.[26] Nor are there recommendations to increase the share of government revenues from corporation. Instead, there is recognition of international competitive constraints, and the practical requirements of harmonization. As noted, the commission rejected (to no avail) the government's call for a corporate minimum tax.

There are, however, two important attempts to render the tax system more "progressive", or to further redistribution of wealth and income. First, as already noted, the commission did recommend, subject to a few dissenting opinions, the reintroduction of succession duties, but only by way of a recommendation to the federal government for a national tax.[27] The "progressive" elements made greater headway with regard to the personal income tax rate schedule. As part of the federal tax reform of 1987, the number of brackets was reduced to three. Actually, Ontario surtaxes have the effect of increasing the number of brackets, but in a somewhat haphazard way. The majority of commissioners recommended the establishment of more brackets, and significantly increased marginal rates on high incomes (assuming, of course, adoption of the other recommendations to change the federal-provincial collection agreement to permit such provincial action).[28] Ontario already has one of the highest personal tax rates in Canada, considerably higher than in the United States (the natural competitor for individual talent).[29] The rate increases were not part of an overall attempt to reward entrepreneurship or initiative. On the contrary, the purpose was clearly to redistribute wealth, and shift the tax mix away from taxes perceived as "regressive", particularly consumption tax. To this extent, the Fair Tax Commission was bucking a trend.

The level of discussion regarding progressivity was disappointing. While there were attempts to measure the progressivity of the existing tax system, and of its elements, data problems and technical difficulties rendered that exercise somewhat suspect. Moreover, there seemed no willingness on the part of most participants to examine, from basic principles, what is meant by progressivity, how it can be justified, what are the implications of different "shapes" of progressivity curves, etc. Rather, it was taken as an article of faith that more brackets and steeper rates at the top were appropriate and "fair". The considerable literature on the subject was not

21. As a result of recent reforms at the federal level, there is a maximum amount which may be deducted annually in respect of these contributions and, in theory, equivalence formulae to bring into that calculation payments to various types of plans, whether they provide defined benefits or merely reflect cash savings. Registration of plans is federal.
22. Recommendation 27, Commission Report, at 333.
23. See Recommendation 5, Commission Report, at 222.
24. Commission Report, at 328.
25. Recommendation 26, Commission Report, at 332.
26. Although the commission did boldly suggest going it alone to abolish the so-called capital gains exemption. In fact, the exemption was repealed by the federal government in the 1994 budget, and that move was unlikely affected by the commission's suggestion.
27. Recommendation 32, Commission Report, at 393.
28. Recommendation 123, Commission Report, at 806.
29. The recent Ontario rate increases have been accomplished by (a) increasing the general rate applied to the federal tax payable, and (b) imposing surtaxes. The latter do have a "progressive" effect, but it was found insufficient and insufficiently flexible by some commissioners.

© 1994 International Bureau of Fiscal Documentation

integrated, and arguments against the progressivity paradigm were not considered

Since the property tax was regarded as regressive (a debatable point, according to the Canadian literature) and is clearly problematic in other ways, the commission decided on a massive shift in the tax mix away from property tax towards the more progressive income tax.[30] Curiously, although some commissioners urged a similar shift from consumption to income tax, again on grounds of progressivity, this was not adopted. The financial constraint simply did not permit it.

6. Consumption tax

The federal government had introduced a value-added tax (the goods and services tax, or GST) following its 1987 tax reform. Certain groups had expressed outrage at the increased reliance on consumption taxation (viewed as regressive), notwithstanding attempts by the federal government to mitigate the effects on the poor through income tax credits. At that time, there was an unsuccessful attempt to integrate the proposed GST with provincial retail sales tax regimes into a national sales tax. Since introduction of the GST only Québec has shifted to a multi-stage tax with joint administration and partial harmonization. The Fair Tax Commission, over the objections of certain commissioners (whose constituencies had been on the front lines opposing the GST), recommended that Ontario follow the federal lead and replace its retail sales tax with a multi-stage VAT, with a view to harmonization.[31] Most of the anti-VAT commissioners were converted as they came to understand the adverse economic effects of the tax on business inputs, a by-product of the existing retail sales tax, and the compliance and administrative burden associated with two levels of consumption tax.

7. Property tax

While this subject is of less interest to readers outside North America, there are numerous recommendations regarding property tax, and local taxation generally. As observed above, this was a thorny and emotionally-charged subject which the commission was bound to investigate, being entirely a matter of provincial jurisdiction. The most far-reaching and contentious series of recommendations relate not to taxation as such, but to the use of taxes. The commission suggested that education funding no longer depend on the local tax base, but be elevated to the provincial level.[32] With regard to the issue of valuation, the commission suggested a change from the current irrational system to a version of "unit assessment".[33] The significance of the suggestion is that it is not "market value assessment", a proposal from which successive provincial governments had backed off.

There are numerous detailed recommendations which might have been better examined by technical experts than by a commission such as ours.

E. Dissents

The report contains "personal comments" (a more tactful expression than "dissent") from eight of the ten commissioners, ranging from two paragraphs to 30 pages. There is no single thrust.

Both vice-chairs drafted lengthy and not very gentle dissenting opinions, from two completely different perspectives. The other vice-chair was looking for greater "progressivity" in the system, higher taxes on the wealthy, less emphasis on consumption tax and with less concern for arguments based on international competitiveness. Yet, he and I essentially agreed in our criticisms of the substance, sophistication and depth of the report.

Overall, there are dissenting views on virtually every issue in the report. Commissioners expressed concern over the conclusions regarding education funding, property taxation, corporate minimum tax, value-added tax, tax mix, wealth tax, etc. The breadth of these dissenting views raises the interesting prospect that a commission designed as this one could, quite conceivably, have agreed on nothing at all. Indeed, the commission did find that here were no majority views on many topics. Not all tax policy questions can be formulated as binary decisions; where there are several alternatives, and a majority rule process, there is no reason to expect any recommendations to appear.

F. Press and public reaction

The Canadian financial press (there really is no "fiscal" press) approaches taxation matters with little sophistication. For example, journalists continue to trumpet statistics about high income individuals who "pay no tax" without any real understanding of loss carry-overs, tax expenditures or imputation systems for corporate level tax. Not surprisingly, the press only bothered reporting those recommendations which might be expected to get a rise out of the readership, such as the high proposed marginal tax rate.

What was surprising, at least to me, was the lack of understanding by the media of the real nature of the report. There seemed to be no comprehension that the commission's recommendations should be weighed in the light of the analysis lying behind them, and indeed in light of other recommendations. I do not think the press (leaving aside professional commentators, such as accounting firms) ever noticed the extensive and sometimes scathing dissents. What I would have regarded as a bomb-shell, such as the recommendation against the government's proposed corporate minimum tax, was not even news, probably because it was considered too complicated.

Overall, the general media seemed to regard the report as a left-wing call for higher taxes, reflecting their prejudgments

30. Recommendations 120-22, Commission Report, at 802-04.
31. Recommendations 57-62, Commission Report, ch. 24.
32. Recommendation 74, Commission Report, at 677.
33. Recommendation 82, Commission Report, at 704.

© 1994 International Bureau of Fiscal Documentation

rather than the actual content. While personal tax rate proposals were reported, the restraint on corporate tax went essentially unnoticed. The majority view in favour of succession duties made the papers, but the significance of the qualifier that it was only a recommendation to the federal government was largely buried.

In fact, media reaction was restrained, and short-lived. After a few days, such interest as there was seemed to disappear. Commissioners were not besieged with interview requests. The government did not react in any substantial way.

IV. MORALS AND CONCLUSIONS

The need for tax "reform" is usually explained by the ad hoc introduction of tax measures. If each amendment to taxation legislation were a carefully crafted addendum to the existing system, with due regard for its interaction with other measures, and if the system as a whole were constantly considered in light of changing economic and social circumstances, there would be no need for periodic overhaul. However, the pace of change in commercial activity, globalization, competitive pressures, social and family arrangements and other external factors is such that the normal process of amendment inevitably leaves anachronisms in the system.

One possible model for reform is a body of experts. In many countries, such a body composed of public finance economists, tax practitioners and public servants could produce a useful result. Certainly Canada lacks a tax policy body or institute, with access to the best and most up-to-date expertise, to advise and cajole government. Some have suggested the need for a permanent tax reform commission, styled on the model of a law reform commission. Whether such an imprimatur is necessary, or even desirable, may be debated. It is unlikely any official body could gain access to all the required talent, particularly from the Department of Finance itself. Perhaps a more informal and discontinuous organization is preferable.

The Fair Tax Commission model has little to offer in the service of improving tax policy. It is too prone to political debate, and spends too much time in mutual education. It was predictable that the freshly-elected NDP government in the province would succumb to the mirage of social consensus on taxation. Unfortunately, vain attempts to find solutions to the technical problems of government in a process of negotiation among special interest groups are not limited by partisan politics, and seem to reflect the spirit of the times. The overarching principles upon which our society is based must, of course, reflect the will of the people, but the implementation of those principles in such mundane fields as taxation is the job of government, which will be judged on its success or failure through the electoral process. At the very least, if a government wishes to consult widely for the purpose of bringing the citizenry along with its own evolving thinking on such a matter, it must (a) know what its thinking is (subject, of course, to keeping an open mind), (b) expend considerable effort on education and information, and (c) not confuse the sum (weighted by decibels and level of organization) of special interests with the public interest.

The Fair Tax Commission exercise raises a further question, applicable to federal states. I was struck during this process not by the reasonable constraints imposed on provincial policy within the Canadian confederation, but rather by the extraordinary resistance to such constraints felt by those who, for whatever reason, disagreed with federal government policy. It may be that the overlap of jurisdiction in a federal state provides a measure of protection to the people, through a further division of the powers of government. However, some matters are not easily divided. In Canada, currency and interest are matters of federal jurisdiction. There is no room for provincial fiscal policy.

Historically, provincial tax policy in Canada has been largely a matter of raising sufficient revenues to pay for programmes which are the responsibility of the provincial government. In the case of retail sales tax and property tax, which were exclusively provincial, such policy as there was admittedly derived from provincial ministries of finance, but it was relatively unsophisticated and not very complex.

When the province of Ontario incurred its first major deficit in 1991, it undercut federal fiscal restraint policy (not that the federal government was itself being all that restrained). This is not a local matter. The province borrowed heavily, and to a substantial extent abroad. One might argue that it exported its inflationary pressure across the country.[34] Provincial fiscal policy, which comports external deficit financing, is problematic where monetary policy is solely the responsibility of the federal government.

The role of the province in establishing tax policy must also be limited. Some associated with the commission seemed to feel that Ontario's voice was not being heard at the federal level. Since residents of Ontario are citizens of Canada, and the federal parliament is their legislature, I translate this perception as the not uncommon desire for a minority view to assert itself by finding a subdivision of the larger body politic in which it is a majority view. This is likely to be a danger in any sub-national tax reform commission.

To paraphrase the words of a less than eminent jurist, if ever there was a case of clearer evidence than this of commissions we do not need, this case is that case.[35]

34. It is of interest to a Canadian that the strictures which would be imposed within the European Union, were there to be a common currency, do not exist within the Canadian confederation.

35. Serjeant Arabin of the Old Bailey, as cited by R.E. Megarry, *Arabinesque-at-law* (London: Wildy & Sons Ltd., 1969), at 19. The actual quotation is from *R. v. Chilston and Chandler* (1832) Arab. 9: "If ever there was a case of clearer evidence than this of persons acting together, this case is that case."

© 1994 International Bureau of Fiscal Documentation

THE DIVISION OF CANADIAN TAXING POWERS: A TUG OF WAR, WITH TAXPAYERS IN THE MIDDLE

Blair P. Dwyer and Katherine A. Thiessen

Mr Dwyer is a tax partner at Crease Harman & Co. He is the author of *Taxation and Investment in Canada*, and a regular contributor to *Tax Planning International*.

Ms Thiessen is an employment and administrative law assistant at Crease Harman & Co. She is a graduate of Queen's University (Kingston) B. Comm. (Hons), and received an LL B from the University of Victoria.

Canada is often described as a parliamentary democracy modelled on the British system of responsible government. Unlike Britain, however, Canada is a federal state. Parliament is supreme, but more than one parliament exists. Legislative authority is divided between a federal government on the one hand[1] and ten provincial governments on the other.[2]

Canada also has two northern territories: the Yukon Territory and the Northwest Territories.[3] These sparsely-populated areas, although largely self-governing in practice, are creations of the federal government and do not have provincial status. The territorial governments derive their authority by virtue of federal statutes rather than through the Canadian constitution.

Each province has created a third level of government for cities, towns and villages (generally, "municipalities") within the province. A municipality derives its authority from the provincial statute that creates the municipality. A municipal government administers matters of purely local concern, such as local roads and sewer systems.

The federal nature of Canada reflects a nation with a strong regional texture rooted in diverse regional histories and economies. Provincial governments are keenly aware of the regional sentiments of their electorate. Consequently, the exchange of views between the federal and provincial governments can become fairly strident at times. To an outside observer, the fervour of these regional sentiments can make Canada the most unlikely of nations. National unity and constitutional reform are perennial themes of Canadian politics. A major province – Quebec – periodically threatens to secede in order to better pursue the distinct elements of its largely francophone culture. Nevertheless, Canada remains intact.

This federal dynamic is reflected in the Canadian tax system. The federal, provincial and municipal levels of government must each raise revenue to pursue their respective legislative agendas. The various levels of government have managed to coordinate taxing powers in a broad sense – not due to any constitutional mandate, but rather through arrangements made by agreement between the federal and provincial levels of government. These arrangements include a complex system of transfer payments between levels of government, the object of which is to equalize economic conditions throughout the country.

Despite this broad harmonization, each province has retained its ability to set its own tax policy. While the federal government administers the income tax system on behalf of most provinces, certain provinces – Quebec and, to a lesser extent, Ontario and Alberta – have retained their own separate provincial income tax regimes.

I. THE CONSTITUTIONAL DIVISION OF TAXING POWERS

The federal level of government has general jurisdiction throughout Canada except in respect of matters that the Canadian constitution has assigned exclusively to the provincial governments. The matters assigned to provincial jurisdiction are quite broad and include property and contract law. The ten provincial governments have legislative authority over these enumerated matters only within their respective geographic limits.[4]

Some matters – including taxation – are within an area of concurrent, or overlapping, federal and provincial jurisdiction. Usually, federal authority takes precedence over provincial authority when both levels of government have concurrent jurisdiction. However, this principle does not apply in respect of taxation: if both levels of government validly enter into the same field of taxation, the two taxing provisions are allowed to stand side by side.[5] For example, both levels of

1. The federal capital is located in Ottawa, Ontario.
2. The ten provinces and their respective capitals are as follows (from west to east):

(a)	British Columbia:	Victoria
(b)	Alberta:	Edmonton
(c)	Saskatchewan:	Regina
(d)	Manitoba:	Winnipeg
(e)	Ontario:	Toronto
(f)	Quebec:	Quebec City
(g)	New Brunswick:	Fredericton
(h)	Prince Edward Island:	Charlottetown
(i)	Nova Scotia:	Halifax
(j)	Newfoundland (and Labrador):	St. John's

3. The Northwest Territories is to be divided into two smaller units in the near future. The eastern portion of the territory will be called Nunavet.
4. The division of powers is set out in Sec. 96 of The Constitution Act, 1867, 30-31, Vict. c.3 (U.K.).
5. It was once argued that federal income taxation constituted an interference with the exclusive legislative authority of the provincial legislatures as to direct taxation; however, the Judicial Committee of the Privy Council confirmed that the Parliament of Canada may impose either direct or indirect taxation for the raising of money and that federal income tax legislation was validly enacted. See *Caron v. The King*, [1924] A.C. 999.

© 1994 International Bureau of Fiscal Documentation

government may impose taxes on income. As a result, a Canadian taxpayer must pay income tax to both the federal and provincial levels of government.

The federal government has constitutional authority to raise funds "by any mode or system of taxation".[6] Consequently, the federal government has a virtually unrestricted taxing power.[7] In contrast, provincial governments are restricted to levying "direct taxation within the province" in order to raise revenue "for provincial purposes".[8] Canadian municipalities are able to levy taxes only on the basis of authority delegated to them by the provinces; accordingly, municipalities also can levy only direct taxes.

A. Direct and indirect taxes

Since the provinces and municipalities can levy only "direct" taxes, a favourite taxpayer technique for getting rid of an unwanted provincial tax has been to argue that the tax is "indirect". As a result, a large body of jurisprudence has grown up to distinguish between "direct" and "indirect" taxes. In this regard, Canadian courts have adopted the following definition from the economist, John Stuart Mill:[9]

> Taxes are either direct or indirect. A direct tax is one which is demanded from the very person who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another; such are the excise or customs.

For example, income tax is regarded as a direct tax. It is levied on the person earning the income, who must bear the tax. The income earner may attempt to increase his or her income in order to deal with the tax, but this is merely an incidental effect of the tax. In contrast, customs duties are indirect taxes. The tax is levied on the person who imports goods into the country; however, it is expected that the importer will increase the selling price of the goods in order to recover the amount of the tax. In this sense, the importer is passing on the economic incidence of the tax to another.

Prior to the formation of Canada in 1867, the main sources of government revenue were indirect taxes (primarily, customs duties and excise taxes). Direct taxation was looked upon unfavourably. In limiting provincial taxation power to direct taxes, the framers of the Canadian constitution intended to place definite restrictions on the scope of provincial taxing powers. This made sense at the time, since the federal government provided what was then regarded as the most essential government service: national defence. Over time, however, governments took on a larger role. This led to a greater need among the provinces for additional revenue, as the provinces were exclusively responsible for the increasingly significant – and expensive – items of health care and education.

Although the expectations of Canadian society changed, the Canadian constitution did not. The balance between provincial and federal revenue needs on the one hand and constitutional taxation powers on the other has been a matter of accommodation and negotiation between the two levels of government, rather than a reliance on clearly defined rights and obligations.

The patchwork of provincial taxation that exists today reflects the varying emphasis placed on certain types of taxation by some provinces. While a great degree of uniformity exists between federal and provincial income taxes, this degree of uniformity has not been matched in other fields of taxation. The differences between provinces, and between provinces and the federal government, can be enormous outside of the income tax field.

B. Geographic jurisdiction

1. Federal taxes

Federal taxing power extends throughout Canada. For federal income tax purposes, Canada extends 12 miles offshore on the ocean surface. This boundary would apply for purposes of determining the territorial source of income from a fishing business, for example. In the case of the oceanbed, however, Canada includes all areas in which oil or gas drilling is licensed by the federal or a provincial government. This licensing area extends to the edge of the continental shelf and beyond.

2. Provincial taxes

In contrast, provincial taxing authority is limited to tax imposed "within the province". In deciding whether a tax is within the province, one must identify the subject matter of the tax. If the subject matter is inside the province, the tax is within the province. If the subject matter is not inside the province, a provincial tax would be invalid.

Non-residents of a province are subject to provincial income tax only if they exercise some form of economic activity which is tantamount to being "found" in the province. Such activity could include carrying on business in the province. Accordingly, the provinces impose income tax only on income earned in the province and on income of persons resident in the province.

For example, provincial income taxation is generally limited to income earned by individuals resident in the province on

6. Constitution Act, 1867, Sec. 91(3).
7. Although the federal taxing power is broad in scope, it is not without limits. The Government of Canada is limited by the Constitution to enacting taxation legislation for the raising of money and any legislation that is to be supported must conform to that limitation or be considered "colourable". See *Caron, supra* note 5. For example, the federal government could not validly impose a tax that was designed specifically to regulate an area subject to exclusive provincial legislative authority (for example, by taxing an activity so as to make it uneconomic). This depends on the intention at the time of enacting the provision; most Canadians would contend that federal taxes have the result of making various activities uneconomic, but no court has yet declared federal taxes unconstitutional on that basis. In addition, the federal government may not pass legislation under the guise of "taxation" which in its pith and substance is a measure regulating the exercise of civil rights, a power within the exclusive jurisdiction of the provinces.
8. Constitution Act, 1867, Sec. 92(2).
9. For example, see *The Attorney General for Quebec v. Walter Reid*, 10 A.C. 141.

© 1994 International Bureau of Fiscal Documentation

the last day of the taxation year or by any taxpayer carrying on business in the province through a permanent establishment located in the province. Individuals resident in a province on the last day of a taxation year are taxed on their employment income regardless of where the employment is performed. Provinces do not generally tax employment income earned within their boundaries by individuals resident in another province. However, where an individual resident outside Canada earns employment income from the performance of duties of employment in a province, that province will tax the non-resident to the extent of such employment income.

The provinces assert worldwide jurisdiction in respect of income earned by resident individuals, subject to relief for foreign income taxes. However, the provinces do not tax non-resident individuals (i.e not resident within the province) on worldwide income.

Corporations are not taxed by the provinces on the basis of their residence or place of incorporation. They are taxed in the provinces in which they have permanent establishments. If a corporation has a permanent establishment in a province and nowhere else in the world, that province will tax the corporation on its worldwide income. If, however, a corporation has a permanent establishment in a province and another one elsewhere, only the income allocated to the permanent establishment in the province will be taxed in that province.

Where a corporation carries on business through permanent establishments in more than one province, its income is allocated for tax purposes based on the average percentage of revenue earned and salaries paid in each such province.

C. Other provincial taxing powers

The Canadian constitution also provides the provinces with express jurisdiction over licensing. The provinces also have the power to make laws for the taxation of both non-renewable natural resources and forestry resources located in the province and primary production from such resources, as well as all sites and facilities in the province for the generation of electrical energy.

II. SHARING OF INCOME TAX: FEDERAL–PROVINCIAL AGREEMENTS

The federal–provincial agreements on taxing authority have tended to focus on income taxes. The agreements serve both to prevent overlapping income taxes from placing an undue burden on taxpayers and to make federal transfer payments available to the less wealthy provinces as a supplement to the revenues that the provinces can raise by their own taxes. These equalization payments help to alleviate regional income disparity and are intended to enable lower-income provincial governments to provide services at national standards without having to resort to excessive rates of taxation. The computation of a province's entitlement to equalization payments is based on a complex formula.

Initially, federal–provincial tax agreements prevented the provinces from levying any income tax, thereby giving the federal government exclusive authority over the field. Most of the provinces agreed to give the federal government exclusive power to collect income taxes in return for federal payments. In essence, the provinces were "renting" their income tax powers to the federal government. Since this system was based on federal–provincial agreements, certain provinces preferred not to participate; these provinces imposed their own provincial income taxes. Agreements ran for five-year periods and were periodically renewed and revised. The tax rental system involved a high degree of centralization: the income tax bases and rates in participating provinces were coordinated and the federal government maintained full control of the tax system.

A new system for sharing income tax powers was introduced in 1962. Instead of the provinces "renting" income tax jurisdiction to the federal government, the two levels of government decided to share their taxing authority. The federal government reduced its rates of individual and corporate income tax in order to permit the provinces to impose provincial income taxes. Rates of federal income tax were set at such a level as to permit the provinces to impose income taxes of their own without making the combined rates oppressively high (although many Canadian taxpayers would beg to differ on this point).

All provinces now impose their own corporate and personal income taxes at rates chosen by them. However, most provinces continue to delegate the administration and enforcement of their income tax laws to the federal government. Federal–provincial agreements continue to be entered into for five-year terms and the federal government continues to act as the collection agent for each participating province.[10] Taxpayers in the participating provinces file a joint federal–provincial income tax return with the federal tax authority, which collects the provincial tax revenue and remits it to the appropriate province.

In order to facilitate tax collection and assessment, the tax collection agreements require that participating provinces levy their non-corporate income tax by reference to a base that is identical to the federal income tax base; in effect, the federal government determines the tax structure for all participating provinces, with provincial freedom extending only to the rate of tax. The tax collection agreements also allow provinces to grant certain credits against provincial tax payable (a $ 1 tax credit reduces tax by $ 1, and so does not affect the calculation of income for tax purposes).

The technique of restricting the fiscal freedom of all participating provinces is an important element in achieving substantial uniformity in the Canadian income tax structure. This

10. The federal-provincial tax collection agreements authorize the federal government to require the withholding of provincial income tax at source for employment income and other types of income, transfer to the Department of National Revenue the assessment and enforcement provisions of the relevant provincial income tax legislation, and provide for a full exchange of information between federal and provincial revenue officials.

© 1994 International Bureau of Fiscal Documentation

form of tax harmonization prevents the duplication of income tax collection and the fragmentation of provincial systems. It also eases the administrative burden on taxpayers, while giving the provinces some measure of flexibility in setting their own rates.

Some provinces have chosen not to participate in the collection agreements. These provinces retain the freedom to design their own income tax structure but also have the obligation of collecting their own income taxes and administering their own income tax systems. Quebec operates its own personal (i.e non-corporate) and corporate income tax system. Ontario and Alberta participate in the federal–provincial collection scheme in respect of personal income taxes but operate independently in respect of corporate income taxes. This means that all persons subject to Quebec provincial income taxes must file a separate provincial return; the same holds true for corporations (but not individuals) who are subject to Ontario and Alberta provincial income taxes. In all provinces except Quebec, federal and provincial personal income taxes are computed on a single tax return.

Even in the provinces that have their own individual or corporate income tax systems, a large degree of similarity exists between the federal and provincial systems. For example, Ontario uses its separate tax system to provide for different tax depreciation rates in respect of certain items. However, the basic rules for the computation of income are virtually identical to the federal system. Thus, the system remains largely standardized.

The provinces have recently indicated an interest in modifying the basic structure of the tax collection system so as to give the provinces more flexibility in designing their own provincial non-corporate income tax systems. A federal advisory committee has studied this issue and released a report in March of 1992. The report warned that giving the provinces more flexibility would increase the complexity of the system. To date, no specific changes have been implemented.

In the rest of this article, the term "participating province" means a province that has the federal government act as its income tax collection agent pursuant to the agreements discussed above.

III. PERSONAL (NON-CORPORATE) INCOME TAX RATES

Non-corporate income tax is imposed at graduated rates. Taking the federal rate as an example, the first $ 29,590 of taxable income is taxed at 17 percent; the next $ 29,590 of taxable income is taxed at 26 percent, and taxable income in excess of $ 59,180 is taxed at 29 percent. As taxable income increases beyond the $ 59,180 threshold, the effective rate begins to approach the marginal rate.

Except in the case of Quebec, provincial rates of personal income tax are generally expressed as a percentage of the federal tax payable. For example, British Columbia provincial income tax on individuals is 52.5 percent of the federal taxes payable. If the federal rate of income tax is 29 percent, the British Columbia rate is 52.5 percent of 29 percent (or 15.2 percent). By adding the federal and provincial rates, one gets the combined rate of income tax applicable to that province. Since the federal rates of income tax are graduated, the provincial rates are also graduated in effect.

In the case of Quebec, personal income tax rates are expressed as a percentage of taxable income; the provincial tax is levied independently from federal tax (i.e. the Quebec rate is 21.5 percent of taxable income and not a stated percentage of the federal rate). The federal government grants an abatement of federal tax in respect of income that is subject to Quebec provincial tax in order to compensate for this separate federal rate. When comparing Quebec rates with the rates of other provinces, one must keep this basic difference in mind.

The federal and provincial governments also impose income tax surtaxes. A surtax is essentially a tax on a tax. For example, the top rate of federal personal income tax is 29 percent. However, all individuals are also subject to a surtax equal to 3 percent of federal tax payable (in this example, 3 percent of 29 percent). Consequently, the effective top federal personal income tax rate after application of this surtax is 29.87 percent. For participating provinces, the provincial tax is applied as a percentage of the basic federal tax (before application of the federal surtax).

Many of the surtaxes are imposed on taxes that exceed a certain threshold level. For example, a 5 percent federal surtax applies on basic federal income tax that exceeds $ 12,500. In this case, the surtax becomes a method of imposing an additional tax on high-income earners.

The following table shows the combined federal–provincial income tax rates for individuals. All rates are the top marginal rates and include all applicable surtaxes. For ease of comparison, the provincial income tax rate is expressed as a percentage of taxable income.

	Provincial or Territorial Rate (% of taxable income)	Combined Rate (% of taxable income)
Newfoundland	20.0	51.3
Nova Scotia	22.4	53.8
Prince Edward Island	19.0	50.3
New Brunswick	20.0	51.4
Quebec	21.5	52.9
Ontario	21.9	53.2
Manitoba	19.7	51.0
Saskatchewan	20.3	51.6
Alberta	14.1	45.4
British Columbia	22.9	54.2
Yukon Territory	15.2	46.5
Northwest Territories	13.0	44.3

To the extent that income has not been earned in a province, no provincial income tax applies. The federal system imposes an additional surtax of 52 percent on such income. The general and high-income federal surtaxes do not apply to the surtax on income earned outside a province. The effective top marginal rate on income earned outside a province is consequently 46.4 percent [the usual federal rate (including surtax-

© 1994 International Bureau of Fiscal Documentation

es) of 31.32 percent, plus 52 percent of the basic 29 percent federal rate].

IV. CORPORATE INCOME TAX RATES

In contrast to non-corporate rates, all provinces express their corporate income tax rates as a percentage of taxable income. For the participating provinces, taxable income is usually computed under the federal computation rules. However, some slight variations exist.

To allow room for the provincial income tax rates, the basic federal rate of corporate income tax (38 percent) is reduced by 10 percent of total taxable income earned in any province. After this 10 percent abatement, the basic federal rate is 28 percent. Unlike the non-corporate income tax system, the stated rate applies to each dollar of taxable income (lower levels of income are not subject to graduated rates). The federal and various provincial governments also impose some surtaxes on corporate income taxes. For example, the federal government imposes a general 3 percent surtax on federal corporate income tax. This increases the basic federal corporate tax to 28.84 percent (after the provincial abatement).

As noted, the provinces of Quebec, Ontario and Alberta administer their own separate corporate income tax systems.

The following table gives the general provincial rates as well as the combined federal–provincial rates. The rates include all surtaxes.

	Provincial or Territorial Rate (%)	Combined Rate (%)
Newfoundland	16	44.84
Nova Scotia	16	44.84
Prince Edward Island	15	43.84
New Brunswick	17	45.84
Quebec		
active business	7	35.84
non-business	16.25	45.09
Ontario	15.5	44.34
Manitoba	17	45.84
Saskatchewan	17	45.84
Alberta	15.5	44.34
British Columbia	16.5	45.34
Yukon Territory	15	43.84
Northwest Territories	12	40.84

To the extent that a corporation's income has not been earned in a province, no provincial income tax applies. Since no provincial income tax applies, the 10 percent federal abatement does not apply. Consequently, the overall rate of tax on income earned outside a province is 38.84 percent (the basic federal rate of 38 percent, plus 3 percent of 28 percent).[11] For example, this rate might apply on foreign income earned by a Canadian corporation carrying on business in a foreign jurisdiction.

The federal government offers incentive rates on certain types of income. For example, a 12.84 percent federal rate applies on the first $ 200,000 of income earned by Canadian-controlled private corporations (a "CCPC") from an active business carried on primarily in Canada. The $ 200,000 limit applies on an annual basis and is not cumulative, although it must be shared among associated corporations. Certain provinces also reduce the provincial income tax rate on such income, as indicated by the following table:

	Provincial or Territorial Rate (%)	Combined Rate (%)
Newfoundland	5	17.84
Nova Scotia	5	17.84
Prince Edward Island	7.5	20.34
New Brunswick	9	21.84
Quebec	3.75	16.59
Ontario	9.5	22.34
Manitoba	9.5	22.34
Saskatchewan	8.5	21.34
Alberta	6	18.84
British Columbia	10	22.84
Yukon Territory	6	18.84
Northwest Territories	5	17.84

Other incentive rates apply for Canadian manufacturing and processing income that does not qualify for the incentive rate for the first $ 200,000 of active business income. For example, this manufacturing and processing rate would apply to manufacturing and processing income of a CCPC that exceeded the $ 200,000 active business income threshold. The rate would also apply if a non-CCPC carried on manufacturing or processing activities. The manufacturing and processing rates are as follows:

	Provincial or Territorial Rate (%)	Combined Rate (%)
Newfoundland	7.5	29.34
Nova Scotia	15	36.84
Prince Edward Island	7.5	29.34
New Brunswick	17	38.84
Quebec	6.9	28.74
Ontario	13.5	35.34
Manitoba	17	38.84
Saskatchewan	17	38.84
Alberta	14.5	36.34
British Columbia	16.5	38.34
Yukon Territory	2.5	24.34
Northwest Territories	12	33.84

V. INCOME TAX TREATIES

Canada has entered into numerous bilateral income tax treaties with numerous other jurisdictions. These treaties are adopted by the federal Parliament as Canadian law so that the treaty takes precedence in the case of a conflict between the treaty and the provisions of federal income tax legislation.

The provinces are not signatories to tax treaties. Even though the treaties are incorporated into federal statute law, federal statutes do not bind the provinces. Nevertheless, participating provinces effectively subject themselves to treaties. In the case of non-corporate income tax, this result follows from

11. However, the abatement does apply for purposes of calculating the 3% federal surtax.

© 1994 International Bureau of Fiscal Documentation

setting the provincial tax rate as a percentage of federal tax payable. In the case of corporate income tax, the provincial rate is expressed as a percentage of taxable income computed under the federal statute; the federal statute has a specific provision allowing the deduction of amounts that are made non-taxable pursuant to a treaty. By computing taxable income for corporations under the federal rules, participating provinces in effect incorporate this deduction into their provincial legislation.

Non-participating provinces usually incorporate treaty provisions, but not always. As a result, it is possible for a non-resident to escape federal income tax but be subject to provincial income tax. For example, the Ontario corporate income tax system and the Quebec personal and corporate income tax systems levy provincial income tax on non-residents who dispose of certain types of capital property in the province. Even if the disposition is exempt from federal income tax by virtue of a tax treaty, the provincial income tax may still apply.

VI. THE LEGISLATIVE PROCESS OF TAXATION

The federal and provincial governments have enacted various taxing statutes, which are amended from time to time. The following comments will concentrate on the legislative process of the federal government in respect of tax laws. Provincial processes are broadly similar.

Federal legislation in respect of taxation must originate in the federal House of Commons on the recommendation of the government. The federal Minister of Finance is responsible for developing tax policy and announces amendments to tax laws at least annually. This usually occurs in February, when the Minister of Finance tables his Budget to the House of Commons for the upcoming fiscal year. The Budget gives the government an opportunity to review the state of the economy and to announce economic and fiscal policies. Debate follows the Budget speech. If the government controls a majority of members in the House of Commons, the Budget will normally pass as a matter of course.

Amendments to tax statutes are not always announced in connection with a Budget. In recent years, the Minister of Finance has proposed significant amendments outside the Budget process; these have usually been designed to counter forms of tax avoidance regarded by the Department as abusive. As well, technical bills are periodically introduced to correct technical deficiencies.

The announcement of tax changes at Budget time usually takes the form of general principles. Detailed legislation (referred to as a "bill") is usually introduced at a later time. The bill goes through three "readings" or votes. The first reading makes the bill a public document, which is then debated in principle during second reading. Following second reading, income tax bills are debated by one or more committees. On report back from the committees, the bill is given third and final reading. After third reading, the bill is sent to the Senate. Although the Senate does not have the power to initiate income tax legislation, it has the constitutional authority to debate tax bills that have been referred to it by the House of Commons. In practice, the Senate (an unelected body) never amends tax bills. After approval by the Senate, the bill is usually proclaimed into law.

While the above series of "readings" and approvals takes a long time, passage of a bill is a virtual certainty if the government holds a majority of the seats in the House of Commons.

Proposed amendments to income tax law usually take effect on the date the proposed amendment is first announced. Since draft legislation to implement the change may not be released until a considerable time after the announcement, this can cause difficulties in tax planning between the date of announcement and the date that the legislation is finally enacted. Constitutional law dictates that taxes may be imposed and collected only by act of Parliament; accordingly, there is no legal authority to collect taxes before the legislation imposing the tax is enacted and receives Royal Assent. In practice, however, federal income taxes are usually collected on the basis of the proposed legislation. It can often take well over a year before proposed legislation is actually enacted into law.

When enacted, tax legislation is usually made retroactive to the date on which the measure was originally announced. Making the measure retroactive to the date of announcement in effect does away with the constitutional illegality referred to above. However, this does little to ease the planning process.

A long tradition exists at the federal level of providing exemptions ("grandfathering treatment") for transactions in progress and reflected in writing on the date a tax change is first announced. However, this is not always the case. In certain instances, grandfathering treatment may be limited or require that the transaction be completed by a specific date.

VII. CUSTOMS DUTIES

Customs duties are a classic example of an indirect tax. Consequently, only the federal government can levy this form of tax.

Federal customs legislation[12] imposes customs duties on importers at varying rates on the vast majority of goods imported into Canada. Customs duties vary with the type and origin of the good imported and are determined under a customs tariff which contains over 8,000 specific tariff items. The Canadian customs tariff conforms to the International Convention on the Harmonized Commodity Description and Coding System, an internationally-based system of standardized tariff classification.

Duty payable is usually determined by multiplying the rate set out in the tariff schedule in respect of the particular item by the "value for duty" of that item. Customs legislation pro-

12. Customs Tariff Act, R.S.C. 1985, c. C-54.

© 1994 International Bureau of Fiscal Documentation

vides for several methods of valuing imported goods for duty purposes. The primary method is to use the transaction value of the goods (essentially the price paid or payable for the goods, subject to certain additions and deductions). The transaction value method cannot be used if any of the following conditions is present:

- the purchaser and vendor are related and this relationship influences the transfer price;
- restrictions exist on the disposition or use of the goods (other than specific named restrictions);
- a value cannot be placed on any part of the consideration being given for the goods (for example, the vendor is selling the goods at a certain price on the condition the purchaser buys other goods from the vendor); or
- proceeds of subsequent resale, disposal or use of the goods accrue to the vendor but cannot be determined within a reasonable time of importation.

If the transaction value method cannot be used, specified subsidiary valuation methods must be employed.

Remission (or refund) of duty is available for the importation of items used in the manufacture of products for export and for certain goods, including machinery and equipment that are not produced in Canada.

Canada, the United States and Mexico have entered into the North American Free Trade Agreement ("NAFTA"). Canada and the United States have entered into a separate Free Trade Agreement governing certain other matters of trade.

VIII. EXCISE TAXES AND EXCISE DUTIES

Excise taxes and duties are imposed exclusively by the federal government. The federal Excise Tax Act[13] imposes these taxes at varying rates on certain goods, including jewellery and cosmetics. The taxes are paid by a person on the performance of some action, such as the manufacture or sale of goods. Goods subject to excise taxes can be described generally as luxury goods.

IX. SALES TAXES

Both the federal and provincial levels of government impose various transaction-based taxes.

A. Provincial sales taxes

Except for Alberta and the two territories, all provinces impose a retail sales tax on the sale or lease price of tangible personal property (movable property) and some services.

As noted, the provinces are restricted to the imposition of direct taxes. While one might think that a sales tax would qualify as an indirect tax, the provinces have avoided this restriction by imposing the tax on the end-consumer and making the retail vendor an agent for the province for collection purposes. Most provinces provide a very minor tax rebate to retail vendors as payment for their collection services.

The retail sales tax base varies from province to province.[14] For example, some provinces provide an exemption for machinery and equipment purchased by manufacturers or producers for use in their manufacturing or production process. The range of services included in the retail sales tax base also varies. For example, British Columbia applies its retail sales tax to legal services.

The tax applies to the end-user of a product. For example, a business must pay the tax on desks and other equipment used in its business operations. However, no tax applies on items purchased for resale (i.e. inventory).

The Quebec provincial sales tax is structured slightly differently from the sales taxes of other provinces (see below). For example, it applies to transfers of real (immovable) property as well as to transfers of tangible personal property.

All provinces and territories impose consumption taxes on specific commodities such as gasoline, liquor and tobacco. Some special "environmental" levies are imposed on automobile tyres, batteries, and vehicles that fall below specified fuel-efficiency ratings.

Provincial taxation of commodities is restricted to commodities sold or consumed in the province, given that the provinces can impose taxation only "within the province".

B. Federal goods and services tax

The federal government imposes a 7 percent goods and services tax (th "GST") on supplies of most goods and services. Notwithstanding the term "goods and services tax", the GST also applies to most real estate transactions. The GST is a value-added-type tax on the European model: it is imposed on the value added at each step in the production and distribution chain down to the retail level. The GST requires most businesses in the production and distribution chain to charge GST on domestic sales. However, vendors are able to claim refunds of GST paid on supplies used in the course of their commercial activity. Accordingly, the tax is paid and refunded throughout the distribution chain so that the final incidence of the tax falls on the end-user of the item in question.

As a simplified example, assume that a logger cuts logs and sells them to a sawmill for $ 100. The value added to the logs

13. Excise Tax Act, R.S.C. 1985, c. E-15.
14. The general sales tax rates (%) are as follows:

Newfoundland	12
Nova Scotia	11
Prince Edward Island	10
New Brunswick	11
Quebec	6.5
Ontario	8
Manitoba	7
Saskatchewan	9
Alberta	none
British Columbia	7

Other rates may apply to specific goods and services.

© 1994 International Bureau of Fiscal Documentation

is $ 100 and, assuming that the logger can claim no refund for GST paid on his business inputs, the net tax payable is $ 7. If the sawmill then turns the logs into boards and sells the boards for $ 300, it will collect $ 21 in GST (7 percent of $ 300). Since the sawmill paid $ 7 in GST when it purchased the logs, it must remit only $ 14 in tax ($ 21 in tax collected minus the $ 7 in tax paid). Total tax remitted to this point, however, is equal to the $ 7 remitted on the original sale plus the $ 14 remitted on the sale by the sawmill. This process of collecting tax on sales and subtracting tax paid on purchases continues all the way to the point of retail sale. The final consumer ultimately bears the full cost of the tax, since he is unable to claim any refund of the GST paid at that level.

Certain goods and services are exempt from GST while other goods and services are subject to a zero-rate of tax. An exemption means that no tax is charged on supplies of the exempt good or service. However, the vendor is unable to claim any refund for GST paid on any business inputs used in connection with the exempt supply. Consequently, the vendor bears the cost of the GST in connection with the transaction and must attempt to recover that expense as another cost of doing business. If a zero rate of GST applies to an item, the vendor collects no tax on the sale but nevertheless may claim a refund of GST paid on any business inputs used in connection with the zero-rated supply. In this manner, no GST is hidden in the cost of the zero-rated item.

Exports are not subject to the GST.

C. Harmonization of GST and provincial sales taxes

When the federal government first introduced the GST, it attempted to have the provinces agree to impose a national sales tax that would be administered by the federal government. This would have required a uniform tax base. The provinces rejected this proposal. Given that the GST was a very unpopular tax, most provinces also loudly criticized the proposed tax. The current federal government has pledged to revamp the GST, and has expressed a renewed interest in having the provinces harmonize their provincial sales tax systems with the GST. Only time will tell whether this new initiative will succeed. One can expect some provinces to use the negotiations as an opportunity to push for greater provincial freedom in connection with income taxes.

The lack of harmonization between the GST and the various provincial sales taxes creates administrative difficulties for businesses. The two tax systems have separate administrative arms and different reporting times. As well, some products are subject to both taxes, other products are subject to only the GST and yet other products are subject to only the provincial sales tax.

Since the introduction of the GST, Quebec has decided to partially harmonize its provincial sales tax system with the GST. Due to the constitutional requirement that provincial taxes be direct, however, the Quebec version of the GST is imposed only at the retail level (not at all points of the production and distribution chain). Significant differences exist in the respective tax bases of the Quebec provincial sales tax and the GST: for example, financial intermediation services are exempt for GST purposes but zero-rated for Quebec provincial sales tax purposes. In Quebec, the GST and the provincial sales tax are administered by a provincial agency under the broad direction of the federal taxation authority.

The GST base does not include provincial retail sales taxes. Similarly, the provincial retail sales tax base does not include GST in Ontario, Manitoba, Saskatchewan and British Columbia. However, the GST is included in the retail sales tax base in Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland. This raises the effective sales tax rate in those provinces, since the provincial tax is imposed on the sale price plus the exigible GST.

X. CAPITAL TAXES

A. Provincial capital taxes

All provinces levy a form of capital tax on corporations that have a permanent establishment in the province. Ontario, Quebec, Manitoba, Saskatchewan and British Columbia impose a general capital tax on all corporations (ranging between 0.3 percent in Manitoba to 0.5 percent in Saskatchewan and Quebec). These provinces also impose a higher rate of capital tax on banks and loan and trust corporations. Newfoundland, Nova Scotia, New Brunswick, Prince Edward Island and British Columbia impose capital taxes exclusively on banks and loan and trust corporations. The highest provincial rate of capital tax for banks and loan and trust corporations is 3.25 percent (applicable in Saskatchewan).

The two territories do not impose a capital tax.

B. Federal capital taxes

The federal government imposes a large corporations tax equal to 0.2 percent of corporate capital employed in Canada in excess of $ 10 million. A federal income tax surtax may be credited against this large corporations tax; effectively, the tax is a form of minimum tax. To the extent that a taxpayer is unable to credit the capital tax against the federal surtax, a seven-year carry-forward and three-year carry-back provision will apply.

The federal government imposes an additional capital tax on financial institutions. This capital tax may be credited against federal income tax, and so also operates as a form of minimum tax.

C. Deduction of provincial capital taxes

As part of the continuing tug of war between the federal and provincial taxing powers, the federal government has announced proposals to place restrictions on the deductibility of provincial capital taxes in computing income for federal income tax purposes. Implementation of these proposals

© 1994 International Bureau of Fiscal Documentation

has been delayed several times while federal and provincial tax administrators hold discussions on the issue.

XI. LAND TAXES

A. Land transfer taxes

New Brunswick, Nova Scotia, Quebec, Ontario, Manitoba and British Columbia impose tax on transfers of real property or immovables (including fixtures attached to land). The rate of tax is a percentage of the amount paid for the property and varies from 0.25 percent in New Brunswick to 2 percent in British Columbia. Two provinces impose higher rates for transfers of certain land to non-residents: a 33 percent rate in Quebec and a 20 percent rate in Ontario.

Unlike the provincial retail sales taxes, land transfer taxes apply on each transfer of real estate (even land that is purchased for resale). The tax is generally payable on registration of the transfer in the provincial real property registry. In some provinces, it is possible to avoid the tax if the transfer remains unregistered. This technique is available only in respect of non-arm's length transfers, since the registered owner of the real estate is treated as the owner of the land and can usually pass good title to a third party who is unaware of the actual ownership situation.

These taxes are in addition to the federal goods and services tax, which also applies on most transactions involving real property. In the case of Quebec, the land transfer tax is in addition to the Quebec provincial sales tax.

B. Municipal property taxes

Annual real (immovable) property taxes are imposed in each province, usually at the municipal level of government, and are generally based on the annual assessed value of the real property. Property tax rates vary from one municipality to another. Many municipalities also impose business taxes.

XII. SUCCESSION DUTIES AND GIFT TAXES

No Canadian jurisdiction imposes a formal gift or inheritance tax. A form of such tax is imposed, however, through deemed disposition provisions in federal income tax legislation. This regime taxes only the accrued gain on the asset rather than the entire value of the asset.

A person who gives property as a gift is deemed to dispose of it for proceeds equal to fair market value. Depending on the property involved, this deemed disposition may cause the donor to recognize income or capital gains. For example, a gift of corporate shares held as capital property may result in a capital gain to the extent that the fair market value of the shares at the time exceeds the donor's cost of the shares. The recipient of the gift is deemed to have acquired the property at its fair market value, with the result that the recipient will be taxed on a future disposition only on gains that accrue beyond the fair market value of the property at the time of the gift.

A deceased taxpayer is deemed to dispose of all property owned immediately before the time of death. This may result in taxation of income or a capital gain, as discussed above. The estate of the deceased generally is deemed to acquire the property at a cost equal to the deceased's deemed proceeds of disposition. Deferral of tax is possible to the extent that property passes to the deceased's spouse or a qualifying trust for the spouse.

XIII. PAYROLL TAXES

A payroll tax is applied to the annual gross wages, salary and other remuneration paid by an employer. Newfoundland, Manitoba, Quebec, Ontario and the Northwest Territories are the only Canadian jurisdictions that impose a formal payroll tax. The federal government funds several social security programmes through premiums calculated on the basis of payrolls (see below).

The rates of payroll tax vary from 1 percent to 4.5 percent. The Ontario payroll tax also applies to the income of self-employed individuals.

The federal government has proposed restrictions on the deductibility of provincial payroll taxes in computing income for federal income tax purposes. Implementation of these proposals has been delayed several times while federal and provincial tax administrators hold discussions on the issue.

XIV. SOCIAL SECURITY LEVIES

A. Unemployment insurance

The federal government administers an unemployment insurance fund to provide assistance to workers during periods of unemployment. Benefits payable out of the fund vary with the number of weeks worked and the level of earnings during the period before unemployment began. Subject to specific exceptions, most employers and employees must pay premiums to the fund.

The employer portion of the premium is 1.4 times the employee portion. In 1995, the employee and employer contribution rates will be $ 3.00 and $ 4.25, respectively, per $ 100 of insurable earnings. The maximum level of insurable earnings per employee is $ 780 per week ($ 40,560 per year) in 1994.

The employer must collect the employee portion of the premium and remit the combined employer-employee premium to the federal government on a regular basis.

B. Canada pension plan

The federal government administers a contributory pension plan designed to provide a minimum level of retirement, dis-

© 1994 International Bureau of Fiscal Documentation

ability and certain other benefits to Canadian residents. The plan does not directly affect private pension plans and is not intended to take the place of individual retirement planning. The province of Quebec administers a separate but similar plan for residents of Quebec.

Under the (federal) Canada Pension Plan, employees and employers must make contributions calculated on a formula basis, subject to a maximum annual amount. Employer contributions are on a per employee basis and are equal to the amount of the employee contribution. In 1994, the maximum employer contribution per employee is $ 752.50. If an employee is also subject to the Quebec Pension Plan, premiums paid under the Quebec plan will be deducted from the required contribution under the federal plan. Self-employed persons resident in Canada are obligated to contribute to the federal plan by paying both the "employer" and "employee" portions of the premiums.

An employer must make contributions on a per employee basis, regardless of the amount of contributions made by other employers in respect of that employee. In the case of a newly-hired employee, for example, the employer does not receive credit for contributions made in the calendar year by the previous employer. This can lead to double contributions if a corporate reorganization involves the transfer of employees to a new corporation mid-way through a calendar year.

Employers must collect the employee portion of the contributions and remit the combined employer-employee amount to the federal government on a regular basis.

Quebec administers its own provincial pension plan which is similar to the federal plan.

C. Provincial medical insurance

Each province administers a general health insurance plan to assist provincial residents with the cost of medical care.

The method of funding the plan varies from province to province. In most provinces, residents must pay monthly premiums. Employers ordinarily must collect the premiums and remit them to the provincial government. Employers may make no charge for collecting the premiums. Ontario funds its provincial health plan through a payroll tax rather than through monthly premiums.

D. Worker's compensation

Each province administers an accident fund to compensate employees who have been injured on the job. Membership in the fund is mandatory for certain industries and, in some provinces, voluntary for some industries. Employers participating in the fund must make monthly contributions on a per employee basis.

XV. ADMINISTRATION OF TAXES

At the federal level, tax policy and tax administration are split between two separate government departments. The Department of Finance develops tax policy and drafts the enacting legislation. The Department of National Revenue administers most federal taxation laws once they have been enacted.

The Department of National Revenue is commonly referred to as "Revenue Canada". It formerly was divided into two separate divisions: Taxation (which administered income tax) and Customs and Excise (which administered custom, excise and sales taxes). This was not entirely satisfactory, as a business would have to deal with two separate bureaucracies for income tax and sales tax matters (even requiring two separate Revenue Canada account numbers). Revenue Canada is currently in the process of unifying its divisions, with the result that taxpayers will be able to enjoy "one-stop taxpaying", with only one Revenue Canada account number.

By arrangement with many of the provinces, Revenue Canada collects both provincial and federal income taxes. This has been dealt with above.

Each province administers its own provincial taxes other than income taxes.

XVI. CONCLUSION

Canadian legislative and administrative functions with respect to taxation are very decentralized. While a fair degree of harmonization exists in respect of income tax, large variations exist in respect of other types of taxes. The balance between harmonization and variation will continue to fluctuate over time. While the federal government is attempting to convince the provinces to harmonize their sales taxes with the federal GST, many provinces wish to gain greater flexibility in respect of provincial income taxes.

Given that the system for sharing tax jurisdiction in Canada is largely agreement-based rather than the product of firm constitutional distinctions, the degree of harmonization between federal and provincial taxes will continue to reflect considerable ebb and flow. Taxpayers can merely watch and wait to see which of their governments will demand how much and in what form.

© 1994 International Bureau of Fiscal Documentation

HIGHLIGHTS OF THE 1994 CANADIAN BUDGET

Stephen S. Ruby

Partner, Fasken Campbell Godfrey
Partner, Fasken Martineau

On 22 February 1994, the Honourable Minister of Finance, Paul Martin, tabled his inaugural federal Budget[1] in the House of Commons. The Notice of Ways and Means Motion to Amend the Income Tax Act[2] tabled with the Budget, contains numerous amendments concerning the taxation of life insurance benefits, the elimination of the $ 100,000 capital gains exemption for Canadian residents, the deduction for meals and entertainment expenses, the use of partnerships in connection with tax shelters, the entitlement to the small business deduction by large private corporations, scientific research and experimental development expenses and others. This article, however, focuses on four areas that were subject to significant amendment by the Budget and which are most likely to be of interest to the international investing community. These areas are: divisive corporate reorganizations, foreign affiliates, debt forgiveness and financial institutions. The Budget papers contained draft legislation concerning the amendments to divisive reorganizations and foreign affiliates. After consultation with the tax and business community, on 23 June 1994, the Department of Finance released further draft legislation concerning these two areas but has not, as yet, released draft legislation concerning the Budget amendments to debt forgiveness or to financial institutions.

The areas of tax discussed in this article are, in general, technically complex, as is the draft legislation that has been released to date. Accordingly, any discussion of these topics is, unavoidably, technical in nature.

I. DIVISIVE CORPORATE REORGANIZATIONS

A. The demise of the purchase butterfly

Where a 90 percent owned Canadian subsidiary liquidates into its Canadian parent, subsection 88(1) of the Act effectively permits the parent to exchange its shares of the subsidiary for the subsidiary's assets on a tax-deferred basis. However, where a Canadian corporation has multiple shareholders, there is no holistic provision in the Act similar to subsection 88(1) that permits a *pro rata* tax-deferred distribution of its assets to its shareholders in exchange for their shares.

Nevertheless, where the shareholders are corporations, tax-deferred divisive corporate reorganizations or demergers can be achieved for Canadian tax purposes through a series of sequentially ordered rollovers and share redemptions that essentially rely upon subsection 112(1) which permits the tax-free payment of dividends between taxable Canadian corporations and subsection 85(1) which permits the tax-deferred rollover of assets to a taxable Canadian corporation.

The established sequence (and its variations) of the ordering of transactions to effect a transfer of assets of a Canadian corporation on a tax-deferred basis to its historical corporate shareholders is known as a "butterfly" transaction. Where the transferee corporation is not a historical shareholder of the distributing corporation but has purchased the shares of the distributing corporation for the purpose of acquiring certain of its assets on a tax-deferred basis, the sequence of transactions is known as a "purchase butterfly".

The purchase butterfly technique can best be illustrated by an example.

Assume that Canco operates a business using an asset (the "target asset") that has appreciated substantially in value and that Canco has no assets other than those connected with its business. Assume that individual A owns all of the issued shares of Canco and that individual B wishes to acquire the target asset. If B simply purchased the target asset from Canco for its fair market value, Canco would realize a capital gain on its disposition. However, A and B can arrange to have the target asset effectively transferred by Canco to a corporation owned by B, on a tax-deferred basis, through the use of the purchase butterfly technique. To effect the purchase butterfly, the following transactions would be completed in the following order.

(i) B would incorporate a Canadian corporation, Holdco, for the purpose of acquiring the target asset and would subscribe for share capital of Holdco equal to the negotiated purchase price of the target asset (the "Purchase Price").

(ii) A would sell to Holdco upon payment to A of the Purchase Price, that number of shares of Canco that represented the Purchase Price by fair market value. A would realize a capital gain on the disposition of such shares to Holdco.

(iii) Canco would then transfer the target asset to Holdco in exchange for preference shares of Holdco redeemable at the option of the holder and having an aggregate redemption price equal to the Purchase Price.[3] The transfer of the target

1. Hereinafter referred to as the "Budget".
2. All statutory references in this paper are to the Income Tax Act, R.S.C.,1985, C. 1, (5th Supp.), as amended, (the "Act") and to the Regulations thereto (the "Regulations"), except where otherwise expressly stated.
3. As a matter of corporate law, under Sec. 28 of the Ontario Business Corporations Act and Sec. 30 of the Canada Business Corporations Act, Canco cannot acquire shares in Holdco if Holdco controls Canco. It is assumed for the purposes of this butterfly illustration that the shares of Canco that are transferred to Holdco do not represent voting shares issued by Canco carrying more than 50% of the votes for the election of directors.

© 1994 International Bureau of Fiscal Documentation

asset would be effected on a rollover basis under subsection 85(1) by Canco and Holdco jointly electing, for tax purposes, that the target asset be disposed of to Holdco at its adjusted cost basis to Canco. The elected amount becomes the adjusted cost base of the Holdco preference shares to Canco and the tax cost of the target asset to Holdco. The aggregate paid-up capital of the Holdco preference shares would be fixed at an amount equal to the elected amount.

(iv) Holdco would then redeem its preference shares and would satisfy the redemption price by delivering to Canco its promissory note (the "Holdco Note") for the Purchase Price. This payment essentially constitutes a tax-free intercorporate dividend to Canco pursuant to subsection 112(1).[4]

(v) Canco will then purchase for cancellation all of its shares held by Holdco and will satisfy the purchase price by delivering to Holdco its note (the "Canco Note") for an amount equal to the Purchase Price. This payment also essentially constitutes a tax-free intercorporate dividend received by Holdco pursuant to subsection 112(1).[5]

(vi) The Holdco Note and the Canco Note will then each be repaid by being set off against each other and such notes will be cancelled.

If Canco had simply sold the target asset to Holdco for the Purchase Price, Canco would have paid tax on any capital gain that otherwise would have been realized by it on such sale and A would have been subject to tax on the distribution by Canco of the after-tax sale proceeds, to him or her, as a dividend. Although A will pay tax on the capital gain realized by him or her on the sale of the shares of Canco to Holdco, the butterfly avoids the realization of a capital gain at the corporate level on the transfer of the target asset from Canco to Holdco. Tax on the appreciated value of the target asset at the corporate level is deferred until Holdco sells it to a third party on a taxable basis. Moreover, in many circumstances, the adjusted cost base to A of the shares of Canco will be higher than the tax cost of the target asset to Canco. In these circumstances, an additional tax advantage is obtained by A indirectly realizing the appreciated value of the target asset as additional proceeds of disposition of his or her shares of Canco. This advantage is particularly significant where A is a resident of a country with which Canada has entered into a tax treaty that exempts the capital gain realized by A on the disposition of his or her shares of Canco to Holdco from tax by Canada. In these circumstances, Canadian tax on the appreciated value of the target asset is avoided as is the Canadian withholding tax that would have been exigible on a dividend distribution to the non-resident shareholder of the after-tax sale proceeds.

Subsection 55(2) is an anti-avoidance section which is intended to prevent the transformation of capital gains that would have been realized by corporate shareholders on a disposition of shares for their fair market value, into tax-free intercorporate dividends. In such circumstances, subsection 55(2) recharacterizes such dividends as either additional proceeds of disposition of shares where the transformation is part of a reorganization that includes a disposition of shares, or, simply into capital gains where the dividend arises in circumstances that do not include a disposition of shares. For example, in the butterfly illustrated above, subsection 55(2) is potentially applicable to the tax-free dividend arising on the redemption by Holdco of its preferred shares held by Canco since these shares have an adjusted cost base to Canco equal to the amount elected under subsection 85(1) in respect of the transfer of the target asset but a fair market value equal to the Purchase Price which exceeds the elected amount. Had such shares been sold by Canco for proceeds equal to the Purchase Price, a capital gain would have been realized by Canco to the extent of the excess of the Purchase Price over their adjusted cost base. The butterfly eliminates this gain. However, subsection 55(2) does not apply to recharacterize the tax-free dividend received by Canco on the redemption of its Holdco preferred shares as additional proceeds of disposition of such shares because such dividend constitutes an integral part of a series of transactions that qualifies, pursuant to paragraph 55(3)(b), for exemption from subsection 55(2). Paragraph 55(3)(b) is known as the "butterfly exemption".

It is noted that the butterfly illustrated above could also have been accomplished by the following series of transactions. A incorporates Holdco and transfers to it the appropriate number of shares of Canco, on a tax-deferred basis under subsection 85(1), in exchange for shares of Holdco. The butterfly of the target asset from Canco to Holdco could then have been effected in the manner illustrated, following which, A could have sold his or her shares of Holdco to B. A would realize a capital gain on the sale of the shares of Holdco to B. A butterfly effected in this manner is referred to as an "internal purchase butterfly".

In December 1992, the Department of Finance sought to curtail the use of the purchase butterfly by non-residents of Canada where the target assets included real estate situate in Canada and the non-resident was resident in a country which had entered into a tax treaty with Canada that afforded an exemption from Canadian tax on capital gains resulting from the disposition of shares of Canadian corporations, by denying the application of the butterfly exemption to these transactions. Five months later, in May 1993, the Department of Finance further curtailed the application of the butterfly exemption where the butterfly involved the disposition by a non-resident of any shares of a Canadian corporation that

4. Pursuant to subsec. 84(3), the Purchase Price received by Canco on the redemption of the Holdco preferred shares is deemed to be a dividend to the extent that it exceeds the paid-up capital of the preferred shares and, pursuant to para. 54(h)(x), that excess is deemed not to be proceeds of disposition of such shares. The balance of the Purchase Price, which is equal to the paid-up capital of the Holdco preferred shares, constitutes the proceeds of disposition to Canco of the preferred shares. Since the adjusted cost base to Canco of these shares is equal to their paid-up capital, Canco realizes neither a gain nor a loss on their redemption.

5. Pursuant to subsec. 84(3), the price paid by Canco on its purchase of its shares held by Holdco is deemed to be a dividend to the extent that it exceeds the paid-up capital of these shares and to that extent is deemed not to be proceeds of disposition to Holdco pursuant to para. 54(h)(x). The balance of the purchase price of the Canco shares, equal to their paid-up capital, constitutes proceeds of disposition to Holdco of these shares. Since the adjusted cost base to Holdco of these shares is equal to their fair market value, which is assumed to exceed their paid-up capital, Holdco will realize a loss on the disposition of these shares which loss will be denied by subsec. 112(3).

© 1994 International Bureau of Fiscal Documentation

constituted taxable Canadian property to the non-resident, regardless of whether Canadian real estate was involved and regardless of whether the non-resident could access a tax treaty exemption in respect of the capital gain that would be realized by the non-resident on the disposition of such shares. In this regard, it is noted that the participation in the butterfly of even one non-resident owning shares that constituted taxable Canadian property tainted the butterfly for all of the shareholders. However, both the ordinary butterfly and the purchase butterfly reorganization remained available for Canadian corporations having Canadian resident shareholders or non-resident shareholders whose shares did not constitute taxable Canadian property.

The discussion so far does not indicate either the breadth or complexity of the technical requirements to be satisfied for a series of transactions to qualify for the butterfly exemption. The Budget proposes several changes to these requirements. It is beyond the scope of this article to discuss all of these changes. Rather, this article focuses on the main change made by the Budget to the butterfly exemption which is to restrict its application after 21 February 1994, to divisive corporate reorganizations where at the end of the series of transactions, the historical shareholders of the distributing corporation at the beginning of the series of transactions maintain a sufficient degree of continuity of interest in the underlying businesses and assets owned by the distributing corporation at the beginning of the series. In substance, this change eliminates purchase butterfly transactions. It is noted that for butterfly transactions effected after 21 February 1994 the new rules replace the more recent restrictions mentioned above regarding non-residents owning shares of a distributing corporation that constitute taxable Canadian property to them so that such non-residents will be now able to participate in a butterfly without tainting the exemption provided that the new rules are complied with.

B. Spin-offs and split-ups

The effect of the Budget changes in the area of divisive reorganizations is that the only butterfly transactions that will qualify for the butterfly exemption after 21 February 1994, will be "spin-offs" and "split-ups".

A spin-off contemplates a transfer by the distributing corporation of a *pro rata* share, by value, of each type of property (discussed below) owned by it to another corporation having the same shareholders as the distributing corporation. This type of reorganization permits an existing corporation to divide its assets, *pro rata*, among itself and other corporations each having the same shareholders as the existing corporation. For example, an existing corporation may wish to transfer 20 percent of all of its property of each type to another corporation owned by the same shareholders as the existing corporation. The spin-off will accommodate this type of reorganization. A split-up contemplates a reorganization in which one or more shareholders of an existing corporation ceases to be a shareholder of that corporation and becomes a shareholder of another corporation that receives its *pro rata* share of each type of property owned by the existing corporation. For example, shareholders owning 40 percent by value of the shares of an existing corporation may desire to cease to be shareholders of the existing corporation and have their 40 percent share, by value, of each type of property of that corporation transferred to a new corporation of which they are the only shareholders. The split-up will accommodate this type of reorganization.

From the perspective of the distributing corporation, both types of reorganizations are the same in the sense that the distributing corporation distributes a proportionate share of each type of property by value owned by it to a transferee corporation. The difference is that the composition of the shareholders of the transferee corporation will be different.

The permitted spin-off and split-up butterfly reorganizations result essentially from three amendments.

The first amendment pertains to the *pro rata* limitation. For the purposes of the butterfly exemption, assets of a corporation are considered to consist of three types of property: cash, business assets and investments. Where the distributing corporation owns assets comprising more than one type of property, the current exemption can apply where the distributing corporation distributes property of only one type, provided the transferee corporation receives property of that type having a fair market value that is equal to that proportion of the fair market value of all property of that type owned by the distributing corporation that the fair market value of the shares of the distributing corporation owned by the transferee corporation is of the fair market value of all of the shares of the distributing corporation. This type of butterfly is known as a "partial butterfly". The amended exemption eliminates partial butterfly transactions and requires that the transferee corporation receive its *pro rata* share of each type of property owned by the distributing corporation.[6]

The second amendment is the addition of the definition of "permitted exchange".[7] Two types of permitted exchanges are defined. The first type permits an exchange of the shares of the distributing corporation into other shares of the distributing corporation on a tax-deferred basis under subsection 86(1) provided the exchange does not result in an acquisition of control of the distributing corporation. This type of exchange is generally used in a "spin-off" as a preliminary step to create the appropriate shares of a class of the distributing corporation that will ultimately be transferred to a transferee corporation to effect a distribution of property from the distributing corporation to the transferee corporation. Since this type of exchange is usually used as a mechanic to facilitate the appropriate steps in a butterfly, it is not discussed further.

The second type of permitted exchange contemplates the transfer of shares of the distributing corporation to a transferee corporation in exchange for shares of the transferee corporation in contemplation of a transfer of property from the dis-

6. This amendment is contained in the new definition of "distribution" contained in new subsec. 55(1).
7. The new definition of "permitted exchange" appears in new subsec. 55(1).

© 1994 International Bureau of Fiscal Documentation

tributing corporation to the transferee corporation, where immediately after the exchange, no shares of the transferee corporation are owned other than by a shareholder who participated in the exchange. In the case of a spin-off effected under this definition, the exchange will only qualify if the participating shareholder's *pro rata* share interest in the transferee corporation immediately after the exchange equals that shareholder's *pro rata* share interest in the distributing corporation immediately before the exchange. For example, if the shares of a participating shareholder in the distributing corporation represent, by value, 20 percent of the total value of the shares of the distributing corporation and such shareholder transfers one-half of such shares to the transferee corporation in exchange for shares of that corporation, the shareholder's shares of the transferee corporation must represent 20 percent, by value, of all of the shares of the transferee corporation immediately after the exchange. For the purposes of the *pro rata* test, shares that qualify as "special shares" are excluded. An example of a special share is a redeemable preferred share that was issued for its redemption price, is redeemable for that price plus any unpaid dividends thereon and is not convertible into or exchangeable for other shares except shares of a special class. In addition, a share will only qualify as a special share where the exchange requires that either all or none of such shares be exchanged. Special shares are excluded in the determination of whether the *pro rata* test for a spin-off is met.[8]

In the case of a split-up, the definition of permitted exchange requires that all of the shares of the distributing corporation, including special shares,[9] owned by a participating shareholder immediately before the exchange, be transferred to the transferee corporation for shares of that corporation. In the case of a split-up, to qualify as a permitted exchange, the *pro rata* share interest of a participating shareholder in the transferee corporation immediately after the exchange must equal his *pro rata* share interest in the shares of the distributing corporation immediately before the exchange having regard only to all of the shares of the distributing corporation owned by participating shareholders. For example, if the fair market value of all of the shares of a participating shareholder in the distributing corporation represent 10 percent of the fair market value of all of the shares of the distributing corporation and the fair market value of the shares of all of the participating shareholders in the distributing corporation represent 40 percent of the fair market value of the shares of the distributing corporation, the fair market value of the shares of the transferee corporation acquired by that shareholder on the exchange must represent 25 percent of the fair market value of all of the shares of the transferee corporation immediately after the exchange.

The third amendment defines those transactions and events occurring as part of a series of transactions or events to implement a butterfly which will disqualify a dividend arising in the course of the butterfly for the butterfly exemption. Briefly, these circumstances are as follows:

• Any shares of the distributing corporation or of a transferee corporation are acquired, directly or indirectly, from a specified shareholder[10] of that corporation by a person who is not related[11] to that shareholder, unless the acquisition results from a permitted exchange.[12] Generally, a specified shareholder of a corporation owns, directly or indirectly, not less than 10 percent of the shares of any class of that corporation. It is noted that if the acquiror of the share is related[13] to the vendor, the acquisition need not qualify as a permitted exchange, provided that all of the other qualifying rules are complied with. In this regard, new paragraph 55(3.2)(c) provides that a transferee corporation is deemed not to be related to any person from whom it acquired a share of a distributing corporation in contemplation of a distribution if, immediately after the butterfly reorganization, the transferee corporation is not related to the distributing corporation.

This provision permits shareholders holding insignificant shareholdings in the distributing corporation or in the transferee corporation, as the case may be, to dispose of such shareholdings in the course of the butterfly series, otherwise than by means of a permitted exchange, without disqualifying the butterfly for the exemption.

• Control[14] of the distributing corporation or of a transferee corporation is acquired, otherwise than by a permitted

8. It is noted that the *pro rata* formula for a permitted exchange as defined in the 23 June 1994 draft legislation does not obtain the intended result where, in the case of a spin-off, all of the special shares of the distributing corporation are transferred to a transferee corporation. The incorrect result obtains because special shares are not excluded in the introductory paragraph of para. (b)(ii) of the definition of permitted exchange.

9. In the case of a split-up, the definition of special shares is not intended to be applicable. Consequently, shares that meet the description of special shares are included in the *pro rata* test applied in split-up exchanges.

10. A "specified shareholder" of a corporation is defined in subsec. 248(1) to generally mean a shareholder of the corporation that owns, directly or indirectly, not less than 10% of the issued shares of any class or series of a class of shares of the corporation or of another corporation that is related to the corporation. Such ownership is deemed to include shares owned by a person with whom the shareholder does not deal at arm's length, a proportion of the shares of the corporation owned by a partnership of which the person is a member and all or a portion of the shares of the corporation owned by a trust in which the person has a beneficial interest depending upon whether the trust is a non-discretionary trust or a discretionary trust.

11. Subsec. 251(2) defines those circumstances in which persons are deemed to be related. For example, persons are related to each other if they are connected by blood relationship, marriage or adoption. This would include, for example, husbands and wives, parents and children, brother and sisters, grandparents and other relationships. Subsec. 251(2) also defines those circumstances in which shareholders of corporations are deemed to be related to such corporations, such as when they control or are deemed by subsec. 251(5) to control, such corporations as well as those circumstances in which corporations are deemed to be related to each other such as when they are controlled by the same person or are each related to the same corporation. A detailed discussion of the concept of "relatedness" is beyond the scope of this article. In this regard, it is noted that para. 55(5)(e) and para. 55(3.2)(c) stipulate circumstances in which persons are deemed not to be related for the purposes of Sec. 55 and para. 55(3.1)(b), respectively. For example, brothers and sisters are deemed not to be related for the purposes of Sec. 55.

12. Subpara. 55(3.1)(b)(i).

13. See *supra* note 11.

14. In this context control means *de jure* control which is the right to elect the majority of the board of directors and generally means ownership of shares representing more than 50% of the votes attached to all shares of the corporation. In this regard, see subsecs. 256(7) and (8) as they are proposed to be amended by the draft legislation.

© 1994 International Bureau of Fiscal Documentation

exchange, permitted acquisition or permitted redemption[15], by any person or group of persons.[16]

• In contemplation of a distribution by a distributing corporation, a share of the distributing corporation is acquired by a transferee corporation from a person to whom the transferee corporation was not related or is acquired by a person who, directly or indirectly, acquires control of the distributing corporation.[17] In the context of this provision, it is again noted that paragraph 55(3.2)(c) deems a transferee corporation not to be related to any person from whom it acquired a share of the distributing corporation in contemplation of a distribution, if the transferee corporation was not related to the distributing corporation immediately after the butterfly. This provision is designed to disqualify the following butterfly. Assume that Opco has 20 shareholders each owning 5 percent of its shares and that Opco's only type of property consists of business assets. Further assume that Buyco wishes to acquire a target business asset from Opco having a value equal to 1/4 of the fair market value of all of Opco's assets. Each of the shareholders transfers 1/4 of his or her shares to Buyco for cash. Opco then transfers the target asset to Buyco on a butterfly transaction. The shareholders of Opco have effected a purchase butterfly of Opco's target business asset without offending the first two rules described above. This series of transactions is not caught by the first rule because no shareholder of Opco is a specified shareholder. Moreover, it is not caught by the second rule because there has not been an acquisition of control of Opco by Buyco. However, this third rule would disqualify the butterfly because Buyco acquired its shares of Opco from persons to whom it was not related.

It can be seen that the application together of the three amendments described above, essentially limit butterfly transactions, except in limited circumstances, to those that qualify as spin-offs or split-ups that result from permitted exchanges.

Paragraph 55(3.1)(c) contained in the 23 June 1994 draft legislation but not in the draft butterfly legislation tabled with the Budget, adds yet one more restriction to the butterfly exemption. This paragraph essentially disqualifies a butterfly where a transferee corporation is not related to the distributing corporation immediately after the reorganization, and sells property received by it on the butterfly, having a fair market value exceeding 10 percent of the total fair market value of all of the assets received by it on the butterfly, to a person to whom it is not related, unless the sale occurs in the ordinary course of business. A similar restriction applies to property retained by the distributing corporation. It is noted that the restriction does not apply where the property is sold in the ordinary course of business. Moreover, the restriction does not apply where the transferee corporation remains related to the distributing corporation immediately after the reorganization thereby permitting members of a group of related corporations to transfer property from one member of the group to another in the course of a butterfly reorganization in contemplation of a sale of the property to an unrelated buyer. It is understood that this rule was added to ensure that the historical shareholders of a corporation maintained continuity of interest not only in the shares of the distributing corporation or the transferee corporation, but also in the underlying businesses and assets of these corporations. A further concern appears to be that a qualifying butterfly could be used to distribute an asset to a transferee corporation having a high basis for tax purposes. If that asset were to then be sold by the transferee corporation, little or no tax might be paid on its sale, thereby permitting the transferee corporation to "cash-out" its interest in the distributing corporation on a tax-deferred basis. The restriction in paragraph 55(3.1)(c) will now prevent the use of a butterfly in such circumstances.

The new butterfly rules described above apply after 23 June 1994. For the period between 24 February 1994 and 23 June 1994, the butterfly amendments as proposed in the Budget apply to butterfly transactions occurring during this period of time.[18]

C. Amendment to Paragraph 88(1)(d) bump

In conjunction with the butterfly amendments described above, an anti-avoidance amendment is made to paragraph 88(1)(d). As mentioned, subsection 88(1) provides that where a corporation owns at least 90 percent of the shares of each class of a subsidiary, the subsidiary can liquidate into its parent on a tax-deferred basis. Paragraphs 88(1)(c) and (d) provide that where a subsidiary is wound-up under subsection 88(1), the cost to the parent of certain non-depreciable capital property owned by the subsidiary at the time that the parent last acquired control of it that is received by the parent on the wind-up of the subsidiary, can be increased by the amount by which the aggregate adjusted cost base of the shares of the subsidiary to the parent exceeds the net tax cost to the subsidiary of its assets, but such increase cannot exceed the fair market value of such property at the time the parent last acquired control of the subsidiary.

The Department of Finance was concerned that the butterfly rules could be circumvented by utilizing the paragraph 88(1)(d) "bump" in the following circumstances. Opco has a retail division and a wholesale division and wishes to sell the assets of its retail division to an arm's length purchaser (Buyco). The new butterfly rules prevent Buyco from acquiring the retail assets utilizing a purchase butterfly. Accordingly, Opco incorporates a subsidiary, Subco, and transfers the wholesale assets to Subco on a tax-deferred rollover basis under subsection 85(1) in exchange for shares of Subco. Opco's shareholder then sells the shares of Opco to Buyco for cash. Buyco liquidates Opco and paragraph 88(1)(d) applies to increase the adjusted cost base to Buyco of the Subco shares to their fair market value. Buyco then sells the shares of Subco back to Opco's shareholder for their fair market value and because of the paragraph 88(1)(d) increase to the

15. The terms "permitted acquisition" and "permitted redemption" are defined terms which are relevant to any butterfly but are not discussed in this article since these definitions are not critical to understanding the main thrust of the butterfly amendments.
16. Subpara. 55(3.1)(b)(ii).
17. Subpara. 55(3.1)(b)(iii).
18. The 23 June 1994 draft legislation contains a transitional para. 55(3.1)(b) for this period of time which is not discussed in this article.

© 1994 International Bureau of Fiscal Documentation

adjusted cost base to it of the Subco shares, Buyco does not realize a gain on that sale.

Clearly, this transaction only makes sense if Opco's shareholder does not realize a significant gain on the sale of the shares of Opco. Accordingly, it must be assumed that this transaction would only occur where the selling shareholder has a high adjusted cost base in the shares of Opco or otherwise has sufficient tax shield to shelter the gain, if any, that would arise on the disposition of the Opco shares. In any event, to prevent this type of transaction, paragraph 88(1)(c)[19] is amended on and after 23 June 1994[20] to provide that it does not apply to any property disposed of by the parent as part of a series that includes the winding-up where, as part of the series, the parent acquired control of the subsidiary and the property is acquired by any person, other than by the parent or by a person who is related to the parent, who was a specified shareholder of the subsidiary at any time during the series and before control of the subsidiary was last acquired by the parent.

The foregoing discussion concerning the amendments to corporate divisive reorganizations contained in the Budget, as modified by the 23 June 1994 draft legislation, has been necessarily substantially truncated due to space restrictions. Indeed, because of the complexity of the draft legislation in this area, myriad of details have been omitted from this discussion. Therefore, readers interested in this area are urged to consult the actual draft legislation for details.

II. AMENDMENTS TO FOREIGN AFFILIATE RULES

Canada has a complex system of taxation of Canadian residents in respect of their interests in non-resident corporations.[21] Generally, where a resident of Canada owns, directly or indirectly, 10 percent or more of the issued shares of any class of shares of a non-resident corporation, that corporation is a foreign affiliate of the Canadian resident.[22] Where a Canadian resident alone or together with certain other persons is in a position to control an offshore corporation that is a foreign affiliate of the Canadian resident, the foreign affiliate is a controlled foreign affiliate of the Canadian resident.[23]

Where a foreign affiliate (including a controlled foreign affiliate) earns income from carrying on an active business in a country other than Canada, the income from that activity is not subject to immediate taxation by Canada. When that income is repatriated by the foreign affiliate to its Canadian shareholders as a dividend, such dividend may or may not be subject to further Canadian tax depending upon a number of factors, such as whether the Canadian shareholder is an individual or a corporation, whether or not the foreign affiliate is resident in a "listed" country, whether or not the active business is carried on by the affiliate in a listed country and the rate of foreign income tax imposed upon such income. In this regard, where an affiliate of a corporation resident in Canada is resident in a listed country and earns income from an active business carried on by it in either that or another listed country or in Canada, such income will constitute exempt earnings[24] included in computing its exempt surplus.[25] Exempt earnings also include all or part of certain capital gains realized by an affiliate.[26] In any other case, income earned by the affiliate from carrying on an active business and the balance of capital gains realized by the affiliate that are not included in exempt earnings, constitutes taxable earnings[27] and is included in computing the taxable surplus[28] of the affiliate. Dividends paid to corporation resident in Canada by a foreign affiliate of that corporation out of the affiliate's exempt surplus, are not subject to further tax in Canada.[29] Income earned by a foreign affiliate from property, from businesses other than active businesses, from certain services and from certain types of capital gains constitutes foreign accrual property income ("FAPI").[30] Where the affiliate is a foreign affiliate of a corporation resident in Canada its FAPI is included in computing its taxable earnings and taxable surplus. Where the affiliate is a *controlled foreign affiliate*, its FAPI is included in the income of its Canadian shareholders[31] and is subject to Canadian tax (with relief for foreign tax paid by the affiliate in respect of such income[32]) in the taxation year in which it arises, whether or not such income is distributed in that year. The Act affords relief from double taxation of FAPI when it is repatriated to Canada as a dividend out of the affiliate's taxable surplus.[33]

A. Elimination of active business losses to shelter FAPI

The Act permits FAPI of a controlled foreign affiliate of a taxpayer in a particular taxation year to be reduced by the aggregate of its FAPI losses and losses incurred from an

19. Technically, para. 88(1)(c) is amended such that the shares of Subco constitute property that is ineligible for the para. 88(1)(d) bump. The amendments also add para. 88(1)(c.2) to the Act which has the effect of excluding from the definition of ineligible property for the purposes of para. 88(1)(c), any property acquired from the subsidiary on its winding-up, by the parent or by a person who is related to the parent. This latter amendment is required because of those circumstances in which the parent is already a specified shareholder of the subsidiary before it acquires control of it. In these circumstances, but for the addition of para. 88(1)(c.2), if the property of the subsidiary acquired by the parent on the winding-up of the subsidiary was transferred by the parent to another subsidiary of the parent as part of the series, the increase to the adjusted cost base of the property acquired by the parent on the winding-up of the subsidiary would be denied. For the definition of "specified shareholder", see *supra* note 10.
20. A transitional version of this amendment applies for windings-up that begin during the period from 22 February 1994 to 22 June 1994.
21. Subdiv. i of the Act concerns shareholders of corporations not resident in Canada.
22. The definition of "foreign affiliate" is contained in subsec. 95(1). Technically, the Canadian resident must own an "equity percentage" as defined in subsec. 95(4) in the non-resident corporation that is not less than 10%.
23. The definition of "controlled foreign affiliate" is contained in subsec. 95(1).
24. Reg. 5907(1)(b).
25. Reg. 5907(1)(d).
26. Reg. 5907(1)(b)(i).
27. Reg. 5907(1)(i).
28. Reg. 5907(1)(k).
29. Para. 113(1)(a) affords a deduction for the full amount of such dividends.
30. Foreign accrual property income is defined in subsec. 95(1), subject to the provisions of subsec. 95(2).
31. Subsec. 91(1).
32. Subsec. 91(4).
33. Para. 113(1)(b) and subsec. 91(5).

© 1994 International Bureau of Fiscal Documentation

active business, each computed separately, for its five taxation years immediately preceding the particular year in which it was a foreign affiliate of the taxpayer or of certain non-arm's length persons.[34] The Budget proposes to amend Regulation 5903 for taxation years of controlled foreign affiliates commencing after 1994 to remove the ability to use active business losses from prior years to shelter FAPI of a particular taxation year and to permit FAPI losses for prior years to be so used only to the extent that such losses were incurred in a prior taxation year of the affiliate when it was a controlled foreign affiliate of the taxpayer or certain non-arm's length persons. It was not an uncommon practice for Canadian taxpayers to access the active business losses of their controlled foreign affiliates by transferring funds to such affiliates which would be invested by them in passive investments with the investment income earned therefrom being sheltered from FAPI by the accumulated active business losses of such affiliates. From a tax policy perspective, this was considered a misuse of such losses. This change will curtail this practice.

B. Listed countries replaced by designated treaty country

Subsection 5907(11) of the Regulations to the Act lists the "listed" countries for the purposes of the foreign affiliate regime. This list was originally intended to include only countries with which Canada had entered into an income tax treaty that had been ratified and was in force. However, the list includes countries with which Canada has entered into tax treaty negotiations that have not yet been concluded and, conversely, does not include certain countries with which Canada has ratified treaties. The Budget proposes to purge the list of those countries with which Canada does not have treaties and to ensure that countries with which it has ratified treaties are included. In this regard, Regulation 5907(11) will be repealed and will be replaced by a concept of "designated treaty country". A country will automatically be a designated treaty country for a taxation year of a foreign affiliate upon an income tax treaty between that country and Canada entering into force and having effect. Moreover, where a treaty between Canada and another country enters into force, that country shall be deemed to have been a designated treaty country in respect of a foreign affiliate of a corporation for the taxation year of the affiliate that includes the day on which the treaty was signed. Where a treaty with a designated country ceases to have effect, that country shall be deemed to be a designated treaty country for the entire taxation year of a foreign affiliate of a corporation that includes the day on which the treaty ceased to have effect.[35]

C. New foreign affiliate residency rules

With the exception of subsection 250(6) concerning international shipping corporations,[36] the Act does not provide statutory rules that determine the residence of a foreign affiliate for the purposes of the foreign affiliate rules. The residence of a foreign affiliate of a corporation resident in Canada is important since such affiliate can only have exempt earnings from carrying on an active business in a designated treaty country, if it itself is resident in a designated treaty country. The Budget proposes to enact statutory rules[37] to determine whether an affiliate is resident in a designated treaty country for the purposes of the foreign affiliate regime. The new rules propose to adopt the residency rules of the applicable treaty to determine whether a foreign affiliate is resident in a country with which Canada has entered into a tax treaty. These rules provide that a foreign affiliate of a corporation shall be deemed not to be resident in a country with which Canada has entered into a tax treaty, unless:

> (i) the affiliate is resident in that country for the purposes of that tax treaty;
> (ii) the affiliate would be resident in that country, for the purposes of that tax treaty, if it were treated as a body corporate for the purposes of income taxation in that country, or,
> (iii) the affiliate would be resident in that country for the purposes of that tax treaty but for a provision in that treaty which provides that it does not apply to the affiliate, or, would be so resident at the relevant time if the tax treaty had entered into force.

Paragraph (ii) ensures that corporations such as limited liability corporations formed under the laws of one of the states of the United States that are treated as corporations for Canadian tax purposes but as partnerships for the purposes of the Internal Revenue Code, 1986, as amended, (the "Code") are resident in the United States for the purposes of the foreign affiliate rules. Paragraph (iii) is intended to ensure that corporations such as International Business Corporations in Barbados that are excluded[38] from the benefits of the Canada–Barbados Income Tax Agreement (1980) are nevertheless resident in Barbados for the purposes of the foreign affiliate rules.

These new residency rules are generally effective for taxation years of a foreign affiliate that begin after 1995.

D. New active business income rules

Subparagraph 95(2)(a)(i) deems income of an affiliate of a taxpayer from sources in a country other than Canada that would otherwise be income from property or an inactive business to be income from an active business, rather than FAPI, to the extent that such income pertains to or is incident to an active business carried on in a country other than Canada by the affiliate or by a non-resident corporation with which the taxpayer does not deal at arm's length.

Subparagraph 95(2)(a)(ii) of the Act deems income received by a foreign affiliate of a taxpayer from another foreign affiliate of that taxpayer or from a non-resident corporation with which the taxpayer does not deal at arm's length, to be

34. The definition of "F" in the definition of FAPI in subsec. 95(1) and Reg. 5903.
35. Proposed Regs. 5907(11) and (11.1). These amendments generally apply to taxation years of foreign affiliates that begin after 1995.
36. This subsection deems an international shipping corporation to be resident in the country (other than Canada) under whose laws it was incorporated or otherwise formed.
37. Proposed Reg. 5907(11.2).
38. Para. 3 of Art. XXX of the Canada–Barbados Income Tax Agreement (1980).

© 1994 International Bureau of Fiscal Documentation

income from an active business and not FAPI, to the extent of the amount thereof that is deductible by the payor affiliate in computing its earnings from an active business carried on by it in a country other than Canada or would be so deductible by the non-resident corporation if it were a foreign affiliate of the taxpayer. This provision ensures, for example, that interest, rents or royalties paid by one foreign affiliate to another will not constitute FAPI in the hands of the recipient affiliate to the extent that these amounts are deductible in computing the earnings of an active business carried on by the payor affiliate.

The Budget proposes the following amendments to the rules contained in paragraph 95(2)(a), effective for taxation years of affiliates that begin after 1994.

Subparagraph 95(2)(a)(i) is amended by deleting therefrom the rule that deems income that would otherwise be income from property or an inactive business to be income from an active business to the extent that it pertains to or is incident to an active business carried on by the affiliate or by a non-arm's length non-resident corporation. Income that "pertains to or is incident to" an active business carried on by an affiliate is incorporated in the definition of "income from an active business" for foreign affiliates discussed below and accordingly, continue to be active business income of that affiliate.

In the case of income that is referable to an active business carried on by a non-resident corporation, subparagraph 95(2)(a)(i) is amended to include in the active business income of a particular affiliate, any income of the affiliate from sources outside Canada that would otherwise be income from property to the extent that such income is derived from its activities that can reasonably be considered to be directly related to the active business activities of a related[39] non-resident corporation (rather than a non-arm's length[40] non-resident corporation) carried on by that corporation outside Canada, provided that such income would have been included in computing the earnings or loss from an active business carried on by the non-resident corporation outside Canada if that corporation were a foreign affiliate of the particular affiliate and the income was earned by it.

As presently drafted, this subparagraph will likely prove to be a difficult provision to apply in many circumstances. The Explanatory Notes accompanying the Notice of Ways and Means Motion illustrate the intended operation of proposed subparagraph 95(2)(a)(i) in the following example.

A foreign affiliate that is in the real estate development business decides, for business reasons, to use a wholly-owned non-resident subsidiary with no employees to develop and construct a building. The building will be an investment property[41] of the subsidiary because it is real estate. Because the subsidiary does not employ at least six full-time employees in the active conduct of its business, any rental income or profits from the rental or sale of the building, will be income from an investment business and therefore income from property. However, new subparagraph 95(2)(a)(i) would deem such rental or sale income to be income from an active business of the subsidiary if the construction of the building is considered to be directly related to the active business activities of the parent and the rental or sales income would have been included in the active business earnings of the parent if such income had been earned by it. If the subsidiary sold the building for a profit as an adventure in the nature of trade, such profit would be income from property by definition. However, provided again that the conditions of subparagraph 95(2)(a)(i) are satisfied, such profit will be income from an active business. Thus, in this example, if the foreign affiliate were to be a controlled foreign affiliate of a taxpayer, the income described will be deemed not to be FAPI.

Subparagraph 95(2)(a)(ii) is amended and divided into two clauses. The first clause, (A), maintains the existing rule that income received by an affiliate of a taxpayer from a non-resident corporation that would otherwise be income from property will be deemed to be active business income of the recipient to the extent that it is deductible in computing the earnings of the non-resident payor corporation from an active business carried on by it outside Canada or would be so deductible if the non-resident corporation were a foreign affiliate of the taxpayer. This rule is tightened, however, as it now only applies where the non-resident payor corporation is related[42] to the payee affiliate rather than deals at arm's length[43] with such affiliate.

The second clause, (B), is concerned with the following circumstance. Assume that FA1 lends money to FA2 which FA2 uses to acquire the shares of FA3. If FA2 has no activities other than the holding of shares of FA3, any interest paid by FA2 to FA1 will be income from property of FA1. In particular, the rule in clause (A) will not apply because the interest paid by FA2 to FA1 is not deductible by FA2 in computing its earnings from an active business. This result obtains even if FA2 and FA3 file consolidated returns. New clause (B) provides that interest received by FA1 from FA2 will be deemed to be income from an active business of FA1, provided that:

(i) FA1, FA2, and FA3 are related;
(ii) the shares of FA3 constitute excluded property;[44]
(iii) FA2 and FA3 are resident in and subject to tax by the same country and are part of a corporate group that com-

39. See *supra* note 11.
40. Subsec. 251(1) provides that related persons do not deal with each other at arm's length and, in the case of persons who are not related, it is a question of fact as to whether they deal with each other at arm's length at any particular time.
41. The term "investment property" is defined in subsec. 95(1) for the purposes of the new definition of "investment business" in subsec. 95(1). An investment property is property the profit from the disposition of which will be income from an investment business which is included in the definition of income from property unless such profits qualify for one of the exceptions from the definition of investment business.
42. See *supra* note 11.
43. See *supra* note 40.
44. "Excluded property" of a foreign affiliate of a taxpayer is defined in subsec. 95(1) to mean (i) any property of the affiliate that is used or held by it principally for the purpose of gaining or producing income from an active business, (ii) shares of another foreign affiliate of the taxpayer, where all or substantially all of its property is excluded property and (iii) an amount receivable the interest on which is or would be if interest were payable thereon, income from an active business by virtue of subpara. 95(2)(a)(ii) [now clause 95(2)(a)(ii)(A)]. For the purposes of this definition, a partnership is deemed to be a corporation having 100 issued shares and a foreign affiliate owning an interest in a partnership is deemed to own that proportion of such 100 notional shares that is equal to the proportion that the fair market value of its interest in the partnership at the relevant time is to the aggregate fair market value of all such interests of the partnership at that time.

© 1994 International Bureau of Fiscal Documentation

putes the tax liabilities of its members using the consolidated or deduction transfer methods; and

(iv) the interest paid is relevant in computing the taxes of the corporate group to which FA2 and FA3 belong.

In connection with the enactment of clause (B), the interest paid or payable by an affiliate that is deemed to be active business income of the recipient affiliate is not deemed to be deductible in computing the active business income of the payor affiliate. Accordingly, but for an amendment, such interest would reduce the FAPI of the payor affiliate or would increase the foreign accrual property losses of the payor affiliate. To avoid these reductions and increases, the definitions of letters "A" and "D" in the definition of FAPI in subsection 95(1) are amended to deem such clause (B) interest payments to be nil.

Each of the rules in clauses (A) and (B) described above ensure that the inter-affiliate payments contemplated by these clauses do not result in a portion of the active business earnings of a related corporate group being converted from active business income into income from property.

Where paragraph 95(2)(a) applies to characterize payments received by an affiliate resident in a designated treaty country as income from an active business, Regulation 5907(1)(b)(iv) is being amended for taxation years of the affiliate that begin after 1994 to include such payments in the exempt earnings of the affiliate in each of the following circumstances. Where the payments are active business income of the affiliate by reason of the application thereto of subparagraph 95(2)(a)(i), the payments would have been included in computing the exempt earnings or loss of the payor if it were a foreign affiliate and had earned such income. Where the payments are active business income of the affiliate by reason of the application thereto of clause 95(2)(a)(ii)(A), the payments are or would be deductible in computing the exempt earnings of the related non-resident payor corporation if it were a foreign affiliate of a corporation. Lastly, where the interest payments are active business income of the affiliate by reason of the application thereto of clause 95(2)(a)(ii)(B), each of FA2 and FA3 and any other corporation relevant to the determination of whether the shares of FA3 are excluded property[45] must be resident in a designated treaty country.

Where the applicable foreign income tax law defers the deduction by a foreign affiliate of an expense that is subject to the provisions of subparagraph 95(2)(a)(i) or clause 95(2)(a)(ii)(A), to a subsequent year in which certain tests are satisfied, the relevant exempt or taxable earnings of the payor affiliate will be overstated. Regulation 5907(2.7) is being added effective for taxation years of affiliates beginning after 1994, to the foreign affiliate regulations to ensure that such expenses are deducted in computing the earnings or loss from an active business of the payor affiliate for its taxation year in which the expense was first paid or became payable. This rule will apply, for example, to reduce the earnings or loss from an active business of a payor affiliate whose deduction of interest expense for US tax purposes is deferred to a future year by the earnings-stripping rule of Section 163(j) of the Internal Revenue Code.

Similarly, where clause 95(2)(a)(ii)(B) applies to an interest payment by FA2 to FA1 in respect of the acquisition by FA2 of shares of FA3, in computing its earnings or loss from an active business carried on by it in the country in which it is resident, new Regulation 5907(2.8) requires FA2 to deduct such interest in its taxation year in which the interest expense was first paid or became payable in computing its income from an active business carried on by it in the country in which, for purposes of income taxation, it was resident, and not from any other source. For the purposes of this rule, where FA2 does not carry on an active business in the country in which, for income tax purposes, it was resident, it is deemed to have carried on an active business in that country.

Regulations 5907(2.7) and (2.8) provide symmetry between the increase in the earnings from an active business of the affiliate receiving the interest payment and the decrease in the earnings from an active business of the affiliate paying the interest and further assures such symmetry notwithstanding that the deduction of the interest may be deferred under applicable foreign tax law.

E. Extension of FAPI rules

The Budget proposes to extend the ambit of FAPI to the following situations for taxation years of foreign affiliates that begin after 1994.

• Where a foreign affiliate of a taxpayer resident in Canada sells property that was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed or organized and in which the affiliate's business is principally carried on, to the taxpayer, to a Canadian resident or to a non-resident with whom such taxpayer does not deal at arm's length who carries on business in Canada, where such property constitutes inventory of a business carried on in Canada by any such purchaser, the income derived by the affiliate from such sales for a taxation year (including any income from the performance of services as a purchasing agent) is deemed to be income from a separate business other than an active business of the foreign affiliate and therefore FAPI of the affiliate, unless more than 90 percent of the affiliate's gross income from sales of property for that year, other than from the sales described, are from sales to persons with whom the affiliate deals at arm's length. Moreover, any income that is incident to or pertains to such inactive business, such as income earned from a temporary investment of short-term surplus funds generated from such sales, will also be deemed to be FAPI. This amendment will discourage the use of trans-shipment affiliates that purchase goods for resale in Canada by their Canadian shareholders or

45. *Ibid.* For the purposes of applying the definition of excluded property in new Reg. 5907(1)(b)(iv)(B)(III), excluded property does not include a receivable where the interest thereon is not, or would not if interest were payable thereon, be deductible by the debtor in computing its exempt surplus or exempt loss.

© 1994 International Bureau of Fiscal Documentation

by persons with whom such shareholders do not deal at arm's length.[46]

• Income of a foreign affiliate for a taxation year from a business of insuring risks (including income from the reinsurance of risks) in respect of (i) a person resident in Canada, (ii) property situate in Canada or, (iii) a business carried on in Canada, is deemed to be income from a separate business, other than an active business, and therefore FAPI of the affiliate, unless more than 90 percent of the gross premium income (net of premiums for reinsurance ceded by the affiliate) of the affiliate for the year is from the insurance of risks, other than from the risks described, of persons with whom the affiliate deals at arm's length. Moreover, any income that pertains to or is incident to that business is also be deemed to be FAPI. This amendment, for example, will discourage the practice of Canadian financial institutions insuring the lives of the persons to whom they have lent money through a captive offshore insurance company.[47]

• Income of a foreign affiliate for a taxation year derived directly or indirectly from indebtedness or lease obligations (including income of the affiliate from the purchase and sale of indebtedness and lease obligations for its own account) of persons resident in Canada or in respect of businesses carried on in Canada by non-residents of Canada, is deemed to be income from a separate business, other than an active business, and therefore FAPI of the affiliate, unless more than 90 percent of the gross income of the affiliate for the year derived directly or indirectly from indebtedness and lease obligations, is so derived from indebtedness and lease obligations of non-residents of Canada with whom the affiliate deals at arm's length. Moreover, any income that pertains to or is incident to such business, is also deemed to be FAPI. This amendment ensures, for example, that a Canadian financial institution that has a portfolio of Canadian mortgages the interest on which is exempt from Canadian withholding tax, cannot avoid Canadian tax on the income therefrom by transferring such mortgages to an affiliate situate in a tax haven.[48]

One issue that has been frequently litigated in Canada for the purpose of various provisions of the Act from time to time, is whether income such as interest, rent and royalties, which, in one sense, is income from property, is income from an active business. The courts have tended to the conclusion that almost any appreciable amount of labour activity incurred in connection with the earning of such income serves to characterize it as income from an active business.[49] Since preferential tax treatment is afforded to income of Canadian-controlled private corporations from carrying on an active business in Canada by affording such income a reduced tax rate, this judicial trend was disturbing to the fisc. The problem was met domestically by the enactment by Parliament of certain definitions to ensure that income that was essentially passive investment income did not receive the preferential tax rate reduction applicable to income from an active business carried on in Canada by Canadian-controlled private corporations. However, these definitions are not applicable to foreign affiliates[50] and thus do not resolve the critically important issue of when income earned by a foreign affiliate is income from property or is income from an active business.

To deal with this issue as it affects the taxation of the income of foreign affiliates, the Budget uses an approach that is similar to its domestic approach to this problem by adopting definitions that serve to segregate passive investment income from active business income earned by foreign affiliates. These definitions ensure that without a substantial labour component, income that is essentially from property will be FAPI rather than active business income. These new definitions[51] include definitions of "active business", "income from an active business", "income from property", "investment business", "investment property" and related definitions of terms used in the definition of investment business, such as "lending of money".

The term "active business" of an affiliate is defined to mean any business of the affiliate other than an investment business or a business that is deemed to be an inactive business as described above.[52] The term "income from an active business" of an affiliate is defined to mean income from an active business of the affiliate including any income that pertains to or is incident to that business, but specifically excludes income from property. The term "income from property" of an affiliate is defined to include income of the affiliate from an investment business and from an adventure in the nature of trade. With regard to an adventure in the nature of trade, the term "business" as defined in subsection 248(1) is being amended to exclude an adventure in the nature of trade. Consequently, any profit realized from the disposition of an investment property that is characterized as an adventure in the nature of trade will be FAPI and will not qualify for the exceptions to the definition of investment business discussed below. The term "lending of money" is defined to include the factoring of arm's length trade receivables and the arm's length purchase of foreign resource properties.

The term "investment business" is defined for foreign affiliates to mean a business carried on by a foreign affiliate in a taxation year (other than a business that is deemed to be an inactive business as discussed above[53]) the principal purpose of which is to derive income from property (including interest, dividends, rents, royalties fees, insurance premiums or similar returns and profits from the disposition of investment property).

46. New para. 95(2)(a.1). This paragraph is drafted to ensure that income derived by an affiliate of a taxpayer from sales of goods that are manufactured or produced in Canada by the Canadian resident taxpayer of the foreign affiliate or by a person who does not deal with the taxpayer at arm's length in the course of carrying on a business in Canada, for resale by the affiliate to non-resident persons, is not subject to this new rule. In the draft legislation tabled with the Budget, income derived by the affiliate from such sales was technically subject to this new rule.
47. New para. 95(2)(a.2).
48. New para. 95(2)(a.3). The term "lease obligation" used in new para. 95(2)(a.3) is proposed to be defined in amended subsec. 95(1) as including an obligation under an agreement which authorizes the use of or the production or reproduction of property including information or any other thing.
49. *The Queen v. Rockmore Investments Ltd.*, 76 DTC 6156 (FCA); *The Queen v. Cadboro Bay Holdings Ltd.*, 77 DTC 5115 (FCTD).
50. *Canada Trustco Mortgage Company v. M.N.R.*, 91 DTC 1312 (TCC), (under appeal).
51. These new definitions appear as amendments to subsec. 95(1).
52. The businesses described in paras. 95(2)(a.1), (a.2) and (a.3).
53. *Ibid.*

© 1994 International Bureau of Fiscal Documentation

Excluded from the definition of investment business of a foreign affiliate is a business carried on by a foreign affiliate that is a corporation (other than a corporation whose principal business is trading or dealing in debt obligations on its own account or on the account of persons with whom it does not deal at arm's length):

> (i) whose only business, conducted principally with arm's length persons, is the business of a foreign bank (within the meaning of the Bank Act (Canada)), a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, provided that, in each case, the affiliate's business is regulated under the laws of the country in which the business is principally carried on; or,
> (ii) whose principal business conducted principally with arm's length persons, is the development of real estate for sale, the lending of money, the leasing or licensing of property, the insurance of risks or any combination thereof.

In each of cases (i) and (ii) above, the particular affiliate, or where the affiliate carries on the business as an active partner in a partnership, the partnership, must employ at least six employees full-time in the active conduct of the business. This labour requirement ensures that the exclusions from the definition of investment business will only be available where a substantial labour component is present in the conduct of the business carried on by the affiliate, thereby precluding the use of "paper" companies to avoid the characterization of the income of the businesses contemplated by the exclusions as FAPI.

As noted above, profits from the disposition of "investment property" are included in the definition of investment business and are therefore FAPI unless they qualify for exclusion therefrom as described above. The term "investment property" is defined to include almost any type of property that could be considered to be an investment, including shares of corporations, partnership interests, real estate, commodities, resource properties, indebtedness, foreign currencies and interests in funds and other entities. However, shares of corporations, partnership interests and interests in trusts[54] that qualify as "excluded property" as defined in paragraph 95(1)[55] are not included in the definition of investment property. Taxable capital gains from the disposition of excluded property, except when realized on certain rollovers, are excluded from FAPI. The carve-out of excluded property from the definition of investment property appears to be intended to preserve the integrity of the exclusion from FAPI of taxable capital gains realized on the disposition of excluded property where such gains might otherwise be included in FAPI because they would be income from an investment business.

The new definitions are lengthy and complex but when woven together they design a system that categorizes the income of foreign affiliates (other than income from a business that is deemed to be an inactive business as described above) as either income from an active business or as income from property.

The following observations may be made regarding the definition of investment business and its exceptions. First, it is noted that the business of trading or dealing in debt obligations for its own account or for the account of non-arm's length persons by an affiliate, will be an investment business and the income therefrom will be FAPI. On the other hand, where the principal business of the affiliate is the lending of money to arm's length persons and at least six full-time employees are employed in the active conduct of the business, the business will qualify as an active business. Moreover, an affiliate whose only business is trading or dealing in securities principally with arm's length persons will qualify as an active business if it is regulated in the country where it is principally carried on and employs at least six full-time employees in the active conduct of the business. It appears that the Department of Finance is of the view that an affiliate that is engaged in simply trading debt obligations such as commercial money market paper or treasury bills for its own account is not to be considered an active business, whereas the lending of money, which presumably involves gathering credit information, negotiating the terms of the loan and presumably holding the loans until maturity, is to be considered an active business where the applicable requirements are met. Perhaps Finance felt that the latter business was more of a "business" because of the activities involved, whereas purchasing and selling debt obligations is merely a form of investing. But if this is the rationale for this distinction it is also somewhat difficult to discern why trading or dealing in securities is considered substantially different than trading or dealing in debt obligations to the effect that the securities trading qualifies as an active business if it is regulated and has the requisite number of employees whereas trading in debt can never qualify as an active business. Perhaps the rationale for this distinction is that the securities business must be regulated implying that it is more of a business than merely investing.

Second, it is observed that many of the businesses contemplated in case (i) are similar to businesses contemplated in case (ii), such as the business of banks or trust companies in case (i) and the business of lending money mentioned in case (ii) or the business of insurance corporations mentioned in case (i) and the business of insuring risks mentioned in case (ii). There may be certain advantages in qualifying a business as an active business under case (i) than case (ii). For example, if the affiliate qualifies for a case (i) exclusion there appears to be more certainty as to its entitlement for exclusion because of its status. In addition, the special status corporations can, under the aegis of their status, carry on activities that are not contemplated in case (ii). For example, an insurance corporation qualifying under case (i) can issue annuities whereas an affiliate qualifying under case (ii) for the insuring of risks is restricted to that business and cannot issue annuities.

Lastly, it is noted that where an affiliate carries on business as a member of a partnership, the six employee test will be met if the partnership employs that number of employees, unless the affiliate is a specified member of the partnership. "Speci-

54. It would appear that an interest in a trust could constitute excluded property where the trust is deemed by para. 94(1)(d) to be a non-resident corporation since this deeming rule applies for the purposes of Sec. 95 and subsec. 95(1) includes the definition of excluded property.
55. See *supra* note 44.

© 1994 International Bureau of Fiscal Documentation

fied member" of a partnership is defined[56] to mean a limited partner[57] and any member of a partnership unless that member is actively engaged in the activities of the partnership (other than financing activities) or carries on a similar business to that carried on by the partnership (other than as a member of the partnership), on a regular, continuous and substantial basis. Where a foreign affiliate holds an interest in a general partnership that carries on an active business such as real estate development, generally, the affiliate will not have any employees of its own (other than its directors) since all of the employees will be employed by the partnership. How then does the affiliate establish that it is actively engaged in the activities of the partnership business on a regular, continuous and substantial basis? The point is that the definition of specified member was intended for individuals investing in tax shelter partnerships and, in many cases, it does not appear to be easily adapted to partners that are corporations.

F. Miscellaneous foreign affiliate amendments

Other minor amendments to the foreign affiliate rules briefly are as follows.

Where money is borrowed to repay previously borrowed money or an unpaid purchase price of property, subsection 20(3) provides that the borrowed money is deemed to have been used for the purpose for which the original borrowed money or unpaid purchase price was used. The Budget proposes to extend the application of subsection 20(3) to subparagraph 95(2)(a)(ii) for taxation years of affiliates that begin after 1994. This amendment appears to ensure that clause 95(2)(a)(ii)(B) applies to interest paid or payable by FA2 to a FA1 on borrowed money that was used by FA2 to refinance debt that was originally used by FA2 to acquire shares of FA3.

The definition of foreign affiliate provides that a non-resident corporation is a foreign affiliate of a taxpayer resident in Canada if, put simplistically, that taxpayer owns, directly or indirectly, 10 percent of the shares of the non-resident corporation. However, shares of a non-resident corporation owned by a person related to a taxpayer are not included in determining the taxpayer's share ownership in the non-resident corporation. The definition of foreign affiliate is to be amended effective for taxation years of foreign affiliates that begin after 1994 to provide that a non-resident corporation is a foreign affiliate of a taxpayer if the taxpayer owns, directly or indirectly, at least 1 percent of the shares of the corporation and the taxpayer and persons to whom he is related own, directly or indirectly, at least 10 percent of the shares of that corporation. For example, assume that corporation A owns 85 percent of FA, a non-resident corporation, and that corporation B owns 9 percent of FA and that corporation C owns 6 percent of FA. Corporations A, B and C are related. Under the current rule, FA is a foreign affiliate of corporation A and a controlled foreign affiliate of corporation A, but FA is not a foreign affiliate of corporations B or C. Under the new rule, FA will also be a foreign affiliate of each of corporations B and C because each of those corporations owns at least 1 percent of the shares of FA and corporations A, B and C together own 100 percent of the shares of FA. Since FA is a foreign affiliate of corporations B and C, and since corporation A controls FA and is related to each of corporations B and C, then FA will be a controlled foreign affiliate of corporations B and C which will now have to include 9 percent and 6 percent, respectively, of FA's FAPI in their incomes.

III. DEBT FORGIVENESS

Under the present rules,[58] where a debt owing by a taxpayer is settled or extinguished for an amount that is less than its principal amount or the amount for which it was issued, the excess of the lesser of those amounts over the aggregate amount paid on account of the principal amount of the debt is applied to reduce, in the following order, the taxpayer's non-capital losses, farm losses, net capital losses and restricted farm losses for preceding taxation years to the extent that these losses are deductible in the year of forgiveness. Any excess debt forgiveness remaining is then applied to reduce in prescribed manner the capital cost to the taxpayer of depreciable property with any balance being applied to reduce the adjusted cost base of capital property.

The tax policy pertaining to this rule was that the debt served to incur expenses or the cost of property. Accordingly, to the extent that such debt is forgiven, the borrower did not actually incur a related expense or cost and such amounts should be reversed to the extent that they appear for tax purposes in the borrower's losses or cost of property.

A. Application of Section 80

The Budget proposes to amend these rules for debt forgiveness occurring after 21 February 1994,[59] as described below.

As before, debt forgiveness will be applied to reduce losses of the debtor to the extent of such losses. Any remaining balance of such forgiveness not so applied will be applied, to the extent designated by the debtor, to the following tax basis: the debtor's cumulative Canadian development expense account[60] and cumulative Canadian oil and gas property expense account,[61] the capital cost of depreciable property of a prescribed class (to the extent of the undepreciated capital cost), the remaining undepreciated capital cost of depreciable properties of a prescribed class and the undeducted cost of certain intangibles, such as goodwill, that are recognized for

56. Subsec. 248(1).
57. Within the meaning assigned by subsec. 96(2.4).
58. Sec. 80.
59. Budget Resolutions 27, 28 and 29. The Department of Finance has stated publicly and in several private letters that the Budget amendments will not apply to a settlement of a debt after 22 February 1994, where the debt is settled pursuant to an agreement entered into prior to that day. In addition, the Budget amendments will not apply to a debt settled prior to 1996 under a debt restructuring plan which had been presented to a court prior to 22 February 1994.
60. This account includes the cost of Canadian mining properties and is defined in subsec. 66.2(5).
61. This account includes the cost of Canadian oil and gas properties and is defined in subsec. 66.4(5).

© 1994 International Bureau of Fiscal Documentation

Canadian tax purposes.[62] After designating the maximum amount possible, any remaining balance of debt forgiveness may be applied, to the extent designated by the debtor, to reduce the adjusted cost base to the debtor of real property that is capital property to the debtor other than depreciable property[63] and personal-use property.[64] Any balance of forgiveness that thereafter remains unapplied is to be included in the income of the debtor.

There are two significant changes being effected by the Budget in respect of Section 80. The first change is the inclusion in the income of the debtor of the portion of the forgiveness not applied to losses or the cost of assets in the manner described. The second change precludes a debtor from applying debt forgiveness to non-depreciable capital property such as shares of corporations, interests in partnerships and interests in trusts. These changes will clearly obtain an inequitable result and will result in severe financial hardship where the proceeds of the borrowing were used, say, to acquire shares of a corporation and there are insufficient losses or eligible tax costs that can absorb the debt forgiveness.

The reason for the second change is because the application of Section 80 to the tax cost non-depreciable capital properties such as shares of corporations, interests in partnerships or interests in trusts, could be engineered in a manner that neutralized the intended effect of that Section. For example, assume that corporation A owns all of the shares of corporation B and that corporation A has lent money to corporation B for use in its business. Corporation B is in financial difficulty but owns a valuable commercial building. Corporation A would like to forgive the debt owing to it by corporation B but any forgiveness not applied against loss carry-forwards of corporation B may reduce the capital cost of the building to corporation B. To avoid the effects of Section 80, corporation B incorporates Subco and transfers the building and the subjacent land to Subco in exchange for shares of Subco pursuant to a tax-deferred subsection 85(1) rollover at their respective tax costs. Immediately after the transfer and assuming that the rollover of the land and building affords an adjusted cost base to corporation B of the shares of Subco that is at least equal to the amount of the debt owing by corporation B to corporation A, corporation A will forgive corporation B's indebtedness. Section 80 will apply at the time of the forgiveness to reduce the adjusted cost base to corporation B of its shares of Subco. Subco and corporation B will then amalgamate to form Amalco and on the amalgamation the land and building will become assets of Amalco and the shares of Subco will be cancelled. By this series of transactions, the application of Section 80 has been neutralized by being applied to reduce the cost of the shares of Subco, that disappeared on the amalgamation. Although in the view of Revenue Canada, the series of transactions described would be subject to the general anti-avoidance rule ("GAAR"), the series serves to illustrate that technically, Section 80 can be rendered ineffective. There are, however, no doubt, situations where such a result could arise that would not be subject to GAAR. The Budget change is intended to statutorily remove the possibility of this result whether or not it would otherwise be subject to GAAR.

B. Application of Section 80 to non-residents

Subject to an exemption under an applicable tax treaty, non-residents of Canada are subject to Canadian tax on capital gains realized on the disposition of "taxable Canadian property".[65] The Budget proposes[66] that after 21 February 1994, Section 80 forgiveness cannot be applied to reduce the applicable tax cost to a non-resident of property unless it is taxable Canadian property. This amendment will prevent the application of Section 80 forgiveness to the cost of property that is not relevant for Canadian tax purposes and to the extent that it applies to reduce the adjusted cost base of taxable Canadian property, such reduction will result in increased capital gains realized by the non-resident on a taxable disposition of such property, that, subject to an exemption under an applicable tax treaty, may be subject to Canadian tax.[67]

C. Application of Section 80 to distress preferred shares

Dividends received by a taxable Canadian corporation from another taxable Canadian corporation are generally not subject to tax in the hands of the recipient corporation pursuant to subsection 112(1). However, this result does not obtain where the share is a term preferred share[68] that is held by a specified financial institution and that was acquired by the institution in the ordinary course of its business. A specified financial corporation is defined[69] to be a bank, trust company, credit union, insurance company, a corporation whose principal business is the lending of money to or the purchasing of debt obligations from arm's length persons, a corporation that is controlled by any of the foregoing institutions and a corporation that is related[70] to any of the foregoing. In general terms, a term preferred share is a share, which the owner can cause to be redeemed, acquired or cancelled or cause its paid-up capital to be reduced either under the terms or conditions of the share itself or any agreement relating thereto.

Term preferred shares are regarded by Revenue Canada as quasi-debt. Accordingly, dividends received thereon by insti-

62. Cumulative eligible capital is defined in subsec. 14(5).
63. Depreciable property is defined in subsec. 13(21) to be property in respect of which the taxpayer is entitled to claim capital cost allowance.
64. Personal-use property is defined in Sec. 54 to be property of a taxpayer used primarily for the personal use or enjoyment of the taxpayer.
65. This term includes, for example, shares of private corporations, Canadian real estate, any capital property used by the non-resident in carrying on a business in Canada, shares of public corporations if the non-resident alone or together with non-arm's length persons owned at least 25% of the shares of any class or series of a class of the corporation within the five years that immediately precedes the disposition of such shares, certain interests in partnerships, capital interests in trusts resident in Canada and options or interests in respect of any of the foregoing.
66. Budget Resolution 30.
67. Where the taxable Canadian property owned by the non-resident are shares of a corporation resident in Canada, the Budget amendment that precludes the application of debt forgiveness to reduce the adjusted cost base of shares reduces the effectiveness of this proposed amendment where such shares constitute taxable Canadian property.
68. Term preferred shares are defined in subsec. 248(1).
69. Subsec. 248(1).
70. See *supra* note 11.

© 1994 International Bureau of Fiscal Documentation

tutions that are specified financial institutions are required to pay tax on dividends received by them on such shares to the same extent as if such dividends were interest, unless such shares were not acquired by the institution in the ordinary course of its business.[71] Excepted from the definition of term preferred share is a share, commonly referred to as a "distress preferred share", which is described in paragraph (e) of the definition of term preferred share. Accordingly, dividends received on distress preferred shares remain deductible in computing the income of a recipient corporation. Paragraph (e) describes a share that is issued by a corporation resident in Canada for a term not exceeding five years as part of a financial restructuring of the issuer. Commonly, a share is a distress preferred share when, by reason of financial difficulty, the issuer of the share or another corporation resident in Canada with which the issuer does not deal at arm's length, was in default or could reasonably be expected to default, on a debt obligation held by an arm's length person and the share was issued wholly or partly and directly or indirectly in exchange or substitution for that debt and the subscription price of the share may reasonably be regarded as having been used by the issuer or by a corporation with which it does not deal at arm's length in the financing of its business carried on in Canada immediately before the share was issued.

The Budget proposes[72] to apply Section 80 to distress preferred shares on the rationale that such shares are debt substitutes. Accordingly, it appears that Section 80 will apply to these shares when they are cancelled after 21 February 1994,[73] for an amount that is less than their redemption price.

D. Application of Section 80 to conversions of debt to equity

The Budget also proposes[74] to apply Section 80 where a debt is converted into shares of a corporation after 21 February 1994, other than into distress preferred shares, to the extent that the fair market value of the share so issued is less than the principal amount of the debt converted. This amendment merely confirms the administrative position of Revenue Canada.[75]

E. Application of Section 80 to debt parking

The Budget proposes an amendment for so-called "debt parking".[76] This term is used to describe a situation where a creditor, such as a bank, holds a debt of an arm's length debtor and rather than forgiving all or a substantial portion of the debt, which would result in the application of Section 80 to the debtor, the creditor sells the debt at a substantial discount to a person who does not act at arm's length with the debtor at the time of the sale. The new creditor leaves the debt outstanding indefinitely to avoid the application of Section 80 to the debtor in respect of the debt. In other words, the debt is "parked" indefinitely with a non-arm's length creditor. Where such "parked" debt is acquired after 21 February 1994, for the purposes of subsection 15(1.2) and Section 80, whichever is applicable, the new rules will deem the outstanding amount of the debt to have been settled at that time for a payment by the debtor equal to the cost of the debt to the non-arm's length creditor. Where Section 80 applies to the debt, the amount outstanding in excess of the deemed payment will be subject to the application of that section. Where the debt is a loan by a corporation to a shareholder, such excess will be included in the income of the shareholder as a taxable shareholder benefit.[77] If, at the time the debt is acquired, the acquiror deals at arm's length with the debtor but ceases to do so at a subsequent time, this rule will apply to the debtor in respect of that debt at that subsequent time. This rule will also apply where a non-arm's length creditor of a debtor writes off a debt of the debtor as a bad debt as a consequence of which subsection 50(1) deems the creditor to have disposed of the debt for nil proceeds and to have reacquired it at a nil cost. In this latter circumstance, Section 80 or subsection 15(1.2), as the case may be, will apply to the entire outstanding amount of the debt.

F. Application of Section 80 to statute-barred debt

A debt is not considered to be settled or extinguished where its enforceability becomes statute-barred due to the expiry of a statutory limitation period, because the debtor's liability in respect of the debt remains extant. Where a debt becomes statute-barred, the creditor simply cannot bring an action at law to enforce payment. Consequently, Section 80 does not apply to debts when they become statute-barred because such debts are not settled or extinguished. The Budget, however, proposes[78] that where, after 21 February 1994, a debt becomes statute-barred, for the purposes of Section 80, subsection 6(15) and subsection 15(1.2), the debt will be treated as if it had been forgiven at that time. In this regard, paragraph 6(1)(a) requires an employee who is in receipt of a benefit from employment to include the value of the benefit in his income from employment. Subsection 6(15) is a valuation section providing that where a benefit from employment results from a forgiveness of debt, the value of that benefit is equal to the amount of the forgiveness. Similarly, where the debt is a loan made by a corporation to a person *qua* shareholder, subsection 15(1.2) is another valuation section that provides that the amount of the shareholder benefit arising under subsection 15(1) from the forgiveness of that debt, is equal to the amount of the forgiveness.[79] This amendment

71. Subsec. 112(2.1).
72. Budget Resolution 32.
73. It is understood that the Department of Finance has stated publicly and in private letters that distress preferred shares issued before 22 February 1994 will not be subject to these new rules.
74. Budget Resolution 33.
75. See para. 11 of Interpretation Bulletin IT-293R. It is understood that the Department of Finance is considering relief from this resolution for publicly held convertible debt.
76. Budget Resolution 34.
77. Except to the extent that an amount, if any, was included in the income of the shareholder as a taxable benefit at the time that the loan was made. See subsecs. 15(1) and (1.2).
78. Budget Resolution 24.
79. *Ibid.*

© 1994 International Bureau of Fiscal Documentation

will therefore trigger income where it applies to loans made to persons *qua* employee or *qua* shareholder, respectively.[80]

G. Anti-avoidance rule

In case all of the above rules regarding forgiveness of debt failed to apply to a forgiveness of debt, the Budget proposed[81] a "debt forgiveness" anti-avoidance rule which was to apply where one of the main reasons for debt remaining outstanding was to avoid or defer the application of income tax rules relating to debt forgiveness. The Department of Finance has publicly indicated that this proposed anti-avoidance rule will be dropped and that Revenue Canada will rely on the general anti-avoidance rule.[82]

H. Revisions to Section 79

The Budget also proposes certain changes to the tax consequences that arise on foreclosures and repossessions. Section 79 provides rules that apply to both the creditor and the debtor where a creditor acquires or re-acquires property from a debtor by reason of the failure by the debtor to pay to the creditor all or any part of an amount owing by the debtor to the creditor. Section 79 includes, as proceeds of disposition to the debtor in respect of the property repossessed, the outstanding principal amount of the creditor's claim plus the principal amount of each debt that was owing by the debtor to a third party which was extinguished by reason of the foreclosure or repossession. The existing rule does not include as proceeds of disposition any interest that is accrued and unpaid on such debt.

First, the Budget proposes[83] that for property acquired by foreclosure or repossession after 21 February 1994, the debtor's proceeds of disposition will include any interest accrued and unpaid by the debtor in respect of the debts referred to above in addition to their principal amounts. This change brings the treatment of foreclosures more in line with the tax consequences that arise under Section 80 where accrued and unpaid interest on a debt is subject to that section. Second, the Budget proposes that such proceeds of disposition will also include the principal and unpaid interest thereon of any other debts that were secured by the property but were not extinguished by the foreclosure. It is noted that this additional increase to the debtor's proceeds of disposition is only for the purpose of computing the debtor's loss arising from the disposition of such property by reason of the foreclosure or repossession. Third, a technical change is proposed that the cost to the creditor of the property acquired or re-acquired be equal to the creditor's adjusted cost base of his debt rather than its cost as is presently the case. This amendment will add to or reduce the creditor's cost of such property by any additions or reductions made to the cost of the creditor's debt under subsections 53(1) or 53(2). For example, where a debt has been transferred by a taxable Canadian corporation to another taxable Canadian corporation in circumstances that a capital loss otherwise arising on such transfer is deemed to be nil by paragraph 85(4)(a) or paragraph 40(2)(e) and such loss is not added to the adjusted cost base to the transferor of shares owned by it of the transferee corporation, paragraph 53(1)(f.1) adds the amount of that loss to the cost to the transferee corporation of the transferred debt in computing the adjusted cost base of that debt to the transferee corporation. The proposed amendment will now ensure that this increase to the adjusted cost base to the transferee corporation of the transferred debt is also added to the transferee's cost of the property acquired or reacquired on the foreclosure of that debt.

I. Miscellaneous amendments

There are a number of provisions contained in the Act that operate with respect to debt and the priority of the application of these provisions is unclear in circumstances where they can apply concurrently. The Budget therefore proposes[84] to order, after 21 February 1994, the application of these provisions to ensure that the desired tax consequences are obtained. The following provisions will be deemed to apply in the following order. Section 78 in respect of unpaid amounts, Section 6(15) in respect of the forgiveness of loans to employees,[85] Section 15(1.2) in respect of the forgiveness of loans by corporations to shareholders,[86] Section 79 for foreclosures[87] and lastly, Section 80.

Lastly, the Budget provides[88] that after 21 February 1994 Section 80 will apply to debt on which interest is treated as dividends for the purposes of the Act such as small business bonds, small business development bonds, income bonds and income debentures. Technically, Section 80 does not currently apply to these types of debt instruments because the interest payments thereon are treated as dividends and Section 80 only applies to debt in respect of which interest is deductible or would be deductible if it were paid on the debt.

IV. FINANCIAL INSTITUTIONS AND INVESTMENT DEALERS

There has continued to be uncertainty regarding the issue of whether profits or losses realized by financial institutions on the disposition of securities are on income account and therefore fully recognized in computing income or are on capital account and thereby attract capital gains (and losses) treatment. Revenue Canada is of the view that securities held by

80. In this regard, it is noted that Budget Resolution 25 discussed below, provides that paras. 6(1)(a), subsec. 15(1) and Sec. 80 will be applied to forgiveness of debt in that order.
81. Budget Resolution 35.
82. Subsec. 245(1).
83. Budget Resolution 26.
84. Budget Resolution 25.
85. Technically, this should be a reference to para. 6(1)(a) with respect to a forgiveness contemplated in subsec. 6(15) because para. 6(1)(a) is a charging section whereas subsec. 6(15) is merely a valuation section.
86. Technically, this should be a reference to subsec. 15(1) with respect to a forgiveness contemplated in subsec. 15(1.2) because subsec. 15(1) is a charging section whereas subsec. 15(1.2) is a valuation section.
87. Sec. 79 already has priority over Sec. 80, see para. 80(1)(e).
88. Budget Resolution 31.

© 1994 International Bureau of Fiscal Documentation

financial institutions in the ordinary course of their business should be treated for tax purposes as being on income account because investments in securities are an integral part of the financial intermediation business. A collateral issue that arises from treating profits and losses in respect of securities on income account is the timing of the recognition of such profits and losses. Thus, the issue arises as to whether such profits and losses should be recognized only at the time of the disposition of the securities or whether they should be recognized on an accrual basis and if so, what method should be adopted to accrue such gains and losses.

In this regard, firstly, the Budget proposes[89] that all profits and losses realized from dispositions after 21 February 1994, of securities held in the ordinary course of business by restricted financial institutions and investment dealers who are registered or licensed under provincial laws to trade in securities as well as companies controlled by such investment dealers, be treated on income account. A restricted financial institution is defined[90] to be a bank, trust company, a credit union, an insurance corporation, a corporation whose principal business is the lending of money to or purchasing debt obligations from arm's length persons, or any combination thereof and a corporation that is controlled by any of the foregoing corporations. An exception to this rule will apply to prescribed small business shares described below.

The exception from this rule for securities not acquired "in the ordinary course of business" would, by analogy to other provisions of the Act that incorporate this term, appear to contemplate shares and debt of controlled subsidiaries. Prescribed small business shares are shares of a corporation that at the time of acquisition:

(i) is a Canadian-controlled private corporation;[91]
(ii) the total assets of the corporation and all corporations related to it do not exceed $ 50 million;
(iii) the corporation and all corporations related to it do not employ more than 500 employees; and
(iv) the corporation is an eligible corporation as defined in Regulation 5100(1) for deferred income plans. An eligible corporation, in essence, is a corporation resident in Canada all or substantially all of whose assets are used by it or by a corporation controlled by it in an active business carried on primarily in Canada.[92] Excluded from the definition of eligible corporation are various financial institutions,[93] corporations controlled by non-residents of Canada and venture capital corporations.[94]

The Budget further proposes[95] that restricted financial institutions are required, for taxation years ending after 22 February 1994, to accrue any appreciation or depreciation in the value at year-end of equity securities, other than prescribed small business shares, and debt securities that have been accounted for as temporary investments since they were acquired and that, in each case, were acquired in the ordinary course of business. The "mark-to-market" method is the proposed method of accrual. In the case of registered investment dealers, these accrual rules are applicable to all equity and debt securities acquired in the ordinary course of business by them, other than prescribed small business securities. In this regard, it is understood that temporary debt securities are those whose appreciation or depreciation in market value is recorded for accounting purposes by financial institutions. Accordingly, the requirement to mark such securities to market for tax purposes will conform to the accounting treatment for such securities.

The mark-to-market rules do not apply to debt securities acquired by restricted financial institutions that have not been accounted for as temporary investments since they were acquired although it is noted that because of the first Budget Resolution described above, any profit or loss realized on the disposition of such debt securities will nevertheless be on income account if such securities were acquired by the institution in the ordinary course of its business.

The mark-to-market method as applied to an equity or debt security assumes a notional sale of the security at its fair market value and a notional reacquisition by the holder at that value for the purposes of determining its cost for tax purposes to the holder. Any gain or loss realized from such notional sale is required to be included or deducted, as the case may be, in computing the income of the holder.

The financial hardship that is anticipated to result from the immediate adoption of the mark-to-market method is to be alleviated by a transitional rule.[96] Pursuant to this transitional rule, where as a consequence of the application of the mark-to-market method to the taxpayer's first taxation year ending after 22 February 1994, a net gain (income included by application of the mark-to-market method less any net losses realized on the actual disposition of these securities in the first taxation year) is required to be included by a taxpayer in its

89. Budget Resolution 19.
90. Subsec. 248(1).
91. A Canadian-controlled private corporation is defined by para. 125(7)(b) to mean corporation resident in Canada that was incorporated in Canada or has been continuously resident in Canada since 18 June 1971, is not a public corporation and is not controlled, in law or in fact, by any combination of non-resident persons or public corporations. A public corporation generally is a corporation that is resident in Canada whose shares are listed on a prescribed stock exchange in Canada.
92. An eligible corporation is a taxable Canadian corporation all or substantially all (i.e. at least 90%) of the property of which consists of any combination of, assets used by the corporation or by a corporation controlled by it in a qualifying active business and shares or debt obligations issued by a related corporation that qualifies as an eligible corporation. A qualifying active business means any business carried on primarily in Canada other than a business the principal purpose of which is to earn income from property (such as interest, dividends, rents and royalties) or is to derive capital gains from the disposition of investments. For the purposes of determining whether a business is carried on primarily in Canada, a business is deemed to be so carried on if either at least 50% of its employees and the employees of related corporations that are employed in respect of the business are employed in Canada or if at least 50% of all of the salaries and wages paid by the corporation and corporations to which it is related to employees employed in the business are attributable to services rendered in Canada. If neither of these latter tests are met, it is a question of fact as to whether the business is carried on primarily in Canada. Holding corporations of eligible corporations that meet certain conditions also qualify as eligible corporations as do prescribed venture capital corporations which are essentially regulated venture capital corporations that create pools of capital for investment in small and medium size businesses.
93. Persons described in subsec. 39(5) being banks, trust companies, insurance corporations, credit unions, traders or dealers in securities and corporations whose principal business is money lending.
94. Other than venture capital corporations prescribed in Reg. 6700.
95. Budget Resolution 20.
96. Budget Resolution 21.

© 1994 International Bureau of Fiscal Documentation

income for that year, that gain can be included in income over a five year period on a straight-line basis commencing with that year.

A further Budget Resolution[97] requires restricted financial institutions to amortize to income any acquisition premium or discount in respect of a debt security that is not required to be marked-to-market under the rules described above. This would include debt securities of restricted financial institutions acquired in the ordinary course of business but which are not accounted for as temporary investments from the time they are acquired. Pursuant to this rule, premiums will reduce and discounts will increase the annual income realized by the holder of such debt securities. The Budget does not stipulate any particular method to be used to effect such amortization, but presumably the method will be that used by the financial institution to determine the yield to maturity of the debt obligation. Any gain or loss actually realized on a disposition of these debt securities will be required to be amortized to income over their remaining term to maturity as if they had been retained.[98] Presumably, the cost of such debt securities will be "written-up" in the case of a discount or "written-down" in the case of a premium, by the amount of such premium or discount previously included or deducted, as the case may be, in computing the holder's income, for the purposes of determining the gain or loss realized on their disposition.

These amendments which will now tax gains and losses on securities owned by restricted financial institutions and registered investment dealers on an accrual basis will no doubt cause significant concern to such taxpayers.[99] The Department of Finance has stated in the Budget that it will consult with the industry regarding these amendments, and that these consultations will include discussions regarding the impact of the amendments on foreign currency denominated debt securities, an issue not dealt with by the proposed amendments.

V. CONCLUSION

This article was written just after the release of the 23 June 1994 draft legislation concerning divisive corporate reorganizations and foreign affiliates and just prior to the release of the draft legislation concerning debt forgiveness, which is understood to be exceedingly lengthy. Moreover, the draft legislation regarding securities held by financial institutions and investment dealers has not yet been released. There is no doubt that, in these areas, the Department of Finance will be consulting extensively with the tax and business community and we can therefore expect further amendments before the relevant legislation finally settles. Accordingly, readers are cautioned that, at least in the areas of Canadian income tax law covered in this paper, the sands will continue to shift for some time.

97. Budget Resolution 22.
98. *Ibid.*
99. It is understood that it has been the administrative practice of Revenue Canada to treat securities acquired in the ordinary course of business by restricted financial institutions and registered investment dealers as inventory so that this particular change will not come as a surprise to these taxpayers. However, the move to a full accrual system regarding these securities was not anticipated.

TAXATION & INVESTMENT IN CANADA

The laws and systems of federal and provincial governments.

- Individual, corporate, business and property tax systems
- Determination of tax base, application of rates and tax credits
- Description of Canada's treaty network and measures for the relief of double taxation
- International transfer pricing and anti-avoidance rules
- Taxation of branches of foreign companies and other types of vehicles for international investment in Canada
- Overview of federal Goods and Services Tax (GST)
- Taxation of financial institutions, insurance companies and specialized industries
- Income tax incentives
- Important details of provincial taxes
- Full information on investment for companies and individuals

Includes information on both the Canada-United States Free Trade Agreement and the North American Free Trade Agreement.

NEW SUBSCRIPTION 1994: NLG 400
Includes 1994 updates
One binder, updated twice a year

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on prices given
IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

ACQUIRING, HOLDING AND FINANCING CANADIAN CORPORATIONS

Allan R. Lanthier, FCA

Allan R. Lanthier is a senior tax partner with Ernst & Young, Montreal, and is Director of International Tax for the Canadian firm. He is Co-Chair of the Joint Taxation Committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants. He is a Canadian correspondent to the *Bulletin,* and was a national reporter on the subject of cross-border leasing at the 1990 Annual Congress in Stockholm. Mr Lanthier is a member of council of the Canadian Branch of IFA, and a director of the Society for International Maritime Centres. He has been a consultant to the Canadian federal government on international taxation matters, has lectured at McGill University and Concordia University, Montreal, and is a frequent speaker and author on taxation matters.

I. INTRODUCTION

This article addresses some of the Canadian income tax issues which should be considered in the context of a non-resident acquiring, holding and financing Canadian corporations. After a general discussion of the rules establishing liability for Canadian tax, forms of business organization and the choice of conducting business operations in a branch versus a Canadian subsidiary, the article analyses a number of planning alternatives which should be considered in connection with the acquisition, restructuring and financing of Canadian corporations, as well as minimization of withholding tax on repatriation of earnings.

The article is intended to include matters of general interest, and is not industry-specific. It is also assumed (unless otherwise indicated) that the non-resident holds, or intends to acquire, 100 percent of the shares of the Canadian subsidiary. Finally, the article does not generally address the possible application of Canadian or foreign anti-avoidance concepts (including the Canadian general anti-avoidance rule), and planning opportunities should always be tested against such concepts, having due regard to the business context in which the transactions are carried out.

II. LIABILITY FOR CANADIAN TAX

A. Residence of corporations

Canadian federal income tax is levied under the Income Tax Act[1] on the world income of corporations resident in Canada, and on certain Canadian-source income of non-residents, including interest income from business carried on in Canada, and rents and royalties and, subject to possible treaty exemption, capital gains on the disposition of "taxable Canadian property" as defined. Corporations resident or carrying on business in Canada are generally taxable under Part I of the Act, while Part XIII applies in respect of fixed and determinable income such as interest, rents and royalties.

The starting point in Canada for determining corporate residence is the common law test of "central management and control". Under this test, a corporation is generally considered to be resident where its directors meet and exercise their authority.[2] However, the jurisprudence has not been entirely clear in respect of the degree to which management and control must be located in a particular jurisdiction before a finding of residence will be made, or under what circumstances a corporation will be resident in more than one jurisdiction. Ultimately, the question is one of fact and, in circumstances where directors have stood aside from their duties, a corporation has been found to be resident in the jurisdiction where de facto control was actually exercised.[3] There will accordingly be uncertainty in applying the management and control test in certain situations – an uncertainty which is exacerbated by the paucity of jurisprudence on the issue in recent years, during a period when international trade and cross-border alliances have shown dramatic increase and change.

In addition to the above, a corporation is deemed to have been resident in Canada throughout a taxation year if it was incorporated in Canada after 26 April 1965.[4] As an attack against dual resident companies, a corporation is deemed to be a non-resident of Canada if, by virtue of a Canadian tax treaty, it would, if it had income from a source outside Canada, be treaty exempt from tax on that income under Part I of the Act.[5] Finally, international shipping corporations incorporated outside Canada are deemed to be resident in the

1. RSC 1985, c. 1 (5th Supp.), as subsequently amended (referred to herein as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.
2. *DeBeers Consolidated Mines, Ltd. v. Howe*, [1906] AC 455.
3. *Unit Construction Co. Ltd. v. Bullock*, [1959] 3 All ER 831.
4. Subsec. 250(4). In addition, a corporation incorporated in Canada before 27 April 1965 (other than certain foreign business corporations as defined) is deemed to have been resident in Canada throughout a taxation year if it was incorporated in Canada and, at any subsequent time, it was a de facto resident of Canada or carried on business in Canada. Under proposed amendments included in Bill C-27 and tabled in the Canadian House of Commons on 5 May 1994, a corporation which has been granted articles of continuance (or similar constitutional documents) in a particular jurisdiction shall, from the time of continuation, be deemed to have been incorporated in the jurisdiction to which it has continued, and not have been incorporated in any other jurisdiction; this amendment will generally apply in respect of continuances which occur after 31 December 1992.
5. Subsec. 250(5).

© 1994 International Bureau of Fiscal Documentation

country of incorporation and not to be resident in Canada (even if central management and control is located here), provided certain tests are met.[6] This provision was introduced during 1991 in response to representations from the Canadian shipping industry, in an effort to attract and retain international shipping operations in Canada.

B. Taxation under Part I

Under Part I of the Act, residents are taxable on their world income, subject to credit or deduction for foreign taxes in respect of foreign-source income. A non-resident corporation may be subject to tax under Part I if it carries on business in Canada or disposes of taxable Canadian properties as defined. Section 253 of the Act provides an extended meaning of carrying on business for this purpose, and deems a non-resident to have been carrying on business in Canada in a year where, *inter alia*, it solicited orders or offered anything for sale in Canada through an agent or servant, whether the contract or transaction was completed inside or outside Canada. The impact of Section 253, and of certain jurisprudence which has tended to take an expansive view of when a corporation will be considered to be carrying on business in Canada,[7] may of course often be neutralized by the business profits article of any relevant tax treaty, provided the non-resident does not have a permanent establishment in Canada.

The general federal rate under Part I (including a 3 percent surtax) is 28.84 percent. Reduced rates apply to manufacturing and processing income, as well as to certain income earned by Canadian-controlled private corporations as defined ("CCPC's"). The provinces also levy corporate income taxes at rates that range as high as 17 percent, and these taxes are not deductible for federal income tax purposes. The effective Canadian income tax rate can therefore vary significantly, depending on the province in which the business is carried on, the type of business and the classification of the company. The effective rates for companies which do not qualify as CCPC's range from approximately 38 to 46 percent depending on the province in which the business is carried on or, in the case of income eligible for the manufacturing and processing credit, from approximately 29 to 39 percent.

Where a non-resident corporation is subject to Part I tax on income from a business carried on in Canada, the additional branch tax in Part XIV of the Act will normally also apply. In general terms, the base for the branch tax is the corporation's after-tax business income earned in Canada, less an investment allowance for assets retained in Canada at the end of the year. The tax does not apply to banks, or to corporations whose principal business is the transportation of persons or goods, communications or mining iron ore in Canada. The general rate of Part XIV tax is 25 percent, subject to treaty reduction.[8]

In addition to liability for tax on income, corporations (whether resident or non-resident) must contend, *inter alia*, with capital taxes which are levied by a number of provinces (which are deductible for both federal and provincial income tax purposes), federal capital tax[9] (which is not deductible for income tax purposes) and, effective for taxation years beginning after 1993, a special corporate minimum tax in the province of Ontario. Several provinces also levy payroll taxes (which are deductible) at rates which range from 1 to 4.5 percent.

C. Part XIII withholding tax

Non-residents of Canada are also subject to tax under Part XIII of the Act, in respect of certain types of income paid or credited by persons resident in Canada. Subject to a number of exemptions, tax under Part XIII applies in respect of payments of amounts such as interest, dividends, rents and royalties.

Liability for Part XIII tax is generally based on the gross amount paid or credited, with no relief being given for related expenses. The general rate of Part XIII tax is 25 percent, which may of course be reduced (or, in certain circumstances, eliminated) by treaty. As a capital-importing nation, Canada has long resisted the worldwide trend to lower cross-border withholding taxes with its treaty partners. More recently, there has been a softening in this position. In the February 1992 Federal Budget tabled by the then Conservative government, Canada announced its willingness to negotiate reciprocal reductions in its dividend treaty rate to 5 percent over the five-year period commencing 1 January 1993, on dividends paid to a corporate shareholder with a substantial interest.[10] The following year, the same government announced, as part of its April 1993 budget, a willingness to eliminate withholding tax on arm's length payments for the right to use patented information or information concerning scientific experience; the government also affirmed its intention to eliminate, on a reciprocal basis, withholding taxes on payments made for the use of computer software.

The provinces generally do not have any counterpart to the federal Part XIII tax. However, where a corporation makes certain payments (including management fees, rents and royalties) to a related non-resident, the province of Ontario disallows 5/15.5 of the amount for purposes of computing the payor's income subject to Ontario income tax.[11] As the general Ontario corporate income tax rate is 15.5 percent, this disallowance is analogous to a 5 percent Ontario withholding tax in respect of such payments.

6. Subsec. 250(6).
7. See, for example, *Atlas-Gest Inc. et al. v. MNR* (85 DTC 430), *The Queen v. Gurd's Products Company Limited* (85 DTC 5314), *Twentieth Century Fox Film Corporation v. The Queen* (85 DTC 5513), and *GLS Leasco Inc. and McKinlay Transport Limited v. MNR* (86 DTC 1484).
8. Where a particular treaty does not specifically limit the rate of branch tax, the rate is reduced to the dividend treaty rate (Sec. 219.2 of the Act).
9. Part I.3 of the Act.
10. Following this announcement, a protocol to the Canada–Netherlands Income Tax Convention was signed on 4 March 1993, reducing the withholding rate on dividends to 5% where the shareholder is a company owning at least 25% of the capital or 10% of the votes of the payor. For dividends paid by Dutch companies, the reduction will apply as of 1 January 1993: for dividends paid from Canada, the reduction will be phased in over a five-year period.
11. Subsec. 12(6) of the Ontario Corporations Tax Act.

© 1994 International Bureau of Fiscal Documentation

D. Interplay of Part I and Part XIII

There may be situations (for example, where a non-resident corporation carries on a financing or leasing business in Canada, and receives interest or rentals from Canadian payors) where a non-resident could be subject to tax under both Part I and Part XIII of the Act. In these situations, subsection 214(13) of the Act and Regulation 805(1) thereto provide that a non-resident person who would otherwise be taxable under Part XIII of the Act but who carries on business in Canada, shall be taxable under Part I in respect of those amounts that may reasonably be attributed to a business carried on through a permanent establishment in Canada.

III. FORMS OF BUSINESS ORGANIZATION

Business operations are typically carried on in Canada through one of three vehicles – corporations, partnerships or joint ventures. While trusts may also be utilized for this purpose, their use to date has been infrequent.

While a corporation is a separate legal entity and taxable under Part I of the Act in accordance with the normal rules, a partnership is not a taxable entity. Rather, where a taxpayer is a member of a partnership, its income or loss is computed as if the partnership were a separate person resident in Canada. This income or loss is then allocated to the partners in accordance with their respective interests, whether or not received. Where a partnership carries on business through a permanent establishment in Canada, any non-resident partner (whether general or limited) will normally also be considered to be carrying on such activities as a result of its partnership interest.

The characterization of a joint venture, either as an undivided interest in a particular project or undertaking, or as a partnership interest, will generally be determined with reference to the relevant law and the agreements between the parties. Where a joint venture is not assimilated to a partnership, each participant accounts separately for its undivided interest in the assets, liabilities and income or loss of the undertaking. In either event (partnership or undivided interest), the participant would normally have a permanent establishment in Canada as a result of its interest in the joint venture.

IV. BRANCH VERSUS SUBSIDIARY

Regardless of the form of business organization chosen, a non-resident which intends to carry on business in Canada should consider whether to do so through a branch or through a wholly-owned Canadian subsidiary.

In many situations, operating in Canada through a subsidiary is, income tax considerations aside, the only viable alternative, having regard to factors such as limited liability, and to other business and commercial considerations such as public relations, recognition in the marketplace and access to government grants. However, in situations where there is a choice, and where start-up losses are anticipated, it will often be most effective to initially carry on business in Canada in branch form if, depending on the relevant foreign tax law, this enables the non-resident to offset Canadian branch losses against income otherwise taxable in its home jurisdiction. After start-up losses have been utilized, the non-resident might incorporate a Canadian subsidiary, and transfer the branch operations to the subsidiary on a non-recognition basis.[12]

Where the Canadian operations are expected to be profitable from the outset, a Canadian subsidiary (rather than a branch) is most typically used. The use of a subsidiary may be helpful where, for example, there are significant differences in the foreign and Canadian tax rules for timing of income or deductions, which might otherwise create problems for effective utilization of Canadian foreign tax credits in the non-resident's home jurisdiction. Also, branch tax, versus tax under Part XIII in the case of dividend payments from a Canadian subsidiary, is conceptually neutral.[13]

V. USE OF CANADIAN HOLDING COMPANIES

When considering the acquisition of an existing Canadian corporate group, one fundamental principle from a Canadian standpoint is that a non-resident acquiror should virtually always incorporate a Canadian holding company to make the acquisition. Canadian tax rules provide that paid-up capital[14] can be repatriated to non-resident shareholders at any time without the imposition of dividend withholding tax. Computations of underlying earnings and profits are not performed, and any amounts which are paid as dividends, or as redemptions or cancellations of shares in amounts that exceed the underlying paid-up capital as computed for Canadian tax purposes, are subject to Canadian withholding tax. A Canadian acquisition vehicle ensures that the acquisition cost of shares of a Canadian target company is also represented by paid-up capital at the holding company level.

Assume, for example, that a non-resident investor ("Foreign Buyer"), intends to acquire 100 percent of the outstanding shares of a Canadian operating company ("Canadian Target") from an arm's length party for cash of $ 100 million. The historical paid-up capital in Canadian Target is nominal. If Foreign Buyer were to proceed with a direct purchase of the shares of Canadian Target, the amounts that could subse-

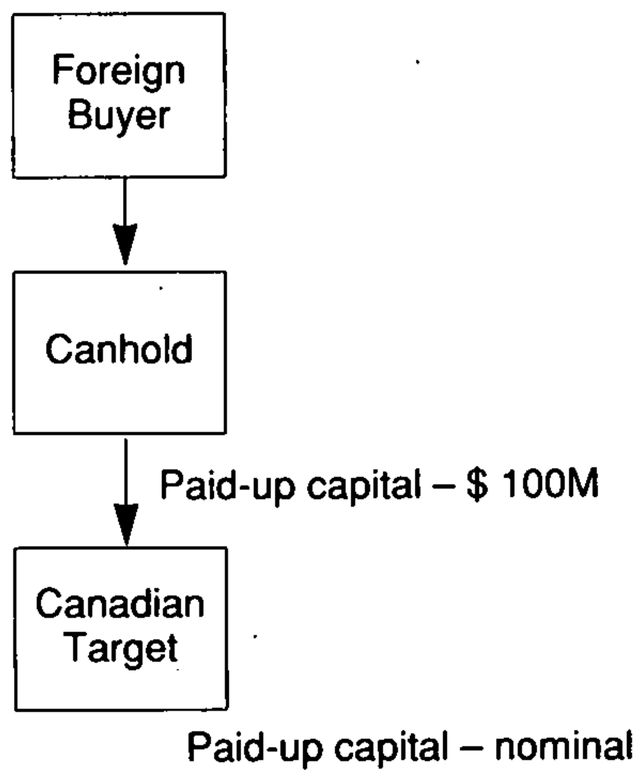
12. Subsec. 85(1) of the Act will generally provide for non-recognition treatment in Canada provided, in general terms, that non-share consideration is limited to the Canadian tax base of the assets transferred. In addition, provided the non-share consideration issued by the Canadian corporation and the paid-up capital of its shares is restricted to an appropriate amount, branch tax should not apply, and any second-level Canadian tax will be deferred until such future time as the Canadian subsidiary pays dividends to its non-resident parent (see, *inter alia*, paras. 219(1)(a.4) and 219(1)(k) of the Act). The foreign tax consequences to this type of branch incorporation would, of course, have to be reviewed in each situation.

13. There may, however, be circumstances where the treaty rate applicable to branch tax differs from the corresponding dividend rate. In addition, the Canada–US treaty provides for a cumulative exemption of up to C$ 500,000 of after-tax, branch profits.

14. As that term is defined in subsec. 89(1).

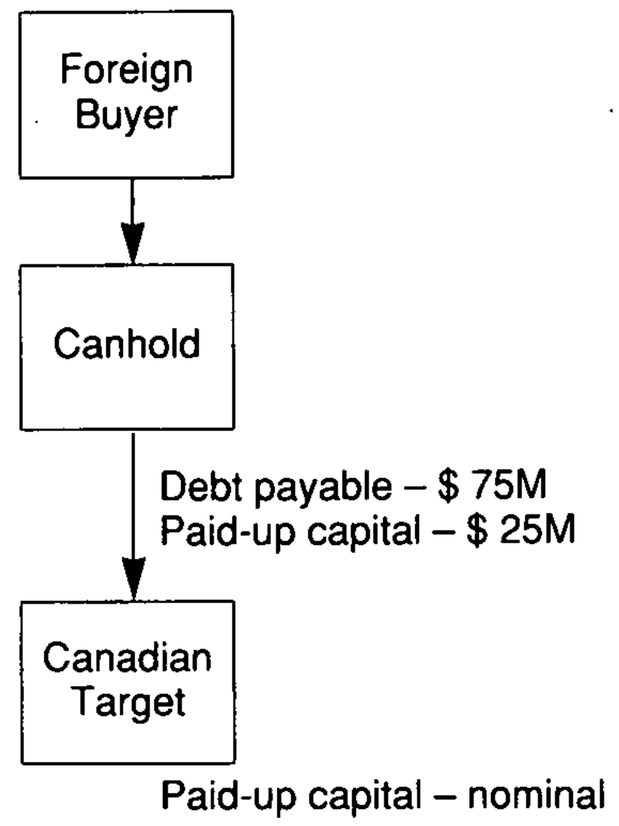
© 1994 International Bureau of Fiscal Documentation

quently be repatriated as capital without the application of dividend withholding tax would be restricted to the nominal, historical amount. Foreign Buyer, as a first step, therefore incorporates a Canadian holding company ("Canhold"), and subscribes for treasury shares of Canhold having a paid-up capital of $ 100 million. Canhold uses the cash to acquire the shares of Canadian Target, so that the corporate structure is as follows:



As Canadian Target earns profits in future, dividends can be paid to Canhold (which are eligible for a 100 percent, dividend-received deduction), and Canhold can repatriate invested capital to Foreign Buyer by statutory reductions of capital.[15] If Foreign Buyer had acquired Canadian Target directly as the first step, anti-dividend stripping rules in the Act[16] would have prevented Foreign Buyer from undertaking subsequent transactions to step-up Canadian Target's paid-up capital to the $ 100 million acquisition cost.

The use of a Canadian acquisition vehicle will also allow all or some portion of the acquisition indebtedness to be applied directly against the Canadian business operations and, where appropriate, to maximize the extent to which Canadian Target can be leveraged with related-party debt while still respecting the statutory 3:1 thin capitalization provision in the Act (the thin capitalization provision is discussed below in "Financing Considerations"). For example, assume again that Foreign Buyer intends to acquire Canadian Target at a cost of $ 100 million, but on a basis which allows the maximum possible amount of acquisition indebtedness to be applied directly against the Canadian business operations, in the form of related-party debt. In this situation, Foreign Buyer might, again as a first step, incorporate Canhold as a wholly-owned Canadian subsidiary, investing $ 25 million in treasury shares of Canhold and lending the balance of $ 75 million to Canhold on an interest-bearing basis. Canhold would then use the cash of $ 100 million to acquire the shares of Canadian Target. The structure would then be as follows:



As there is no consolidated tax reporting in Canada, Canhold and Canadian Target would then be merged, either by way of liquidation or statutory amalgamation, both of which are non-recognition transactions for Canadian tax purposes. This would allow the interest expense to be applied directly against Canadian Target's business operations.

A third benefit to the use of a Canadian acquisition vehicle is that it may provide access to the step-up provisions in paragraph 88(1)(d) of the Act, should Canadian Target liquidate into Canhold. This step-up provision is discussed further below.

A Canadian acquisition vehicle can also be useful on a subsequent disposition of the shares of Canadian Target. Immediately prior to a sale to a third party, Canadian Target could pay dividends to its Canadian parent company, with the dividends being eligible for the 100 percent, dividend-received deduction. Canadian Target would then be sold for reduced proceeds, resulting in a lower capital gain for Canadian tax purposes. The Act does recharacterize dividends that are paid as part of a series of transactions that include a third-party disposition of shares, but only to the extent that the dividend payments exceed after-tax profits as defined.[17]

One downside to the use of a Canadian acquisition vehicle is that it will often result in an increase in federal and provincial capital tax. On a direct acquisition of Canadian Target by Foreign Buyer, Canadian Target's historical capital tax base would not be disturbed (this assumes that "push-down" accounting would not be applied). The use of an acquisition vehicle ("Canhold"), in and of itself, should not have an adverse impact on capital tax, as Canhold will be entitled to an "investment allowance" deduction based on its acquisition cost of the shares of Canadian Target. However, as consolidated tax reporting is not available in Canada, it will often be appropriate to merge Canhold and Canadian Target (either by liquidation of Canadian Target, or statutory amalgamation of

15. It will be important to ensure that the statutory reduction does not involve a legal cancellation or disposition of the shares, particularly if Foreign Buyer would not otherwise be treaty protected from Canadian tax on a fair market value disposition of the Canhold shares.
16. Sec. 212.1.
17. Subsec. 55(2).

© 1994 International Bureau of Fiscal Documentation

the two companies, both of which are non-recognition transactions for Canadian tax purposes). In the event of a liquidation or amalgamation, the excess of the purchase price of the shares of Canadian Target over the historical book value of its net assets would, for accounting purposes, generally be allocated to assets (including goodwill) which do not qualify for the investment allowance, resulting in a potential, significant increase in the amount of capital taxes payable.

VI. ADDITIONAL STRUCTURING ALTERNATIVES

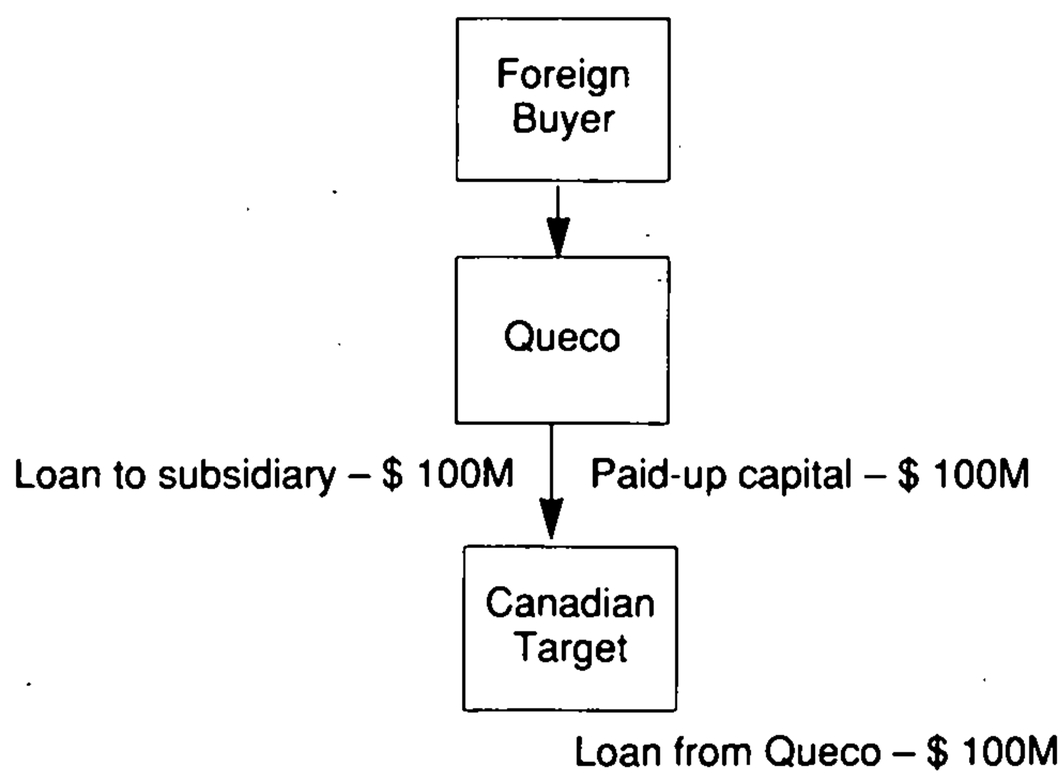
A. Quebec finance companies

As discussed earlier, the effective income tax rate in Canada can vary significantly, due to the relatively heavy incidence of provincial income tax, and different rates which apply in various provinces. Provincial tax rate arbitrage should accordingly be considered in structuring acquisitions.

For example, assume that Canadian Target operates a retailing business in the province of Ontario and has an effective combined federal-provincial income tax rate of 44 percent. Canadian Target has taxable income of approximately $ 10 million on an annual basis, and Foreign Buyer has agreed to purchase the shares of Canadian Target at a cost of $ 100 million. Planning steps which might be considered in this situation are as follows:

- Foreign Buyer incorporates a wholly-owned Canadian subsidiary with its only establishment in the province of Quebec ("Queco").
- Foreign Buyer invests $ 100 million in treasury shares of Queco.
- Queco in turn incorporates its own, 100 percent Canadian subsidiary ("Subco") for purposes of acquiring Canadian Target, and lends $ 100 million to Subco on an interest-bearing basis (say at 10 percent).
- Subco uses the cash to acquire Canadian Target.
- Finally, Canadian Target and Subco merge on a non-recognition basis.

The corporate structure after the above transactions would be as follows:



While the interest income received by Queco might otherwise be classified as income from a "specified investment business" as defined and therefore subject to the higher Quebec-federal rate of 45 percent, the fact that the interest income is being applied to reduce the active business income of an associated taxpayer (Canadian Target), means that the interest income is considered active business income to Queco and qualifies for the lower Quebec-federal rate of 38 percent. The net result is that $ 10 million of income will be shifted from Ontario to Quebec each year, resulting in annual income tax savings of $ 600,000-$ 700,000.[18] The impact of any CFC legislation in Foreign Buyer's home jurisdiction should of course be considered in respect of the intercorporate interest payments.

B. Non-resident owned investment corporations

When acquiring a Canadian group, consideration should also be given to the possible use of a non-resident owned investment corporation ("NRO"). In general terms, an NRO is a company incorporated in Canada that, not later than 90 days after the commencement of its first taxation year, elects in prescribed form to be taxed as an NRO, and complies with all of the following conditions:

- all of its issued shares, and all of its bonds, debentures and other funded indebtedness, are owned by non-residents of Canada;
- its income for each taxation year is derived from (i) the ownership of, or trading in, securities such as bonds, shares, debentures, mortgages, notes or similar property, (ii) lending money, (iii) rents, royalties or annuities, (iv) estates or trusts, or (v) disposition of capital property;
- not more than 10 percent of its gross revenue for each taxation year is derived from rents;
- its principal business is not the making of loans or trading or dealing in bonds, shares, debentures, mortgages, notes or similar property.

An NRO is taxed at a flat rate of 25 percent on all of its income excluding certain capital gains. This 25 percent tax is refunded when dividends are paid (other than the portion of the tax referable to capital gains realized on dispositions of taxable Canadian properties as defined) and, at that time, dividend withholding tax would apply.

Various special rules apply for purposes of computing the taxable income of an NRO. Most importantly, (a) interest expense is not an allowable deduction, (b) capital gains on dispositions of taxable Canadian property as defined are taxed at 100 percent (rather than the inclusion rate of 75 percent that generally applies to capital gains in Canada), (c) capital gains on non-taxable Canadian property are excluded from income, and (d) an NRO is not entitled to the dividend-received deduction in respect of intercorporate di-

18. Other matters to consider in this type of structure are the comparative impact on capital tax and the fact that, if Canadian Target was carrying on a manufacturing rather than a retailing business, the Act does not provide for a flow-through to Queco of the lower rates applicable to manufacturing and processing.

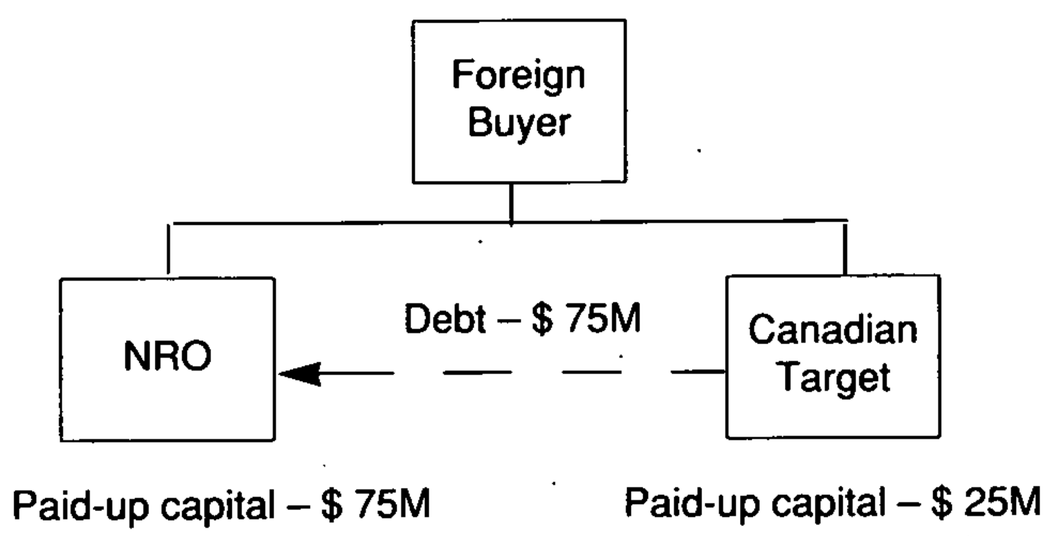
© 1994 International Bureau of Fiscal Documentation

vidends from other Canadian companies. An NRO also is treated as a non-resident for purposes of the statutory 3:1 thin capitalization provision in the Act.

In many ways, the concept of an NRO is an enigma in the Canadian tax system. The concept is a holdover from the 1948 Income Tax Act, and seems to have been originally introduced not so much to attract capital to Canada, as to put non-residents on an equal footing whether they invested in Canada directly or through a Canadian company. However, the continued existence of the NRO concept can produce some interesting planning possibilities. To illustrate the potential advantages to the use of an NRO, assume again that Foreign Buyer intends to acquire Canadian Target at a cost of $ 100 million. The acquisition might be structured as follows using an NRO:

- Foreign Buyer incorporates a Canadian acquisition vehicle ("Canhold"). Foreign Buyer invests in $ 25 million of treasury shares of Canhold, and lends Canhold $ 75 million by way of interest-bearing debt.
- Canhold purchases the shares of Canadian Target for cash of $ 100 million.
- Foreign Buyer incorporates NRO, and sells its note receivable of $ 75 million to NRO in exchange for shares of NRO.
- In order to apply the interest expense on the $ 75 million indebtedness directly against the business operations of Canadian Target, Canhold and Canadian Target are merged.

The structure after the above steps have been completed would be as follows:



The result is that Canadian Target now has a debt payable of $ 75 million to NRO and, while the thin capitalization provisions apply, we have kept within the 3:1 requirement. As noted above, an NRO is disqualified if its principal business is the making of loans. While a debtor/creditor relationship has been established between Canadian Target and NRO, a lender/borrower relationship has not, and the purchase by NRO of the existing receivable in the manner indicated above should not result in a denial of NRO status.[19]

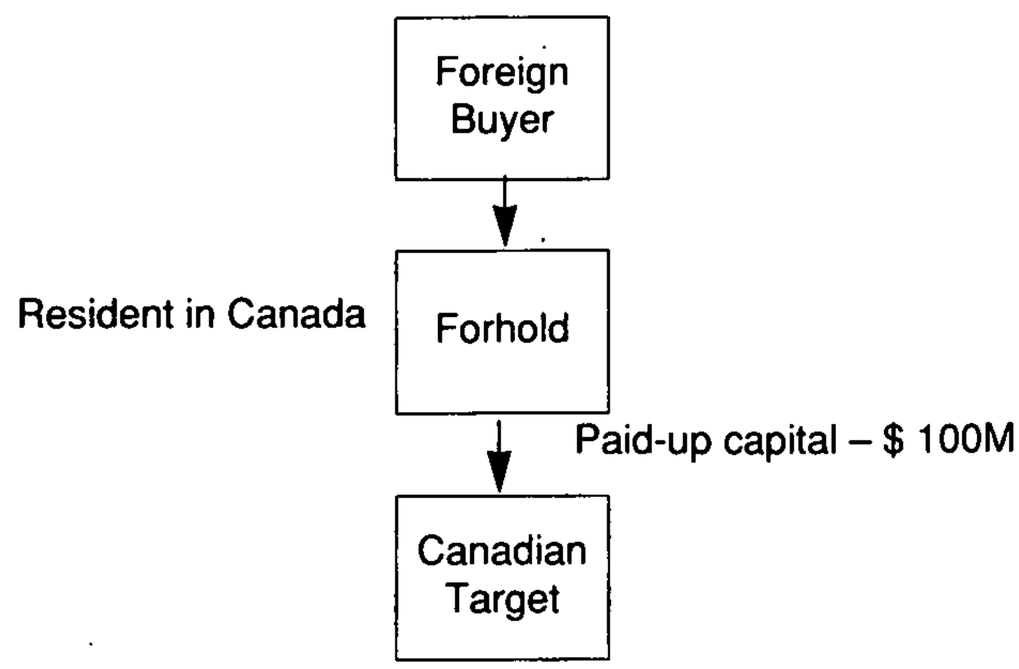
The potential benefits to the NRO structure described above are as follows:

(1) Assuming that Canadian Target is taxable at a rate of 45 percent, and given that the rate of refundable tax to NRO is 25 percent, there is an immediate savings of 20 percent in respect of interest paid to NRO (the impact of any CFC legislation in Foreign Buyer's home jurisdiction should again be considered).
(2) On an ultimate payment of dividends from NRO to Foreign Buyer, the 25 percent tax is refunded to NRO, and Canadian withholding tax applies at the dividend treaty rate.
(3) In certain jurisdictions (such as the United States) the payment of a stock dividend is generally not a taxable event. In these circumstances, it may be possible for NRO to pay stock dividends and reduce the effective tax rate in NRO from 25 to 10 percent, without triggering a taxable event to Foreign Buyer.

In circumstances where an NRO is not incorporated as part of the structure at the time of the acquisition, it is often possible to reorganize and incorporate an NRO at a later time.[20]

C. Use of non-Canadian corporations as an acquisition vehicle

For the various reasons noted above, it has been considered *de rigueur* to use a Canadian acquisition vehicle when any foreign investor plans to acquire a Canadian target. However, in view, *inter alia*, of proposed corporate immigration/emigration rules which are expected to be enacted, with retroactive effect, in the near future,[21] assume the same example as used previously (Foreign Buyer intends to acquire Canadian Target at a cost of $ 100 million) but that, rather than establishing a Canadian-incorporated company as the acquisition vehicle, Foreign Buyer incorporates a holding company ("Forhold") in a country that does not have a treaty with Canada, ensuring that Forhold's central management and control (and therefore its residence under Canadian tax concepts) is in Canada. Foreign Buyer invests in treasury shares of Forhold, and Forhold uses the cash to acquire the shares of Canadian Target, so that the resulting corporate structure is as follows:



19. See, *inter alia*, the decision of the Supreme Court of Canada in *MNR v. T. E. McCool Limited* (49 DTC 700).
20. See in this regard the type of planning outlined in Income Tax Ruling ATR-43, dated 17 February 1992.
21. Sec. 128.1 et seq., included in Bill C-27, *supra* note 4.

© 1994 International Bureau of Fiscal Documentation

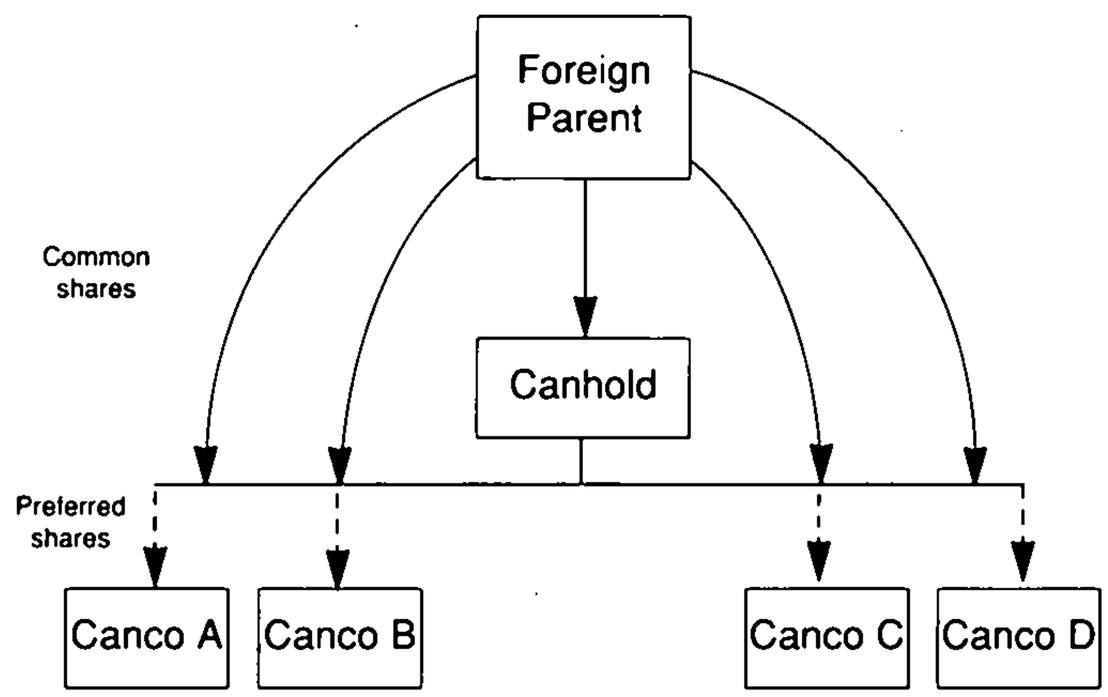
Forhold was incorporated in a non-tax treaty country, to ensure that the dual resident rule in the Act does not apply, which might otherwise deem Forhold to be a non-resident of Canada. Dividends from Canadian Target to Forhold should accordingly be eligible for the 100 percent, dividend-received deduction.[22] As is the case with a conventional Canadian acquisition vehicle, Forhold can now return amounts of up to $ 100 million to Foreign Buyer as statutory reductions of capital without adverse Canadian tax consequences. Assume, however, that a number of years go by, and that amounts significantly in excess of the original acquisition cost are paid as dividends from Canadian Target to Forhold. Forhold now moves its mind and management, and therefore its residence, out of Canada, taking its cash with it. As Forhold was not incorporated under the laws of Canada, its emigration does not result in any liability for branch tax under Part XIV or for dividend withholding tax (had Forhold been incorporated in Canada, secondary tax at rates of up to 25 percent would have applied when the company severed its connection with the Canadian tax jurisdiction, by continuance or otherwise). While the new corporate emigration rules will deem Forhold to have disposed of the shares of Canadian Target at fair market value immediately before the emigration,[23] it may be possible to mitigate or eliminate any adverse tax consequences if Canadian Target borrows an amount from a third party equal to the estimated increase in the value of its shares since the acquisition by Forhold, and then dividends the cash proceeds from the borrowing to Forhold prior to the emigration of the latter company.

D. The Canadian spider

In the past, multinationals have generally used a single Canadian acquisition vehicle, in situations where shares or assets of different Canadian targets are acquired from time-to-time. As noted above, consolidated tax reporting is not available in Canada and, as a result, consolidation must often be accomplished by merging or liquidating each target into the Canadian acquisition vehicle. In addition, the use of a single Canadian holding company has facilitated intercorporate financing arrangements, which have often been acceptable to the Canadian revenue authorities to shift profits and losses within a related Canadian group.[24]

This type of single structure can, however, result in an increased tax cost on a future divestment. If a foreign parent company sold shares of a Canadian company, any capital gain is potentially subject to Canadian tax at the normal 75 percent inclusion rate, but would often be treaty exempt. If, on the other hand, the Canadian company sells one of its divisions to a third-party, there will be income which will be taxed at a 100 percent inclusion rate (such as recaptured capital allowances on depreciable property, accrued inventory gains, etc.); in addition, dividend withholding tax will apply when the after-tax proceeds are paid to the foreign parent. Until very recently, it was often possible to eliminate the adverse consequences on a divestment where a single Canadian holding company had been put in place, by including a cross-border, divisive reorganization as part of the divestment planning. These planning opportunities have now effectively been eliminated by a proposed amendment to the Act.[25] This amendment has been modified and expanded by further proposed amendments, issued in the form of draft legislation together with the 22 February 1994 Federal Budget, which will curtail even more severely the use of divisive reorganizations in many situations involving a third-party acquisition of shares.

In view of the above recent developments, consideration might be given in future to using a series of Canadian acquisition vehicles as sister companies, with each acquisition vehicle holding a separate division. This may be particularly appropriate where the business operations have high growth potential, and where there is a greater opportunity for capital appreciation, than for revenue streams and dividend payments. Another alternative would be to continue to use a single Canadian holding company ("Canhold"), with Canhold holding a series of Canadian subsidiaries in which it has a preferred share investment equal to original acquisition cost, and with the foreign parent acquiring 100 percent of the nominal, common share interest of each underlying subsidiary at the time of its acquisition. This "Canadian spider" structure is illustrated below:



In the above structure, it should be possible to complete a divestment of a particular line-of-business, without the need for a divisive reorganization. Canhold would sell the preferred shares to a third party (which should have full tax basis, and which should also be represented by paid-up capital at the Canhold level). The foreign parent would sell the

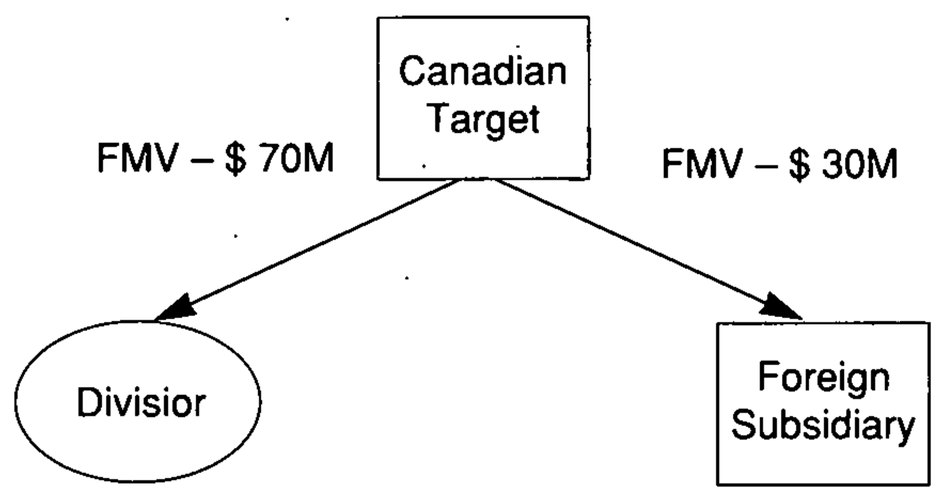
22. As Forhold was incorporated outside Canada, it is not a "Canadian corporation" as defined under the Act (notwithstanding that it is a resident of Canada), and therefore does have potential liability for Canadian branch tax under Part XIV with respect to the dividends received (para. 219(1)(a.1)), but only if the activities of Forhold are such that it is carrying on business in Canada; with proper planning, it should be possible to avoid this result.
23. Para. 128.1(4)(b) included in Bill C-27, *supra* note 4.
24. As in Income Tax Ruling ATR-44, dated 17 February 1992. It is understood, however, that Revenue Canada is reconsidering its administrative practice in this area in view, *inter alia*, of the recent decision of the Tax Court of Canada in *Mark Resources Inc. v. The Queen* (93 DTC 1004).
25. Subsec. 55(3.1) included in Bill C-27, *supra* note 4.

© 1994 International Bureau of Fiscal Documentation

common shares directly, and in many circumstances will be treaty exempt from Canadian tax.[26]

VII. RESTRUCTURING THE CORPORATE GROUP

There will be a number of situations (involving both friendly and hostile takeovers), where it will be desirable to restructure the Canadian corporate group as a result of a third-party acquisition. For example, assume that Canadian Target carries on active business operations in Canada through a division, and in addition owns 100 percent of a foreign subsidiary. The Canadian division has a fair market value of $ 70 million, while Foreign Subsidiary has a value of $ 30 million. The structure is therefore as follows:



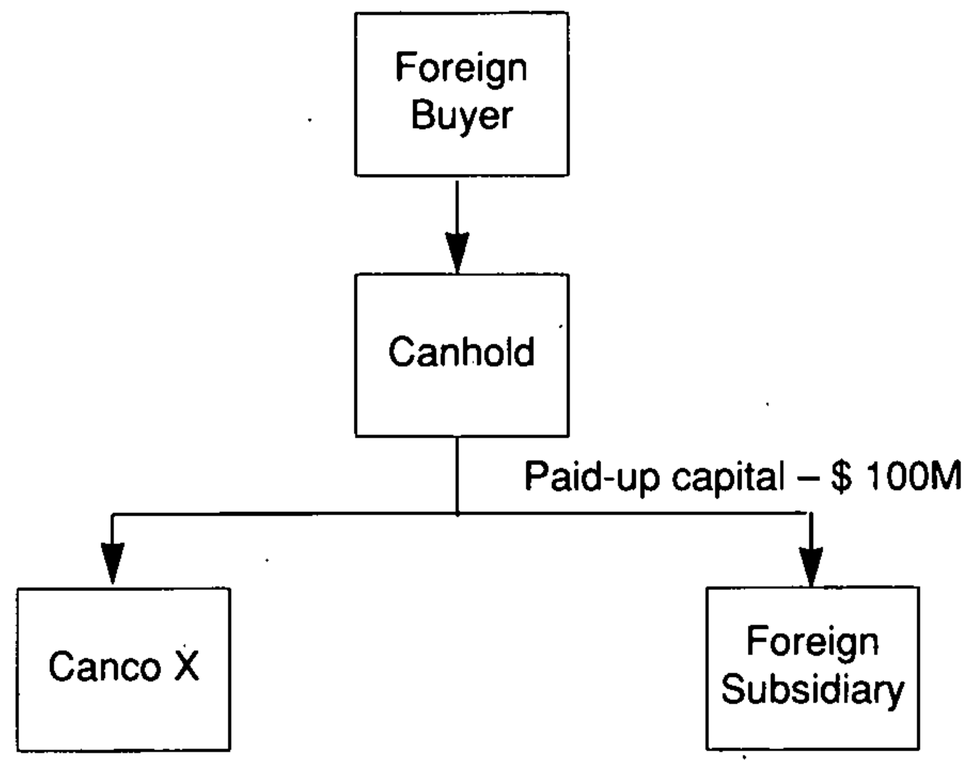
Foreign Buyer has agreed to acquire the shares of Canadian Target at a cost of $ 100 million, and would like to do so in the most tax-effective manner. In particular, it would be most appropriate if Foreign Subsidiary was held directly by the Foreign Buyer, to eliminate the double imposition of withholding taxes on dividend flows, etc.

The Act contains a limited step-up provision, whereby the tax basis of non-depreciable, capital property (such as shares of Canadian or foreign subsidiaries) may be increased from original cost to fair market value, following a liquidation of a Canadian parent company.[27]

In general terms (and subject to a number of restrictions and exceptions), where a taxable Canadian corporation liquidates into another taxable Canadian corporation that holds at least 90 percent of the issued shares of each class, the tax basis to the parent of each non-depreciable, capital property transferred to it on the liquidation may be increased from historical cost, to such amount as is designated not exceeding the fair market value of the property at the time the parent last acquired control of the subsidiary.

Having regard to the above, the following steps should be considered:

- As an initial step, Canadian Target incorporates a new, wholly-owned Canadian subsidiary ("Canco X"), to which it transfers the assets and operations of its Canadian division, on a basis that qualifies for non-recognition treatment in Canada.[28]
- Foreign Buyer incorporates a Canadian acquisition vehicle ("Canhold"), and invests in $ 100 million treasury shares of Canhold. Canhold uses the proceeds to purchase the shares of Canadian Target.
- After the acquisition, Canadian Target is liquidated into Canhold, and the Canadian tax basis of the shares of Canco X are increased to their fair market value of $ 70 million, using the liquidation step-up provisions. Similarly, the Canadian tax basis of the shares of the foreign subsidiary is increased to $ 30 million. The structure is now as follows:



Canhold can now sell the shares of Foreign Subsidiary to Foreign Buyer (or to another, appropriate subsidiary or affiliate of Foreign Buyer), with no capital gain for Canadian tax purposes, having regard to the step-up in tax basis which occurred on the liquidation. In addition, if Foreign Subsidiary is in a tax treaty country, and has accumulated exempt surplus balances *vis-à-vis* Canadian Target, there is an effective continuance of surplus balances on the liquidation of Canadian Target, so that the balances will now be maintained *vis-à-vis* Canhold, offering additional Canadian protection in the form of exempt surplus elections on the disposition of Foreign Subsidiary.[29] The sales proceeds of $ 30 million are now repatriated to Foreign Buyer without Canadian dividend withholding tax, using a statutory reduction of capital at the Canhold level.

26. An alternative would be to use a variation of "tracking" or "income access" shares at the Canhold level, whereby Foreign Parent would invest in a series of shares in Canhold, each series of which derive their value from the underlying value in a particular subsidiary owned by Canhold. This type of structure will, however, introduce a number of additional Canadian and foreign tax considerations.

27. Para. 88(1)(d).

28. The shares of Canco X will presumably constitute capital property, in accordance with Sec. 54.2 of the Act. Alternatively, it may be possible to elect capital treatment under subsec. 39(4) (subject to certain restrictions set out in subsec. 39(5)).

29. Reg. 5905(5)(c) to the Act. The Canadian foreign affiliate provisions are discussed in another article in this issue. However, for an analysis of the interaction between the exempt surplus and liquidation step-up provisions during the course of a corporate restructuring, see D. Kevin Dolan, Allan R. Lanthier, David W. Smith, and James J. Tobin, "Cross-Border Corporate Reorganizations", in Report of Proceedings of the 43rd Tax Conference, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), at 17:13-17:14.

© 1994 International Bureau of Fiscal Documentation

A second advantage to the above steps is that the shares of Canco X retain a Canadian tax basis of $ 70 million, reflecting the economic acquisition cost to Foreign Buyer. If Canadian Target and Canhold had merged by way of a statutory amalgamation (to which the step-up provisions do not apply), or if Canadian Target had not incorporated the Canadian division prior to the acquisition (so that the assets of the Canadian division, with the exception of non-depreciable capital property such as land, would not have qualified for the step-up on the liquidation of Canadian Target), tax basis equal to acquisition cost would be maintained in respect of the shares of Canhold held by Foreign Buyer, but would be eliminated (and would revert to historical tax basis) at the level of the assets held by Canhold. In the absence of the type of steps shown above, this elimination of tax basis can have significant, adverse results if the operations are subsequently disposed of (assuming that there are other business operations in Canhold, so that Foreign Buyer cannot sell the Canhold shares directly).

Caution should be exercised in utilizing the liquidation step-up provisions. The 22 February 1994 Federal Budget included a proposed amendment which would deny the liquidation step-up for property which would otherwise be eligible, but which is disposed of by the parent company as part of a series of transactions that includes the winding-up. This new restriction would apply where the property is acquired by any person that was a "specified shareholder" (not less than 10 percent of any class of shares) of the subsidiary before control of the subsidiary was acquired by the parent. While the provision is evidently designed to prevent taxpayers from circumventing the new restrictions against divisive reorganizations, by means of a series of transactions that effectively result in a sale of part of a target corporation's assets back to the original vendor, the proposed amendment as presently drafted is extremely broad, and can lead to inappropriate results in certain circumstances. It is understood that the Canadian Department of Finance intends to narrow the scope of the amendment, and that the revised version will allow for freer movement of property within the purchaser's group following an acquisition of control. Until the revised legislation has been released and reviewed, however, caution is in order.

VIII. FINANCING CONSIDERATIONS

A. Thin capitalization provisions

Having regard to the relatively high rates of corporate income tax that apply in Canada, it is often advantageous to leverage-up the Canadian acquisition vehicle with the largest possible amount of indebtedness. However, where the indebtedness is held by related non-resident persons, the Canadian thin capitalization rule of 3:1 must be respected.

In general terms, the thin capitalization rule provides that interest that would otherwise be deductible and which is paid by a corporation resident in Canada to a specified non-resident as defined, will be disallowed, where such indebtedness exceeds three times tax equity. For this purpose, a specified non-resident includes (a) a non-resident shareholder who, either alone or together with other persons with whom it does not deal at arm's length, owns 25 percent or more (votes or value) of the shares of the Canadian corporation, and (b) any non-residents that deal at non-arm's length with such shareholders. Tax equity is generally defined to be the aggregate of (i) retained earnings on an unconsolidated basis, (ii) any amounts of surplus contributed by a specified non-resident shareholder, and (iii) the corporation's paid-up capital, to the extent that the capital stock is owned by a specified non-resident shareholder.

If indebtedness owing to specified non-residents exceeds the prescribed limits, interest expense related to the excess is disallowed. Even if the debt is owing to a related, foreign party in a tax treaty country, competent authority relief is not generally available for this type of disallowance, and falling afoul of the rules therefore often results in double taxation. In addition, liability for Part XIII withholding tax is not reduced in respect of any amounts which may be disallowed to the payor under these provisions.

The use of a Canadian acquisition vehicle, described in some detail above, serves to maximize the extent to which the Canadian Target can be leveraged-up with related-party debt within the thin capitalization limitations, due to the fact that tax equity will include paid-up capital at the level of the Canadian acquisition vehicle. If, on the other hand, the Canadian Target had been acquired directly by Foreign Buyer, tax equity would generally have been restricted to the lower, historical amounts.

B. Withholding tax on interest payments

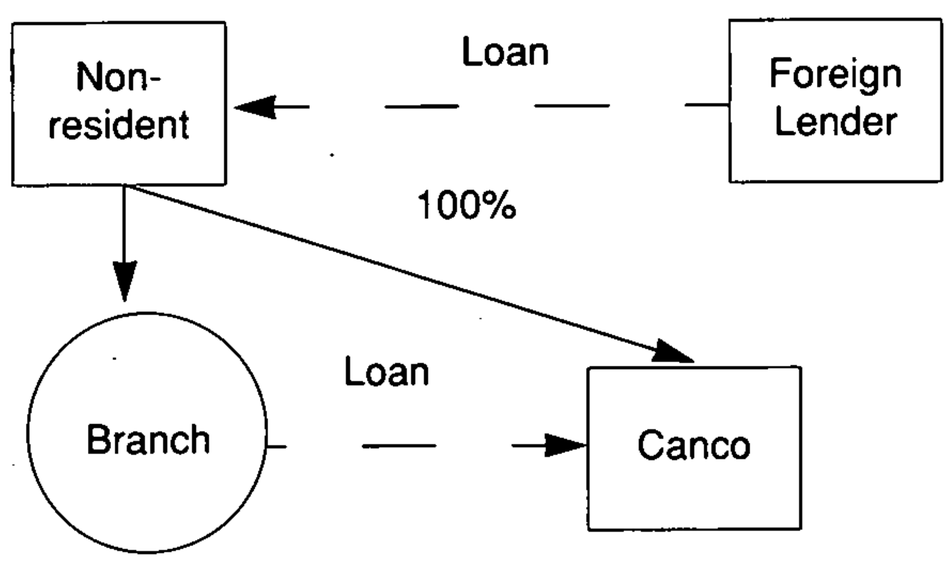
Non-residents of Canada are generally taxed at a flat rate of 25 percent (subject to treaty reduction) on the gross amount of interest income paid or credited by residents of Canada. However, the Act does provide for certain exemptions, perhaps the most important of which is the exemption for interest payable on prescribed long-term intercorporate indebtedness. Interest payments on such debt are generally exempt from Canadian withholding tax if they are payable to an unrelated party, and the Canadian debtor is not required under any circumstances (subject to certain, narrow exemptions) to repay more than 25 percent of the principal amount of the debt within five years from its date of issue. If the Foreign Buyer controls the Canadian Target (directly or indirectly) the exemption does not apply, even where a market rate of interest has been charged. In these circumstances, consideration might be given to a back-to-back arrangement with a foreign lender, whereby the Foreign Buyer would lend funds to the unrelated, foreign lender, and the foreign lender would on-lend to Canhold under terms that otherwise meet the 5-year/25 percent limitation. The thin capitalization provisions contain a specific back-to-back limitation, and the 3:1 ratio would have to be respected in this situation. Somewhat conspicuous by its absence, however, is any similar specific back-to-back rule within the withholding tax exemption. Notwithstanding the foregoing, there is an understanding between the Canadian revenue authorities and the Canadian

© 1994 International Bureau of Fiscal Documentation

Bankers' Association, whereby Canadian chartered banks have agreed that they will not knowingly enter into back-to-back arrangements for the avoidance of non-resident withholding tax. Reporting requirements have also been put in place to assist the Canadian authorities in monitoring compliance with these guidelines.

Having regard to the above, it is generally prudent to avoid transactions which involve back-to-back arrangements, including transactions which involve Foreign Buyer putting funds on deposit with an unrelated foreign lender, which then provides financing to Foreign Buyer's Canadian subsidiary. On the other hand, where the Canadian subsidiary borrows from an unrelated foreign lender within the 5/25 limitation, and Foreign Buyer merely guarantees the loan, exemption from withholding tax should be available.

There may be other methods for avoiding Part XIII tax in respect of interest paid to related non-residents. For example, consider the following:



In the above example, we assume that a non-resident owns 100 percent of an existing Canadian operating company ("Canco"). Canco has arranged for financing from an unrelated, foreign lender, but on terms and conditions that do not qualify for the 5/25 exemption. Rather than borrowing directly, Canco's non-resident parent therefore borrows from the foreign lender, and establishes a branch in Canada for the purpose, *inter alia*, of financing Canco. The financing activities are structured such that the non-resident parent is considered to be carrying on business in Canada through a permanent establishment. The Canadian tax results of the above structure can be summarized as follows:

- While Canco must respect the 3:1 thin capitalization provision, this provision only applies to payments by corporations resident in Canada, and the Canadian branch of the non-resident parent can therefore be highly-leveraged (for Canadian tax purposes, all of the funds borrowed by the non-resident from the foreign lender would presumably be attributed, under direct tracing, to its Canadian branch).
- Interest paid by Canco would not be subject to Part XIII withholding tax; rather, the branch activities of the non-resident parent would be taxable under Part I of the Act, and would also be subject to the Canadian branch tax provisions. This notwithstanding, taxable income in the branch should be minimal, assuming that it is highly-leveraged, and earns only a small spread on funds lent to Canco.
- While there are secondary or "second-tier" withholding tax provisions in Part XIII of the Act which must be considered (and which can apply to impose Part XIII withholding tax on certain payments by one non-resident to another), it should be possible to structure the transaction so that these provisions do not apply. In particular, the debt payable to the foreign lender by the non-resident parent should not be secured by Canadian real property, and the financing business of the non-resident parent should not be carried on principally in Canada.

IX. REPATRIATION OF EARNINGS

The type of structuring discussed above (and particularly the use of a Canadian acquisition vehicle) should allow amounts to be repatriated from Canada up to the original acquisition cost, before dividend withholding tax becomes an issue. However, in situations where the Canadian subsidiary (referred to in this section of the paper as "Canco") has accumulated substantial amounts of earnings subsequent to the acquisition, Canco's assets may be in excess of any ability to repatriate invested capital to Foreign Buyer. Some alternatives for dealing with these types of situations are outlined below.

A. Purchase of Canadian corporations with paid-up capital

One alternative to consider would be for Foreign Buyer to purchase an inactive Canadian company ("Lossco") with high historical paid-up capital and few assets (the paid-up capital being offset by an accounting deficit). Subsequent to the acquisition of Lossco from a third party at a negotiated price (which should be significantly less than the paid-up capital of Lossco), Foreign Buyer transfers Canco under Lossco, on a share-for-share exchange basis, but at fair market value, provided that any gain on the disposition of the shares of Canco would be treaty exempt. Assuming that, on the transfer, Lossco issues additional shares of the same class which are already outstanding, the identical property rules in the Act would average the Canadian tax basis between all outstanding Lossco shares. Foreign Buyer would therefore hold shares of Lossco having high historical paid-up capital, and also significant Canadian tax basis. Canco would then pay dividends to Lossco which are eligible for the 100 percent, dividend-received deduction (alternatively, Lossco and Canco could merge), and cash could be repatriated to the non-resident using statutory reductions of capital.

Prior to the introduction of the general anti-avoidance rule ("GAAR"), there was a specific anti-dividend stripping provision which would have applied to this transaction.[30] This provision was, however, repealed, coincident with the intro-

30. Subsec. 247(1), repealed by 1988, c. 55,S.187(1).

© 1994 International Bureau of Fiscal Documentation

duction of GAAR. The Canadian revenue authorities would no doubt take the position that GAAR applies to this type of planning. This notwithstanding, GAAR has yet to be tested in the courts, and it remains to be seen how wide or narrow an interpretation it will ultimately be given.

B. Purchase of low-growth assets

Another transaction to consider would be to have Canco purchase other assets held by Foreign Buyer, or by other non-resident companies in the group. While one typically looks for low-growth assets in these types of situations, caution must of course be exercised to ensure that the purchase price falls within the parameters of fair market value, and that Canco is not considered to have paid a constructive dividend to Foreign Buyer.

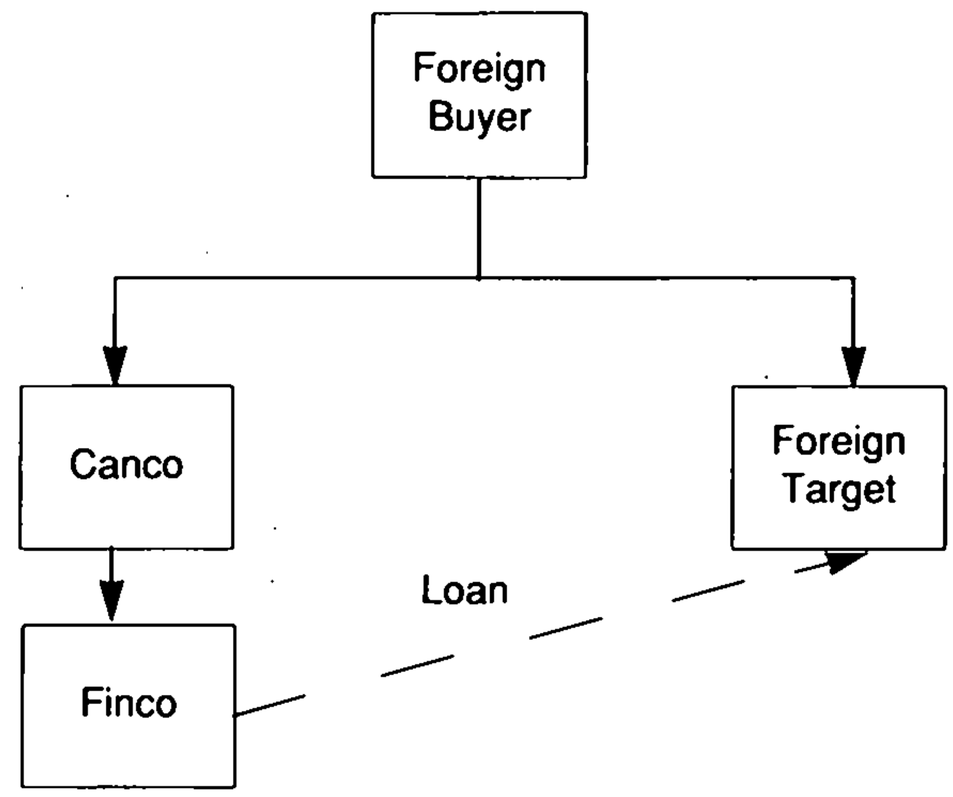
C. Purchase of foreign subsidiaries and/or preferred share cross-holdings

There may be particular benefits in having Canco acquire shares of a foreign subsidiary of Foreign Buyer, where the foreign subsidiary is resident and carrying on business in a tax treaty country, and qualifies for exempt surplus treatment in Canada. Provided that Canco acquires 10 percent or more of any class of shares of the foreign subsidiary, the foreign subsidiary will qualify as a "foreign affiliate" of Canco for Canadian tax purposes,[31] and Canco should be eligible for the 100 percent dividend-received deduction in respect of dividends from exempt surplus paid by the foreign subsidiary (irrespective of the rate of tax which the earnings have borne).

As a variation on the above, a preferred share, cross-holding should be considered. For example, Canco might invest in a new class of shares of the foreign subsidiary which would provide little growth potential and, provided that Canco acquired at least 10 percent of that particular class, the foreign corporation would again qualify as a "foreign affiliate" of Canco, providing potential Canadian tax benefits in respect of dividends which might ultimately be paid to it. The terms and conditions of the preferred shares, and the related valuation questions, will be critical, particularly considering possible shareholder benefit issues in Canada. These concerns will be minimized if the preferred shares are, for example voting, redeemable and retractable at their paid-in value, and have a cumulative dividend rate based on current yields for securities having a similar credit risk.[32]

D. Second-tier financing arrangements

As another example of planning which may effectively repatriate earnings from the Canadian tax jurisdiction, assume that Foreign Buyer again owns 100 percent of Canco, and that Foreign Buyer intends to acquire an operating company in a third country ("Foreign Target"). If Canco has excess cash or excess borrowing capacity, consideration might be given to a second-tier financing arrangement, whereby Canco incorporates a 100 percent-owned finance vehicle ("Finco") in an appropriate jurisdiction, with Finco (or Finco's offshore branch) then lending to the Foreign Target on an interest-bearing basis, respecting whatever foreign thin capitalization restrictions apply in Foreign Target's home country. Finco would be structured so that it bears a relatively low rate of tax on any interest income received – typically, from 5 to 7 percent. The general corporate structure would then be as follows:



Interest income received by Finco will, if properly structured, be exempt from the Canadian FAPI provisions, provided the interest expense is deductible against active business earnings in Foreign Target. Also, if Foreign Target and Finco are both in tax treaty jurisdictions, the interest income received would constitute exempt surplus in Finco, for purposes of ultimate dividend payments by Finco to Canco.

X. CONCLUDING COMMENTS

As can be seen from the above, there are a number of planning opportunities (including potential significant tax savings) when considering investment into Canada. Developments in recent years, including implementation of the Canada–US Free Trade Agreement and of NAFTA, have set in motion the process of increasing and further securing access to the North American market for Canadian goods and services. It is clear that cross-border trade and investment into Canada will continue to increase, as will opportunities for effective tax planning.

31. Draft legislation issued with the 22 February 1994 Canadian Federal Budget would extend the definition of "foreign affiliate" so that the 10% test would be based on shares held by Canco as well as by any person related to Canco.
32. In drafting the share conditions, it is important to consider subsecs. 258(3) to (5) of the Act, which can serve to recharacterize deductible dividend payments from foreign affiliates as taxable interest income under certain circumstances.

© 1994 International Bureau of Fiscal Documentation

TAXATION OF FOREIGN AFFILIATES

Ingrid Sapona, J.D.

The author would like to thank David J. Thompson of McCarthy Tétrault, London, Ontario, for his insightful comments.

I. INTRODUCTION

Canada, like many other western governments, is faced with a tremendous deficit (estimated to be $ 45.7 billion for 1993-94).[1] Consequently, the government is continually looking for ways of increasing revenue. But, because of the political unpopularity of raising taxes, as well as the economic reality that tax increases do not necessarily yield increased revenues, the government increasingly is focusing its attention on stopping perceived abuses of the tax system. One area of Canada's tax system that has come under strict scrutiny the past couple of years has been the rules relating to the tax treatment of income from foreign affiliates of Canadian companies.

Canada's Auditor General is charged with calling to the House of Commons' attention anything he perceives as a threat to the integrity of Canada's tax base.[2] The Auditor General made headlines in the spring of 1992 when, as part of his 1992 Annual Report (the "Auditor General's Report"), he announced that tax arrangements for foreign affiliates are costing Canada hundreds of millions of dollars in lost tax revenues.[3] While the Auditor General's Report itself was newsworthy, the Department of Finance's basic rejection of the Auditor General's conclusions (the Department of Finance Response) opened the door to full political scrutiny of the issue.[4]

The House of Commons' Standing Committee on Public Accounts took up the issue, holding public hearings and issuing its own report (the "Public Accounts Committee Report"), which contained a number of specific suggestions concerning reform of Canada's tax treatment of controlled foreign affiliates.[5] In response to the Public Accounts Committee's Report, as part of the 1994 Federal Budget (the "Budget") the Minister of Finance announced "measures to prevent Canadian-based companies from using foreign affiliates to avoid paying Canadian taxes".[6] The changes announced are the most significant changes to this area of taxation since the 1972 tax reform.

This article will focus on the taxation of income flowing to Canadian corporations[7] from activities of foreign corporations, i.e. corporations not resident in Canada for purposes of the Income Tax Act (Canada) (the "Act"), R.S.C. 1985, 5th Supp., as amended, in which they own an interest. The taxation of foreign income of individuals will be mentioned in passing, but will not be discussed in detail. The article will first outline Canada's current tax treatment of "foreign affiliates", then the Auditor General's Report and recommendations of the Public Accounts Committee will be discussed. The last section will discuss changes proposed in the 1994 Budget and the 23 June 1994 Revised Draft Legislation.

II. CANADA'S CURRENT TAX TREATMENT OF FOREIGN AFFILIATES

A. History

Canada's current tax treatment of income from foreign affiliates dates back to 1972's sweeping tax reform. Prior to implementation of the 1972 tax reform changes,[8] if a Canadian company owned 25 percent of the voting shares of a foreign corporation, regardless of the source or nature of the foreign corporation's income, dividends the Canadian company received from that foreign corporation were tax-free.[9]

As part of its 1972 tax reform, Canada introduced rules regarding the taxation of passive income of foreign-controlled corporations (the taxation of "foreign accrual property income" ("FAPI")) and special rules applicable to dividends received by Canadian corporations from foreign corporations depending on the type and source of the foreign corporation's income (the so-called "foreign affiliate rules"). The changes in the Canadian system, which paralleled changes made by other countries (most notably the United States), were a response to the perception that controlled for-

1. Department of Finance (Canada), 1994 Federal Budget Speech, 22 February 1994, at 2 (hereinafter "1994 Budget Speech").
2. Auditor General Act, R.S.C. 1985, Ch. A-17, Sec. 7.
3. 1992 Report of the Auditor General of Canada, at 46.
4. *Id.* at 51-55.
5. The 13th Report of the Standing Committee on Public Accounts, House of Commons, Issue No. 48, 20 and 22 April 1993 (hereinafter "Committee Report").
6. See 1994 Budget Speech *supra* note 1, at 16.
7. "Canadian corporation" is defined in subsec. 89(1)(a) of the Income Tax Act (Canada), R.S.C. 1985, 5th Supp., as amended as a corporation resident in Canada that was incorporated in Canada or that has been resident in Canada continually since 18 June 1971. Pursuant to para. 250(4)(a), a corporation will be deemed resident in Canada if it was incorporated in Canada after 27 April 1965 or, if incorporated before 27 April 1965 it has carried on business in Canada since then. Also, a corporation may be considered resident in Canada based on the common law test for residence, which looks to the corporation's central management and control to determine the corporation's residence. For a brief discussion of how residency of a corporation for income tax purposes is determined, see Arnold, B.J., "The Taxation of Controlled Foreign Corporations: An International Comparison", Canadian Tax Paper No. 78 (Canadian Tax Foundation 1986), at 151-152 (hereinafter "Arnold").
8. With respect to the tax reform changes applicable to the taxation of foreign affiliates, most changes did not take effect until 1976. See Income Tax Application Rules, Statutes of Canada, 1970-71-72, Ch. 63, as amended Sec. 35.
9. See Dancey, K.J., Friesen, R.A. and Timbrell, D.Y., *The Canadian Taxation of Foreign Affiliates*, 4th ed. (Commerce Clearing House Canadian Limited, 1986), at 1 (hereinafter referred to as "Dancey").

© 1994 International Bureau of Fiscal Documentation

eign corporations established in tax havens were increasingly being used to avoid Canadian tax.

B. Background

Because Canada taxes residents on a worldwide basis, residents must pay Canadian tax on foreign-source income, including income from carrying on business outside Canada, investment income earned outside Canada and capital gains from the disposition of property outside Canada. (In calculating Canadian tax payable, however, residents are allowed a deduction or tax credit for the foreign tax on foreign-source income.) Non-residents are taxable only on income earned in Canada.

An important exception to the principle of worldwide taxation applies to the taxation of foreign-source income earned by certain foreign corporations owned by Canadian residents. Because a foreign corporation is considered a separate entity and is not considered resident in Canada for income tax purposes, even if it is controlled by a Canadian resident,[10] the income earned by the foreign corporation is generally not subject to taxation in Canada until it is repatriated to Canada, e.g. by payment of a dividend to Canadian resident shareholders. Consequently, Canadian tax can be deferred by simply not repatriating the income. The incentive to defer tax is especially attractive in situations where tax rates in the foreign country are substantially lower than those applicable in Canada. While deferral of current Canadian tax has always been a possibility, its significance in terms of lost tax revenue has become magnified since World War II, as foreign investment by Canadians has increased significantly.[11] Special rules have been developed to discourage such deferral, while trying not to discriminate against foreign investment. Indeed, the policy objectives behind the system for taxing foreign corporations controlled by Canadian residents have been succinctly summed up by Brian J. Arnold as follows:

> The legislation is designed to prevent the avoidance of domestic taxation through the diversion of income from domestic sources to controlled foreign corporations established in tax haven countries, and to prevent the accumulation of such income in such corporations. At the same time, the legislation is intended not to interfere, in any detrimental way, with the ability of domestic taxpayers to compete in genuine or legitimate business activities in international markets.[12]

While there are a number of ways of dealing with such deferral,[13] the system Canada has adopted includes both an exemption system, whereby dividends paid by controlled foreign affiliates out of certain types of income are completely exempt from Canadian taxation, and a tax credit system, whereby foreign taxes paid on foreign-source income reduce domestic taxes payable on a dollar-for-dollar basis.[14] In addition, there are special rules whereby a *pro rata* share of the passive income earned by certain foreign corporations is subject to tax in Canada on an annual basis, regardless of whether it is distributed. The rationale for treating passive income earned by certain foreign corporations differently than active business income reflects the general preference for encouraging activities that create active business income over activities that yield passive income, e.g. Canada's preferential tax rate on income from manufacturing and processing activities.

C. Definitions

Before considering the details of how Canadian residents are taxed on income earned by foreign corporations in which they are shareholders, it is helpful to define certain terms that will be used in the discussion that follows.

A "foreign affiliate" is a foreign corporation in which a Canadian resident owns directly or indirectly 10 percent or more of the shares of any class of the foreign corporation.[15] To apply this definition it is necessary to first determine whether the foreign entity is in fact a corporation. As a guideline, Revenue Canada considers a foreign entity a corporation if it has legal personality and existence separate and distinct from the personality and existence of its owners or creators.[16] Revenue Canada has issued a list of entities that it considers to be corporations for purposes of determining whether a foreign entity is a foreign affiliate for purposes of the Act.[17] It should be noted that the shares owned need not be voting shares, and income bonds or debentures issued by the foreign corporation can be deemed to be a share if the foreign corporation is not entitled to deduct the interest paid on the bond or debenture under the tax rules of its home country.[18] Also, the right to acquire shares may be treated as ownership of the shares in certain situations.[19]

A "controlled foreign affiliate" of a taxpayer is a foreign affiliate that is controlled directly or indirectly by: (i) the Canadian resident taxpayer, (ii) the Canadian resident taxpayer and not more than four other persons resident in Canada, or (iii) by a related group of persons, of which the Canadian resident taxpayer is a member.[20] Because of the threshold requirement, the Canadian resident must own at least 10 percent of the shares of one class of the foreign corporation in order to be considered a controlled foreign affiliate. The Act does not contain a definition of "control" specifically for purposes of the foreign affiliate rules, but a right to elect a majority of the corporation's directors is generally considered to constitute control of a corporation.[21]

10. See Arnold *supra* note 7, at 165.
11. *Id.* at 23.
12. *Id* at 134.
13. *Id.* at 83-112, for a discussion of various ways of dealing with this type of deferral.
14. *Id.* at 76.
15. Para. 95(1)(d) read in conjunction with subsec. 95(4) definition of equity percentage.
16. Interpretation Bulletin IT-343R at para. 2.
17. *Id.* at para. 3.
18. Subsec. 95(5).
19. Subsec. 95(6).
20. Subsec. 95(1) definition of controlled foreign affiliate.
21. See Dancey *supra* note 9, at 99.

© 1994 International Bureau of Fiscal Documentation

D. Tax treatment of dividends from foreign affiliates

As part of Canada's integration mechanism, Canadian resident individuals that receive dividends from corporations resident in Canada must gross up the dividend by 25 percent and include the grossed-up amount in their income.[22] However, individuals are then entitled to a tax credit of 2/3 of the grossed-up amount.[23] (Provincial personal income tax systems generally provide an effective tax credit of approximately a further 1/3 of the gross up.) Dividends received by a Canadian resident corporation from other Canadian resident corporations are basically received tax-free (though certain dividends received by private Canadian corporations are subjected to a refundable tax).[24] Under the so-called "foreign affiliate rules", dividends received by Canadian residents from foreign affiliates are treated differently than dividends received from corporations resident in Canada.

1. Dividends from portfolio investments

The tax treatment of dividends from a foreign corporation on a "portfolio investment", i.e. ownership of less than 10 percent of the shares of any class, is the same regardless of whether the recipient is an individual or a corporation: the amount of the dividend is included in income.[25] For individuals, therefore, dividends received on portfolio investments in foreign corporations are subject to tax at the applicable personal rates without the gross-up and tax credit mechanism attributable to Canadian-source dividends. For corporations, dividends received from portfolio investments in foreign corporations are subject to tax at the basic corporate rate. There is no tax credit available to the Canadian resident with respect to any underlying foreign taxes paid by the foreign corporation. The Canadian resident taxpayer can claim a tax credit for foreign withholding taxes on the dividend.[26] In the case of an individual, the amount of the foreign tax credit is limited to foreign withholding taxes up to 15 percent of the amount of the dividend, but foreign withholding taxes that exceed 15 percent may be claimed as a deduction.[27] Canadian corporations have the option of deducting all or part of the withholding taxes.[28]

2. Dividends from foreign affiliates

The tax treatment of a dividend from a foreign affiliate is dependant upon whether the recipient is an individual or a corporation. Dividends received from a foreign affiliate by a Canadian resident individual are included in income and subject to the same foreign tax credit mechanism applicable to portfolio investments in foreign corporations. However, the tax treatment of dividends received by Canadian resident corporations from a foreign affiliate is more generous. The tax treatment of such dividends depends on the nature of the income from which the dividend is deemed paid out of, and such income can be exempt from tax or can entitle the Canadian corporation to a credit for the underlying foreign taxes paid.

Dividends received by Canadian resident corporations from foreign affiliates are included in the corporation's income.[29] However, to the extent the dividend is considered paid out of the foreign affiliate's "exempt surplus", the corporation may deduct the amount of the dividend.[30] To the extent a dividend paid by a foreign affiliate is considered paid out of the foreign affiliate's "taxable surplus", the Canadian resident corporation must include the dividend in income but can claim a deduction for underlying foreign taxes paid by the foreign affiliate on the income and any foreign withholding taxes paid on the dividend.[31] If the dividend paid by a foreign affiliate exceeds the amount of its exempt surplus and its taxable surplus, the dividend is considered paid out of "pre-acquisition surplus". The portion of the dividend paid out of pre-acquisition surplus can be deducted from the Canadian corporation's income,[32] but the adjusted cost base of the shares of the foreign affiliate must be reduced.[33] A dividend is deemed to first be paid out of the foreign affiliate's exempt surplus, then out of its taxable surplus and finally out of its pre-acquisition surplus.[34]

The explanations of the calculation of various surplus accounts, as well as calculation of underlying foreign taxes, have been greatly simplified in the following discussion. Numerous complications can arise. For example, when the foreign affiliate is part of a foreign group that calculates income on a consolidated basis, because Canada taxes corporations on an unconsolidated basis, it will be necessary to separately allocate the income to the individual foreign affiliates. Because a detailed discussion of all the complications is beyond the scope of this article, professional advice should be obtained.

3. Exempt surplus

Exempt surplus[35] of a foreign corporation basically consists of "exempt earnings"[36] and dividends received by the foreign corporation out of the exempt surplus of other foreign affiliates[37] plus taxable dividends received by it from taxable Canadian corporations that would have been deductible if received by the Canadian resident corporation directly.[38] Exempt surplus is a defined term that basically consists of active business income earned by the foreign affiliate in certain listed countries,[39] as well as certain capital gains.[40] Exempt surplus is reduced by (among other things) the for-

22. Subsec. S.82(1).
23. Sec. 121.
24. Sec. 112 and Part IV Tax. For a general discussion of Part IV tax, see Dancey *supra* note 9, at Ch. 12.
25. Sec. 90.
26. Subsec. 126(1).
27. Subsec. 20(11).
28. Subsec. 20(12).
29. Subsec. 90(1).
30. Para. 113(1)(a).
31. Paras. 113(1)(b) and 113(1)(c).
32. Para. 113(1)(d).
33. Subsec. 92(2).
34. Reg. 5901(1).
35. Reg. 5907(1)(d).
36. Reg. 5907(1)(d)(v).
37. Reg. 5907(1)(d)(vi).
38. Reg. S.5907(1)(d)(vii).
39. Reg. 5907(1)(b)(iv).
40. Reg. 5907(1)(b)(i). For a discussion of the capital gains that are included in exempt surplus, see Dancey *supra* note 9, at 21-22.

© 1994 International Bureau of Fiscal Documentation

eign affiliate's exempt losses;[41] income or profits taxes paid by it on dividends received by it out of the exempt surplus of any other affiliate;[42] income or profits taxes paid by the affiliate on dividends received from a corporation taxable in Canada[43] and dividends deemed to have been paid out of its exempt surplus.[44] An "exempt deficit" arises when deductions from exempt surplus exceed inclusions.[45]

What constitutes active business income earned by a foreign affiliate is not specified in the Act, and few cases have discussed the issue. The Regulations to the Income Tax Act (the "Regulations") do specify, however, that a foreign affiliate will only be considered to have active business income in a listed country if it is considered to have a permanent establishment in that country.[46] The Regulations spell out how to calculate earnings of a foreign affiliate for an active business.[47] Historically, practitioners have tended to apply the test developed in case law for the purposes of determining what constitutes active business income for purpose of the small business deduction.[48] As Arnold points out, for purposes of applying the small business deduction, "almost any income earned by a corporation, other than amounts that are clearly passive income from property, constitutes active business income".[49] The countries "listed" are generally those with which Canada has a tax treaty, though there are some "tax haven" countries on the list with which Canada does not have a treaty.[50] Capital gains derived by the foreign affiliate from the disposition of property used or held for the purpose of earning active business income in a listed country are included (in full) in exempt surplus.[51] No foreign tax credit is available to the Canadian resident for any withholding tax paid on a dividend from a foreign affiliate that is paid out of its exempt surplus.[52]

4. Taxable surplus

In contrast to dividends from exempt surplus, dividends from taxable surplus are not exempt from tax, but they do receive favourable treatment since a Canadian resident corporation is entitled to deduct the underlying foreign income taxes paid by the foreign affiliate, as well as any foreign withholding taxes paid on the dividends.[53]

Taxable surplus[54] of a foreign affiliate is basically the aggregate of its "taxable earnings"[55] and dividends received out of the taxable surplus of other foreign affiliates.[56] "Taxable earnings" consist of: (1) the active business income earned by the foreign affiliate in unlisted countries net of income or profits tax paid in respect of earning the income;[57] (2) its passive investment-type income (FAPI) net of income or profits tax paid in respect of the FAPI;[58] and (3) certain capital gains.[59]

Taxable surplus is reduced by the foreign affiliate's taxable losses,[60] income or profits taxes paid by the affiliate on dividends received by the affiliate from the taxable surplus of another foreign affiliate of the taxpayer[61] and dividends deemed paid by the foreign affiliate out of its taxable surplus.[62] A taxable deficit exists if the amounts deducted from taxable surplus exceed the amounts included.[63]

Dividends received by a Canadian corporation out of a foreign affiliate's taxable surplus are included in the Canadian corporation's income.[64] If the foreign affiliate paying the dividend out of its taxable surplus is a controlled foreign affiliate, then, to the extent the dividend represents FAPI that was previously included in the Canadian corporation's income, to avoid double taxation, the dividend is reduced by the amount already included in the Canadian corporation's FAPI.[65] Canadian corporations that receive a dividend out of an affiliate's taxable surplus are allowed deductions in respect of foreign income taxes paid by the foreign affiliate[66] and foreign withholding taxes paid on the dividends.[67] The deductions from income for foreign taxes paid by the affiliate in respect of dividends out of taxable surplus are calculated by formulae. The end results of application of the formula are the same as an indirect foreign tax credit, i.e. it is as though the Canadian tax were levied on the gross amount paid out of the taxable surplus and a credit were allowed for any foreign tax paid on that amount.[68] To determine the deductions for foreign taxes related to dividends paid out of taxable surplus (the so-called underlying foreign tax), the foreign affiliate must allocate the foreign taxes it pays between taxable surplus and other

41. Reg. 5907(1)(d)(ix).
42. Reg. 5908(1)(d)(x).
43. *Id.*
44. Reg. 5907(1)(d)(xi).
45. Regs. 5907(1)(d)(xiii) and (xiv).
46. Reg. 5906.
47. Regs. 5907(1)(a) and 5907(2); see also Dancey *supra* note 9, at Ch. 6.
48. The small business deduction is a tax credit available to certain domestic corporations in respect of certain domestic income.
49. See Arnold *supra* note 7, at 533.
50. The list can be found in Reg. 5907(11). According to the Auditor General, an example of a tax haven country with which Canada has a treaty is Barbados. See Auditor General's Report, *supra* note 3, at 47.
51. Reg. 5907(1)(b).
52. Para. 126(1)(a).
53. Paras. 113(1)(b) and 113(1)(c).
54. Reg. 5907(1)(k).
55. Reg. 5907(1)(i).
56. Reg. 5907(1)(f)(iii).
57. Regs. 5907(1)(i)(ii)(A) and 5907(1)(f)(i).
58. Reg. 5907(1)(i)(ii)(B).
59. Basically taxable capital gains from the disposition of assets used in carrying on an active business in an unlisted country, net of tax paid (Reg. 5907(i)(ii)(D)), read in conjunction with the definition of net earnings in Reg. 5907(1)(f)(iii) and taxable capital gains derived from the disposition of shares of another foreign affiliate of the Canadian corporation, net of any tax paid by the affiliate with respect to the gain (Reg. 5907(i)(ii)(E)) read in conjunction with the definition of net earnings in Reg. 5907(1)(f)(iv).
60. Taxable losses include the foreign affiliate's net loss of the year from an active business carried on by it in an unlisted country (Reg. 5907(1)(j)(ii)(A)), the affiliate's net loss in respect of FAPI (Reg. 5907(1)(j)(ii)(B)), its net loss on dispositions of property used or held principally for the purpose of gaining or producing income from an active business carried on in an unlisted country (Reg. 5907(1)(j)(ii)(C)) and net losses on the disposition of shares of another foreign affiliate of the Canadian corporation that were excluded property of the affiliate (Reg. 5907(1)(j)(ii)(D)).
61. Reg. 5907(1)(k)(ix).
62. Reg. 5907(1)(k)(x).
63. Reg. 5907(1)(k)(xii) and (xiii).
64. Sec. 90.
65. Subsec. 91(5).
66. Para. 113(1)(b).
67. Para. 113(1)(c).
68. See Arnold *supra* note 7, at 537-538; see also Dancey *supra* note 9, at 48-49.

© 1994 International Bureau of Fiscal Documentation

amounts. The tracking of underlying foreign tax can be complicated.[69] The underlying foreign tax is allocated to dividends based on the proportion the dividend is to the total taxable surplus.[70]

5. Pre-acquisition surplus

Pre-acquisition surplus, unlike exempt surplus and taxable surplus, is not specifically defined in the Regulations. Pre-acquisition surplus is simply a notional surplus account designed to deal with distributions that exceed a foreign affiliate's exempt or taxable surplus. Canadian corporations that receive dividends paid out of a foreign affiliate's pre-acquisition surplus can deduct the amount of the dividend.[71] However, the adjusted cost base of a share of a foreign affiliate is also reduced to the extent a dividend is paid out of pre-acquisition surplus.[72] Thus, dividends from pre-acquisition surplus are treated, effectively, as a return of capital or a return of retained earnings of a foreign affiliate at the time of acquisition.

E. Tax treatment of the disposition of shares of foreign affiliates

When a Canadian resident corporation sells its shares of a foreign affiliate, the Canadian corporation will generally have a capital gain (or loss) that must be included in its income for Canadian purposes. However, a Canadian resident corporation that disposes of shares of a foreign affiliate can elect[73] to treat all or a part of the proceeds of disposition as a dividend paid by the affiliate. To the extent the foreign affiliate has exempt surplus, the corporation will be able to fully deduct the deemed dividend; to the extent the affiliate has taxable surplus, the Canadian corporation will be entitled to the deductions for foreign taxes paid. If less than all of the outstanding shares of a foreign affiliate are being disposed of then the amount deemed to be paid out of the foreign affiliate's exempt surplus and taxable surplus is the *pro rata* proportion of those accounts that relate to the shares being disposed of.[74] The result of this election is to permit Canadian corporations to convert what would otherwise be a capital gain into a dividend.[75] (And, since it is simply a deemed dividend, no withholding tax will be exigible so the Canadian corporation has an additional benefit.)

If a foreign affiliate (FA1) of a Canadian corporation disposes of shares it owns in another foreign affiliate (FA2) of the Canadian resident corporation that are excluded property, then the Canadian corporation is deemed to have made an election[76] to treat proceeds of disposition as a deemed dividend. The amount of the deemed dividend will be the lesser of[77] the capital gain and the "net surplus", which is basically the sum of the foreign affiliate's exempt and taxable surplus.[78] This has the effect of forcing taxable surplus up from FA2 to FA1, and prevents FA1 from creating excessive exempt surplus on the disposition. As will be discussed below, shares of FA2 are excluded property basically if greater than 90 percent of FA2's property consists of property used or held principally for the purpose of earning income from an active business.[79] Where the shares of FA2 disposed of are not excluded property there is no deemed election and any taxable capital gain constitutes FAPI.[80] However, FA1 can still elect to treat the proceeds of its shares of FA2 as a dividend. If FA1 so elects, then FA1's tax accounts will be increased by the amount that is deemed to have been paid out of each account, i.e. if the dividend is deemed to have been paid out of FA2's exempt surplus then FA1's exempt surplus will be increased. Also, by electing, FA1 reduces the FAPI that would otherwise arise on the disposition.[81]

Because the election is generally optional (and the taxpayer can choose the amount to be elected), to the extent the deemed dividend is out of taxable surplus, the Canadian corporation will not make the election unless the total tax on the dividend is less than the tax that would be exigible on the capital gain. To make the election, the Canadian corporation must file a special form (T2107) with its annual tax return for the year in which the disposition took place,[82] though a special provision does permit a late filed election (subject to a penalty) within three years of the time when the election should have been filed.[83]

If a Canadian corporation has a capital loss on the disposition of shares of a foreign affiliate, the loss must be reduced[84] by the amount of "exempt dividends", i.e. amounts deductible by the Canadian corporation for dividends paid out of exempt surplus, as well as the deductions permitted for underlying foreign taxes and foreign withholding taxes where the dividend was paid out of taxable surplus.[85] If a foreign affiliate (FA1) disposes of shares of another foreign affiliate (FA2) and has a capital loss on the disposition then the capital loss is reduced by all dividends except those deemed paid out of FA2's pre-acquisition surplus minus withholding or income taxes paid by FA1 on those dividends.[86]

F. Tax treatment of foreign accrual property income ("FAPI")

Canada, like many other countries, taxes resident corporations on their *pro rata* share of undistributed passive income earned by certain controlled foreign affiliates. As a practical

69. For a discussion of underlying foreign tax, see Dancey *supra* note 9, at Ch. 8.
70. Reg. 5907(1)(m)(i).
71. Para. 113(1)(d).
72. Subsec. 92(2).
73. Subsec. 93(1).
74. Reg. 5902(1)(b) and (c); see also Dancey *supra* note 9, at 81-82.
75. For a discussion of the rationale behind this election, see Arnold *supra* note 7, at 542-544.
76. Subsec. 93(1.1).
77. Reg. 5902(6).
78. Reg. 5902(6)(b) read in conjunction with Reg. 5907(1)(h).
79. Subsec. 95(1) definition of excluded property.
80. Subsec. 95(1) definition of foreign accrual property income, specifically item B in the formula.
81. See Dancey *supra* note 9, at 79.
82. Reg. 5902(5).
83. Subsec. 93(5) permits the late filed election; subsec. 93(6) sets forth the amount of the penalty.
84. Subsec. 93(2).
85. Para. 93(3)(a).
86. Para. 93(3)(b). For a discussion of the limitation of the capital loss available on the disposition of shares of a foreign affiliate see Dancey *supra* note 9, at Ch. 11.

© 1994 International Bureau of Fiscal Documentation

matter, it is necessary to limit the application of the FAPI rules to controlled foreign affiliates so that the shareholders are in a position to ensure that the foreign corporation distributes income so that the shareholders have sufficient resources to pay the tax. The FAPI rules, according to Arnold, are essentially anti-avoidance rules intended to prevent the diversion and accumulation of passive income offshore while not interfering with the ability of Canadian corporations to compete in legitimate business activities offshore.[87]

While the theoretical operation of the FAPI rules is fairly straightforward, like the foreign affiliate rules, the legislation implementing the rules is complex and places a significant compliance problem on taxpayers.[88] The discussion herein is intended as an overview only.

1. What constitutes FAPI

The FAPI of a foreign affiliate basically consists of income of the foreign affiliate derived from property and business, other than active businesses, as well as certain taxable capital gains derived by the foreign affiliate.[89] As noted, the concept of active business income is not defined for purposes of the rules applicable to foreign affiliates, so determination must be made on a case-by-case basis.[90] However, certain income that might otherwise *not* be considered active business income will be included in active business and therefore not constitute FAPI. For example, income that "pertains to or is incident to active business" is specifically considered income from an active business of a foreign affiliate.[91] This provision appears to broaden the base so that, as one authority put it, "...income from investments that are connected with or are within the sphere of an active business is to be treated as active business income" and therefore excluded from FAPI.[92] Also specifically included in active business income are amounts paid to a controlled foreign affiliate by another foreign affiliate, or a non-arm's length non-resident corporation, if the paying corporation can deduct the payment under foreign tax law in computing under the Regulations its own earnings from an active business.[93]

The taxable capital gains of a foreign affiliate that are included in FAPI are basically defined as those taxable capital gains other than gains from the disposition of certain "excluded property". As noted above, excluded property is basically property of a foreign affiliate used or held principally for the purpose of producing income from an active business as well as shares of another foreign affiliate where more than 90 percent of that other foreign affiliate's property is excluded property.[94] In other words, to the extent a foreign affiliate has a taxable capital gain on excluded property, that gain will not be included in FAPI. Special rules apply to capital gains derived when the disposition occurs as a result of a reorganization of foreign affiliates.[95] For purposes of the FAPI rules, the taxable capital gains and losses of a foreign affiliate are to be determined in accordance with Canadian rules.[96]

The Act also deems certain income to be income from a business other than an active business, and therefore includible in FAPI. Income derived from certain services is included in a foreign affiliate's FAPI. For example, where a controlled foreign affiliate charges for services and that amount is deductible in computing income from a business carried on in Canada by a person that the foreign affiliate is a controlled foreign affiliate of, or by a person who is related to such a person, that amount will be deemed to be income from a business other than an active business.[97] Therefore, such amounts are included in FAPI. This provision effectively removes any tax incentive a Canadian corporation may have had to set up a subsidiary in a low tax jurisdiction that would provide services to the Canadian corporation, since the subsidiary's profits from such a service business is FAPI. Similarly, service income of a foreign affiliate where the services are performed by an individual resident in Canada that controls the affiliate, or is a member of a group that controls the affiliate, is deemed income from a business other than an active business and therefore FAPI.[98] The purpose of this provision is to make it unattractive for an individual, e.g. an athlete or consultant, to establish a foreign affiliate in a low tax jurisdiction and provide personal services through that offshore corporation. The services to which the deeming provisions apply specifically include the insurance of Canadian risks, but excludes the transportation of persons or goods and services relating to the purchase or resale of goods.[99]

A foreign affiliate's FAPI is reduced by losses for the year from property and businesses other than active business losses as well as losses from active businesses.[100] To the extent such losses exceed amounts included in FAPI, the losses can be carried forward five years and used to reduce FAPI of subsequent years.[101]

2. Specific exclusions from FAPI

Certain amounts are specifically excluded from FAPI, for example, dividends received from other foreign affiliates,[102] taxable dividends received by the foreign affiliate from a Canadian corporation if the dividend would be eligible for the intercorporate dividend deduction if it had been received by the Canadian resident;[103] and certain taxable capital gains.[104] It makes sense to exclude dividends received from another foreign affiliate because such dividends are subject to the foreign affiliate rules. As well, it makes sense to exclude the other dividends from FAPI because if they had been

87. See Arnold *supra* note 7, at 166.
88. *Id.*
89. Subsec. 95(1) definition of foreign accrual property income.
90. *King George Hotels Ltd. v. The Queen*, (1981) CTC 87, 1981 DTC 5082 (FCA).
91. See e.g. subpara. 95(2)(a)(i).
92. See Dancey *supra* note 9, at 104.
93. Subpara. 95(2)(a)(ii).
94. Subsec. 95(1) definition of excluded property.
95. See generally, Dancey *supra* note 9, at Ch. 23.
96. Para. 95(2)(f).
97. Subpara. 95(2)(b)(i).
98. Subpara. 95(2)(b)(ii).
99. Subsec. 95(3).
100. Subsec. 95(1) definition of foreign accrual property income.
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*

© 1994 International Bureau of Fiscal Documentation

received directly by the Canadian resident corporation they would have been excluded from its income.

3. Tax treatment of FAPI income

A Canadian corporation must only include FAPI income if the affiliate is a controlled foreign affiliate at the end of the Canadian corporation's fiscal year, regardless of the length of time during the year that it owned the shares.[105] A Canadian resident shareholder must annually include an amount equal to its "participating percentage" of the foreign affiliate's FAPI that is attributable to each share of the controlled foreign affiliate that it owns. The participating percentage is different depending on the number of classes of shares the affiliate has. If there is only one class of issued shares, the participation percentage is equal to the Canadian resident shareholder's equity ownership in the affiliate. If there is more than one class of shares, the calculation of the participating percentage in respect of any share is much more complicated. Basically the rules apportion the appropriate percentage of the FAPI to each share in such a way that the aggregate participating percentages do not exceed 100 percent.[106]

There is a *de minimis* exception to the application of the FAPI rules. If the controlled foreign affiliate's FAPI for the year is $ 5,000 or less, the participating percentage is deemed to be nil, so no FAPI must be included in the shareholder's income.[107]

The Canadian resident's adjusted cost base of the shares of a foreign affiliate is increased by the amounts of FAPI included in income.[108] Conversely, the adjusted cost base is decreased by amounts deducted for foreign accrual taxes (foreign taxes in respect of FAPI amounts) and for dividends received out of previously taxed FAPI.[109] The results of the adjustments is that any capital gain derived on the disposition of shares of a controlled foreign affiliate does not include previously taxed but undistributed FAPI.

4. Relief for foreign taxes attributable to FAPI income

A Canadian resident corporation that has included FAPI in its income is entitled to a deduction for "foreign accrual taxes" paid by the controlled foreign affiliate on the items included in FAPI.[110] The deduction amounts to an indirect foreign tax credit. Foreign accrual taxes[111] include foreign income or profits taxes paid by the foreign affiliate (FA1) or by another foreign affiliate (FA2) in respect of a dividend received from FA1 to the extent the taxes are reasonably attributed to the FAPI, as well as withholding taxes. The deduction for foreign accrual taxes that is not used in a particular year can be carried back five years.[112] The total amount of foreign accrual taxes deducted over the six year period (i.e. the original year plus the carry-forward) is limited to the total FAPI to which the taxes relate.[113] It should be noted that foreign accrual taxes are not limited to taxes paid to a foreign country. If, for example, a foreign affiliate has passive income from Canada on which Canadian withholding tax is paid, the withholding tax is included in foreign accrual taxes that the Canadian resident shareholder can deduct.

G. Dividends from controlled foreign affiliates

As noted in II.D.4. above, FAPI is included in calculating a foreign affiliate's taxable surplus. And, as seen in II.F. above, FAPI is also included in a Canadian resident shareholder's income under the FAPI rules. Therefore, double taxation could occur if a controlled foreign affiliate were to pay a dividend out of FAPI. To avoid this double taxation, on a dividend out of taxable surplus,[114] taxpayers can deduct from income the amount previously added to the adjusted cost base of shares of the foreign affiliate, net of the deduction permitted under the foreign affiliate rules for underlying foreign taxes.

III. THE AUDITOR GENERAL'S FINDINGS AND RECOMMENDATIONS

The Auditor General's Report brought to the public's attention the concern that the tax rules relating to foreign affiliates are costing the federal government millions of dollars. The Auditor General's Report focused on four areas of major concern: (a) the deduction of dividends paid out of foreign affiliates' exempt surplus; (b) the lack of a definition of active business income as the term applies to FAPI income of foreign affiliates; (c) transferring of foreign losses to Canada; and (d) the deductibility of interest on funds used to invest in foreign affiliates. Each of the areas noted will be briefly discussed below, including a discussion of the specific recommendations of the Public Accounts Committee.

A. Deduction of dividends from foreign affiliates

Regarding the ability of Canadian corporations to deduct dividends received out of exempt surplus, the Auditor General noted that the theoretical basis for this, i.e. the avoidance of double taxation where the active income is already taxed in the country in which the foreign affiliate earns it, is only served when the tax rate in the foreign affiliate's home country approximates Canada's rate. As the Auditor General pointed out, however, many of the listed countries have low tax rates or are tax havens, and certain types of income earned in some of the listed countries are not subject to a rate similar to Canada's rate.[115] In response to this statement, the Deputy Minister of Finance said that all the countries with which Canada has a tax treaty impose corporate taxes at "significant rates", but that an exception is made in the case of

105. Subsec. 91(1).
106. Reg. 5904. For a description of the concept of participating percentage, see Dancey *supra* note 9, Ch. 15.
107. Subsec. 95(1) definition of participatory percentage.
108. Para. 92(1)(a).
109. Para. 92(1)(b).
110. Subsec. 91(4).
111. Subsec. 95(1) definition of foreign accrual tax.
112. Subsec. 91(4).
113. Para. 91(4)(b).
114. Subsec. 91(5).
115. See Auditor General's Report *supra* note 3, at paras. 2.42-2.49.

© 1994 International Bureau of Fiscal Documentation

developing countries. According to the Deputy Minister, the listing of certain countries is in keeping with the government's policy toward encouraging development in lesser developed countries.

The Public Accounts Committee was highly sceptical of the government's purported altruism, quoting from another witness who indicated that no real business is done in most tax havens and that these countries are simply hosts to corporations that are mere conduits.[116] The Public Accounts Committee made two recommendations: first, it recommended that only countries with which Canada has a treaty should be listed; and second, that the Department of Finance reassess the merits of allowing income from subsidiaries in tax haven countries be returned to Canada tax free.[117]

B. Active business income under the FAPI rules

The Auditor General's main concern with regard to the FAPI rules is the fact that the Act does not contain a definition of active or passive income in the context of the FAPI rules. According to the Auditor General, because of the uncertainty, the law is both difficult to administer and difficult to comply with.[118] The Public Affairs Committee, echoing the Auditor General's concern, recommended that the Department of Finance immediately clarify the term in the context of FAPI. The Committee noted that responsibility for defining the term should not be left to the court.[119] The Committee felt that without a definition, the General Anti-Avoidance Rule, which was enacted in 1988 but which has not yet been tested in a court case, cannot be applied if the term is not defined.[120]

C. Transferring of foreign losses to Canada

Under the FAPI rules, the active business losses of a foreign affiliate can be offset against passive investment income of the foreign affiliate. The Auditor General noted that this rule could permit the transfer of affiliate's losses to Canada, thereby eroding Canada's tax base. The Auditor General cited the following example of this: a Canadian corporation's US affiliate has $ 672 million in cash and short-term deposits that originated in the Canadian company. The US corporation used the investment income it earned to offset its US losses. Meanwhile, the Canadian corporation deducted its interest expense for its investment in the US affiliate, the end result being that the US losses were effectively transferred to Canada.[121]

According to testimony before the Public Accounts Committee, other countries do not permit such netting and remedying this loophole would not encourage Canadian corporations to leave Canada. The Public Accounts Committee recommended that the Act be amended to prevent Canadian corporations from using tax losses of affiliates to reduce their taxable income in Canada.[122]

D. Interest deductibility

Under the Act, taxpayers are allowed to deduct interest on funds used to earn income from a business or property, regardless of whether the investment is in Canada or offshore. If a Canadian corporation borrows in Canada to invest in a foreign affiliate, the corporation can claim a current deduction even though the related income is reported in a foreign country and the dividends on the investment may be received tax-free in Canada. The Auditor General pointed out that the deduction reduces Canada's current revenue and the income may never be taxed in Canada if it is ultimately remitted as a tax-free dividend out of exempt surplus. And, since Canada's tax rates are higher than those of many other countries, Canadian corporations have an incentive to incur and deduct interest in Canada. Also, the Auditor General pointed out that even if the income is paid to the Canadian corporation as a taxable dividend, and even if it is from a foreign affiliate in a high tax jurisdiction, though the income would be included in the Canadian corporation's income, no Canadian tax will ultimately be paid to the Canadian fisc because of the tax credit for underlying foreign taxes.[123]

The Public Accounts Committee's response to this issue was quite cautious. The Committee acknowledged the difficulty of reforming the Act's interest deductibility rules, which have been under both public and government scrutiny since a 1987 Supreme Court of Canada case.[124] The Committee's only recommendation on this issue was that the Department of Finance should study the problem in depth before making any changes to the Act.[125]

IV. CHANGES PROPOSED IN THE 1994 FEDERAL BUDGET

Canada's Federal Budget was announced on 22 February 1994. Responding to public criticism, the Budget contained draft legislation that would make a number of changes to the tax treatment of foreign affiliates. On 23 June 1994 Revised Draft Amendments were released for public comment (but were not presented to the House of Commons in a bill). The government is consulting on the proposals and further changes and refinements will be made before the proposals become part of a tax bill to be presented in the House of Commons in the fall. Taxpayers should exercise caution and should obtain professional advice prior to acting on any of the proposals discussed herein. Throughout the following discussion, references to the "new" rules or definitions are

116. See Committee Report, *supra* note 5, at 48:6.
117. *Id.*
118. See Auditor General's Report *supra* note 3, at 48:7.
119. *Id.*
120. *Id.*
121. See Auditor General's Report *supra* note 3, at 50.
122. See Committee Report *supra* note 5, at 48:7-48:8.
123. See Auditor General's Report *supra* note 3, at paras. 2.35-2.41.
124. *The Queen v. Phyllis Bronfman Trust*, (1987) 1 CTC 117, 87 DTC 505 (SCC).
125. See Committee Report *supra* note 5, at 48:8.

© 1994 International Bureau of Fiscal Documentation

references to the proposed 23 June 1994 draft legislation, while references to the "old" rules or provisions are references to the current provisions in the Act.

A. Modification of the definition of foreign affiliate

The first change proposed is a modification of the definition of foreign affiliate so that the equity percentage of shares owned by related corporations must be included in determining whether a corporation is a foreign affiliate.[126] The change is aimed at preventing Canadian corporations from avoiding the full application of the FAPI rules by simply having a small percentage of the shares of a foreign affiliate held by persons related to the controlling shareholder. For example, under the old rules if A Co. owns 73 percent of Foreign Co., and B Co., C Co. and D Co., all of which are Canadian residents and are related to A Co., each owns 9 percent of Foreign Co., Foreign Co. would only be a controlled foreign affiliate of A Co., and therefore only 73 percent of its FAPI would be taxed in Canada. Under the proposed changes 100 percent of the FAPI would be taxed in Canada, as Foreign Co. would be both a foreign affiliate of each company and a controlled foreign affiliate of each. A *de minimis* provision was also added so that the new definition will not apply to shareholders who, by themselves, own less than 1 percent of the total equity of the foreign corporation. These changes are to apply to taxation years beginning after 1994.

B. Definition of active business

The draft legislation includes new definitions for purposes of the foreign affiliate rules and FAPI rules: "active business", "income from an active business", "income from property"; "investment business"; "investment property"; "lease obligation"; "lending of money"; and "licensing of property". What is most notable about the definitions is their interdependence – most of the terms are defined by reference to other terms and by reference to what is *not* within a certain category of income or activity. The starting point is the new definition of "active business", as well as the concept of "business other than an active business". The proposed definitions are to be applicable to tax years beginning after 1994.

"Active business" of a foreign affiliate is any business carried on by the foreign affiliate other than an investment business, and other than a business specifically deemed under subsection 95(2) to be a business other than an active business. "Income from an active business" of a foreign affiliate is defined as income from an active business carried on by the affiliate, including income pertaining to or incident to that active business. Specifically excluded from this definition is income of the affiliate from property.

"Income from property" of a foreign affiliate is defined to include income of the affiliate from an investment business of the affiliate and income of the affiliate from an adventure or concern in the nature of trade. "Investment business" is defined as a business carried on by the foreign affiliate (other than a business specifically deemed by subsection 95(2) to be a business other than an active business), the principal purpose of which is to derive income from property, including interest, dividends, rents, royalties, fees or similar returns or substitutes for such items, and profits from the disposition of investment property. The definition of investment business specifically excludes a business carried on by a foreign affiliate that is a corporation and whose only business is the business carried on with arm's length persons as a foreign bank, trust company, credit union, insurance company or securities trader or dealer. Also specifically excluded is a business carried on by an affiliate that is a corporation whose principal business is the development of real estate for sale, the lending of money, leasing or licensing of property and the insurance of risks, or a combination thereof, to arm's length persons. And, in what might be seen as Canada's attempt to ensure increased employment in foreign countries, the definition of an investment business specifically excludes a business carried on by a foreign affiliate, if the foreign affiliate employs more than five full-time employees in the active conduct of such business.

"Investment property" is defined to include a share of the capital stock of a corporation, or an interest in a partnership or trust, except to the extent that any of these are excluded property of the affiliate; indebtedness and annuities; commodities and commodity futures; currency; real estate; resource properties (both Canadian and foreign); interests in funds or entities other than corporations, partnerships and trusts; and interests or options in respect of any of the above.

"Lease obligation" is defined to include an obligation under an agreement that authorizes the use of, or the production or reproduction of property, specifically including information or any other thing. This definition, therefore, is broad enough to include, e.g. software licensing agreements. "Licensing of property" is defined as including authorization or the use of, the production or reproduction of, property, including information or any other thing.

"Lending of money" by a person is defined to include the purchasing of trade accounts receivable and the purchasing of foreign resource properties from arm's length borrowers.

C. What constitutes FAPI

The sourcing of a foreign affiliate's income is extremely important because a Canadian resident shareholder must include its share of a controlled foreign affiliate's FAPI in its income annually. Conceding that the current wording of certain provisions "causes some uncertainty" when determining components of FAPI,[127] the government has restructured the sourcing rules applicable to different types of an affiliate's income.

Revised paragraph 95(2)(a) sets out situations where income that might otherwise be passive income will be considered

126. Proposed para. 95(1)(d).
127. See Department of Finance technical notes accompanying the 23 June 1994 proposed draft legislation and regulations at 27 (hereinafter "Revised Technical Notes").

© 1994 International Bureau of Fiscal Documentation

income from an active business of the foreign affiliate. Under subparagraph 95(2)(a)(i), income from property of a particular foreign affiliate of a taxpayer will be considered income from an active business of the particular affiliate to the extent it is derived by the affiliate from activities reasonably considered directly related to active business carried on in a country other than Canada by any other non-resident corporation that is related to the particular affiliate. The income must be of the type that would be included in computing the other non-resident corporation's earnings or loss from an active business carried on in a country other than Canada, had the non-resident corporation been a foreign affiliate of the taxpayer.

The Technical Notes accompanying the revised draft legislation (the "Technical Notes") illustrate this provision with the following example:

> ...if a foreign affiliate of a taxpayer that sells equipment that it makes decides, for business reasons, to use a wholly-owned subsidiary to hold equipment that is leased rather than sold to its customers, the rental income of the subsidiary might well constitute income from property of the subsidiary.
>
> ***
>
> [The new rules]...could deem that rental income to be active business income of the subsidiary...[t]he income derived from the leasing activity must be income that would be included in the...earnings or loss of the parent from the active business carried on outside Canada if earned by the parent...[T]he active business earnings of the related group would remain unaffected by the use of a separate corporation to carry on the leasing business.[128]

Under new subparagraph 95(2)(a)(ii), income of a particular foreign affiliate of the taxpayer (FA1) that would otherwise be income from property, will be included in FA1's income from an active business to the extent that the income is derived by FA1 from amounts paid to it in two situations. Under proposed clause 95(2)(a)(ii)(A), income derived by FA1 from amounts paid to it by a related non-resident corporation will be included in FA1's income from an active business to the extent that, if the related non-resident corporation were also a foreign affiliate of the taxpayer, the amount so paid or payable would reduce the amount of the related non-resident's earnings from an active business other than an active business carried on in Canada. Under proposed clause 95(2)(a)(ii)(B), income derived by FA1 from amounts paid to it by another foreign affiliate of the taxpayer (FA2) that is related to FA1 will be included in FA1's income from an active business to the extent the amounts paid by FA2 pursuant to a legal obligation to pay interest on borrowed money used to acquire shares of the capital stock of another foreign affiliate of the taxpayer (FA3) that is also related to FA1, if the shares are excluded property of FA2 and the amounts paid are relevant in computing the liability for taxes of a corporate group of which FA2 and FA3 are members in their home country.

The Technical Notes accompanying the Revised Draft Legislation offer the following helpful illustrations of the application of clauses 95(a)(ii)(A) and (B): if a foreign affiliate loans money to another foreign affiliate of the taxpayer and that other foreign affiliate is related to the lending affiliate, the interest income on the loan would be income from property of the lender. Under new clause 95(a)(ii)(A), however, the interest income would be considered active business income of the lender, so long as the interest expense was deductible in computing the amount prescribed to be the borrower's earning or loss from an active business, other than an active business carried on in Canada.

The example of application of proposed clause 95(2)(a)(ii)(B) is as follows: if FA1 loans funds to another foreign affiliate of the taxpayer (FA2) to which FA1 is related, and FA2 uses the funds to purchase outstanding shares of another affiliate of the taxpayer (FA3) that is also related to FA1, the interest paid to FA1 by FA2 would be income from an active business. Under clause 95(2)(a)(ii)(B), however, where FA2 and FA3 are part of a corporate group that computes its income on a consolidated basis and the interest is deducted in computing the income subject to tax in the country in which the affiliates are resident and subject to income taxation, the interest income derived by FA1 will be treated as active business income.

New paragraph 95(2)(a.1) sets out situations where income from the sale of property will be considered "income from a business other than an active business" (and therefore FAPI). Income of the foreign affiliate for the year from the sale of property (including income from provision of services as an agent in relation to a purchase or sale of property) will be considered FAPI in the following situations: (i) where the cost of the property (other than property manufactured, produced, grown, extracted or processed in Canada in the course of carrying on a business in Canada and subsequently sold to the affiliate for sale to non-residents) is relevant in computing the income from a business carried on by the Canadian corporation, or by a person resident in Canada that is not arm's length with the Canadian corporation or in a business carried on in Canada by non-residents that are not arm's length to the Canadian corporation; and (ii) income from the sale of property that was not manufactured, produced, grown, extracted or processed in the foreign affiliate's country of residence. If, however, greater than 90 percent of the affiliate's gross income is derived from arm's length sales (other than from property described in (ii) above, if that property was referred to in (i) above), the income will not constitute FAPI. Also included in FAPI is income incident to income that is deemed to be FAPI under proposed paragraph 95(2)(a.1). This rule is intended to discourage Canadian corporation's from establishing a foreign subsidiary for the purpose of purchasing goods for resale and use in a business in Canada of the Canadian corporation or a non-arm's length person.[129]

Under new paragraph 95(2)(a.2), income from certain insurance activities will be considered income from a business other than an active business (and therefore FAPI). Income of a foreign affiliate from the insurance of risks (and reinsurance) will constitute FAPI where the risks insured are in respect of a person resident in Canada, property situated in Canada or a business carried on in Canada. The rule does not apply, however, if greater than 90 percent of the gross premium income (net of reinsurance ceded) of the affiliate was derived directly or indirectly from the insurance of arm's

128. *Id.* at 27-28.
129. *Id.* at 32.

© 1994 International Bureau of Fiscal Documentation

length insurance of non-Canadian risks. Also included in FAPI is income incident to or pertaining to income deemed by proposed paragraph 95(2)(a.2) to be FAPI.

Under new paragraph 95(2)(a.3), a foreign affiliate's income derived directly or indirectly from indebtedness or lease obligations (including income of the affiliate from the purchase and sale of indebtedness and lease obligations on its own account) of persons resident in Canada or derived in respect of businesses carried on in Canada by non-residents will be deemed to be FAPI. The rule does not apply, however, if greater than 90 percent of the gross income of the affiliate is derived from indebtedness and lease obligations in respect of business carried on offshore with non-residents that are arm's length to the affiliate. Also included in FAPI is income incident to income deemed by paragraph 95(2)(a.3) to be FAPI. This provision is intended to prevent Canadian corporations in the financing and leasing business from transferring portfolios of debt and lease obligations to an affiliate in a low tax jurisdiction and thereby avoid Canadian tax on interest derived from such activities.

These new provisions, along with the various definitions set forth in Section IV.(B) above, help clarify how different income is to be sourced for purposes of determining whether an amount is included in an affiliate's FAPI. All these provisions are to apply to taxation years beginning after 1994.

It should be noted that the formula for what is included in the definition of foreign accrual property income in subsection 95(1) is to be amended so that exempt surplus of an affiliated group is not overstated. This will be achieved by deeming amounts described in subclause 95(2)(a)(ii)(B) (which pertain to amounts paid to a particular foreign affiliate (FA1) by a related foreign affiliate (FA2) pursuant to a legal obligation to pay interest on money borrowed by FA2 to acquire shares of the capital stock of another related foreign affiliate (FA3) that are excluded property of FA2, where FA2 and FA3 are treated as being in a corporate group) as being nil for purposes of various elements in the formula of foreign accrual property income.

D. Listed countries

Currently, under the foreign affiliate rules, dividends paid by an affiliate out of its active business income earned in a "listed country" can be repatriated to Canada tax free. Under the changes, countries will no longer be "listed". Instead, a country will be considered a "designated treaty country" if it has entered into a comprehensive tax treaty with Canada. (For greater certainty, territories, possessions, etc., to which a convention does not apply are treated as "designated treaty countries".) A country will automatically become a designated treaty country at the time the treaty has entered into force and takes effect.[130] A new regulation will be added so that repatriated active business earnings derived from a designated treaty country after signing of the treaty but before actual ratification will qualify.[131]

Also, a new regulation will be added clarifying when a corporation is considered resident in a listed country. An affiliate will be a resident of a listed country only where it is a resident of the country for purposes of the convention, or where it would be so if it were treated as a corporation under that country's tax laws.[132] A further clarification has been made so that where an affiliate is a resident of a country and it is intended that the affiliate be treated as a resident of that country for purposes of that treaty, it will be so treated regardless of whether the convention applies in respect of the affiliate.[133]

The change in terminology to "designated treaty country" will also be made in the following definitions: "exempt earnings";[134] "exempt loss";[135] "net earnings";[136] "net loss";[137] "taxable earnings";[138] "taxable loss";[139] and the rules for computing "active business earnings".[140]

The proposed changes regarding designated treaty countries generally apply to taxation years of foreign affiliates after 1995.

E. What constitutes exempt earnings

Regulation 5907(1)(b) defines "exempt earnings" of a foreign affiliate. The definition is being amended so that amounts determined under subparagraphs 95(2(a)(i) and 95(2)(a)(ii) to be income from an active business of the affiliate (these provisions are described in detail above) are included in the foreign affiliate's exempt earnings.

F. Foreign affiliates' losses

The rules permitting a foreign affiliate to reduce its FAPI by so-called "deductible losses" are being changed. For taxation years commencing after 1994, the Regulation defining "deductible losses" is being amended so that only losses of foreign affiliates that were controlled foreign affiliates in the year the loss was incurred will be included in "deductible losses".[141] More significantly, the amendments also specify that active business losses will not form part of the deductible losses of a foreign affiliate. The changes will prevent a Canadian corporation from sheltering investment income by placing investments in an offshore company with active business losses, and will stop the technique addressed by the Auditor General of transferring foreign losses to Canada.

130. Proposed Reg. 5907(11).
131. Proposed Reg. 5907(11.1).
132. Proposed Reg. 5907(11.2).
133. Reg. 5907(11.2)(c).
134. Reg. 5907(1)(b).
135. Reg. 5907(1)(c).
136. Reg. 5907(1)(f).
137. Reg. 5907(1)(g).
138. Reg. 5907(1)(i).
139. Reg. 5907(1)(j).
140. Reg. 5907(2.1).
141. Proposed Reg. 5903(1).

© 1994 International Bureau of Fiscal Documentation

G. Rules for computing active business earnings

The regulations provide rules for computing a foreign affiliate's active business earnings from activities in a designated treaty country. Under clause 95(2)(a)(ii)(A), income derived by a foreign affiliate from amounts paid to it by a related non-resident corporation could be included in the active business income of the affiliate when certain conditions are met. Timing differences can arise as a result of the foreign affiliate having to report the income from the non-resident corporation while the paying corporation may be restricted in claiming a deduction for the payments. Proposed new Regulation 5907(2.7) eliminates the timing problems by providing that the amounts paid to the foreign affiliate are to be deducted by the payor in computing its active business earnings or loss in the year that includes the earlier of the day on which the amounts are paid or the day on which the amounts become payable.

Timing problems could also arise in situations where clause 95(2)(a)(ii)(B) applies. New Regulation 5907(2.8) requires FA2 to deduct the interest paid to FA1 in computing its active business income or loss at the same time as the income derived from the interest is reported as active business income of FA1, so that the affiliated group's active business income is not affected by the inter-group charges.

H. Interest deductibility

And finally, it should be noted that the draft legislation does not make any changes regarding the deductibility of interest expense in Canada with respect to investment in foreign affiliates. It is believed that the Ministry of Finance is studying this issue, but no definitive public statement has been made regarding the review, nor has a timetable been set.

V. CONCLUSION

As more and more corporations are doing business internationally and looking for ways of reducing their taxes payable on a worldwide basis, tax advisors are increasingly faced with having to have a working knowledge of the taxation of foreign affiliates. This article is intended to offer a foundational understanding of the Canadian taxation of income from foreign affiliates by examining the historical background in which the rules developed, the rationale behind the rules, and the problems and abuses the government hopes to correct with the recently proposed amendments.

DATABASE ON CORPORATE TAXATION AND CROSS-BORDER PAYMENTS IN OECD COUNTRIES

DATABASE ON DISKETTE

Easy to install and easy to use, IBFD's database is the most convenient way to keep up to date with corporate taxation and cross-border payments.

- Taxation of Resident Companies
- Taxation of Foreign-Source Income
- Taxation of Patent Royalties, Dividends and Interest Received by Non-Resident Companies
- Withholding Tax Rates Chart: showing withholding tax rates for patent royalty, dividend and interest payments from a specific OECD country to all other OECD countries, and to a specific OECD country from all other OECD countries
- Holding Companies

The core of the information in IBFD's 'Database on Corporate Taxation and Cross-Border Payments in OECD Countries' is derived from and expands on Volume I of IBFD's 'Guides to European Taxation', 'The Taxation of Patent Royalties, Dividends, Interest in Europe'. Subscribers to the guide qualify for a 20% discount on the annual licence fee for the database.

Annual licence fee: NLG 550
(includes updates three times a year)
Once-only software licence fee: NLG 350
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

Countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States and one non-OECD country: Liechtenstein.

© 1994 International Bureau of Fiscal Documentation

CROSS-BORDER REORGANIZATIONS INVOLVING CANADIAN CORPORATIONS

James S. Hausman and Kathleen V. Penny

Blake, Cassels & Graydon, Toronto, Canada

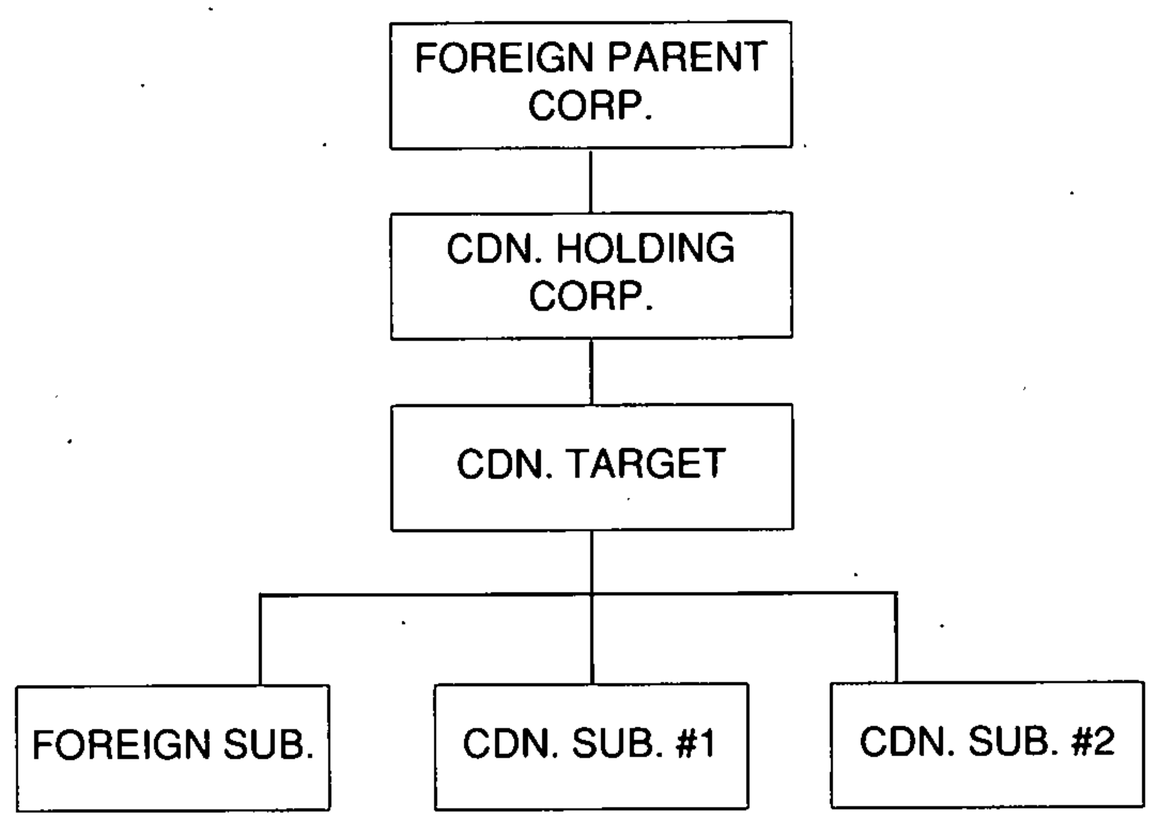
With the greater global integration of national economies, there is likely to be an even greater tendency for business enterprises based in one country to have interests in another. In tax terms, this trend will necessarily result in difficult tax issues arising as a result of corporate changes adopted to maximize the tax efficiency of a corporate structure.

The purpose of this article is to deal with some Canadian tax considerations arising from corporate reorganizations where there are elements of the transaction both inside and outside Canada, with the focus being on Canadian corporations which are part of a foreign-controlled corporate group. The factual situations that are dealt with as examples are relatively simple, but they illustrate the complex Canadian tax issues that can arise in planning for cross-border reorganizations. The tax analysis of the consequences on the other side of the Canadian border is at least as important as the Canadian tax impact and, although ignored in this article, must be taken into account in any proposed reorganization.

The general thrust of our discussion will be directed to the planning measures that can be considered to alter the corporate structure after a non-Canadian corporation has made an acquisition of a Canadian corporation with non-Canadian subsidiaries. Although in most cases such a reorganization is best undertaken immediately following an acquisition, in some cases, similar reorganizations may be effected at a later stage without substantial adverse Canadian tax consequences.

For the purposes of this discussion, we have assumed that a newly formed Canadian subsidiary of a non-resident has acquired a Canadian corporation and its subsidiaries. The utilization of a Canadian acquisition corporation is usually the recommended vehicle for making the purchase. The incorporation of the Canadian corporation permits the non-resident investor to capitalize it for the full amount of the purchase price of the shares of the target company to be acquired. If the purchase price is to be funded in part by borrowing, the use of the Canadian corporation will permit the debt to ultimately be "pushed down" to the operating company so that the deductions so generated may be deducted against the earnings of the target corporation.[1]

The structure after purchase may be illustrated as follows:



This structure is unsatisfactory from an overall tax perspective for the following reasons:

(1) because Canadian tax law does not permit corporate consolidation, the Canadian target corporation must be either liquidated into, or merged with, the Canadian holding corporation in order to allow the interest expense related to the acquisition debt financing to be offset against the earnings of the target;

(2) the earnings of the foreign subsidiary must be passed through the Canadian target before being repatriated to the foreign corporation with the result that those earnings are subject to foreign and Canadian withholding taxes;

(3) if the foreign subsidiary is in the same jurisdiction as the new foreign parent, the foreign subsidiary will most likely not be eligible for consolidated reporting or group relief with the foreign corporation under the tax laws of the foreign jurisdiction; and

(4) on the ultimate sale of the shares of Canadian subsidiary #1 or Canadian subsidiary #2, the foreign parent could suffer less overall tax if the shares were disposed of directly by the foreign parent rather than by the Canadian corporation.

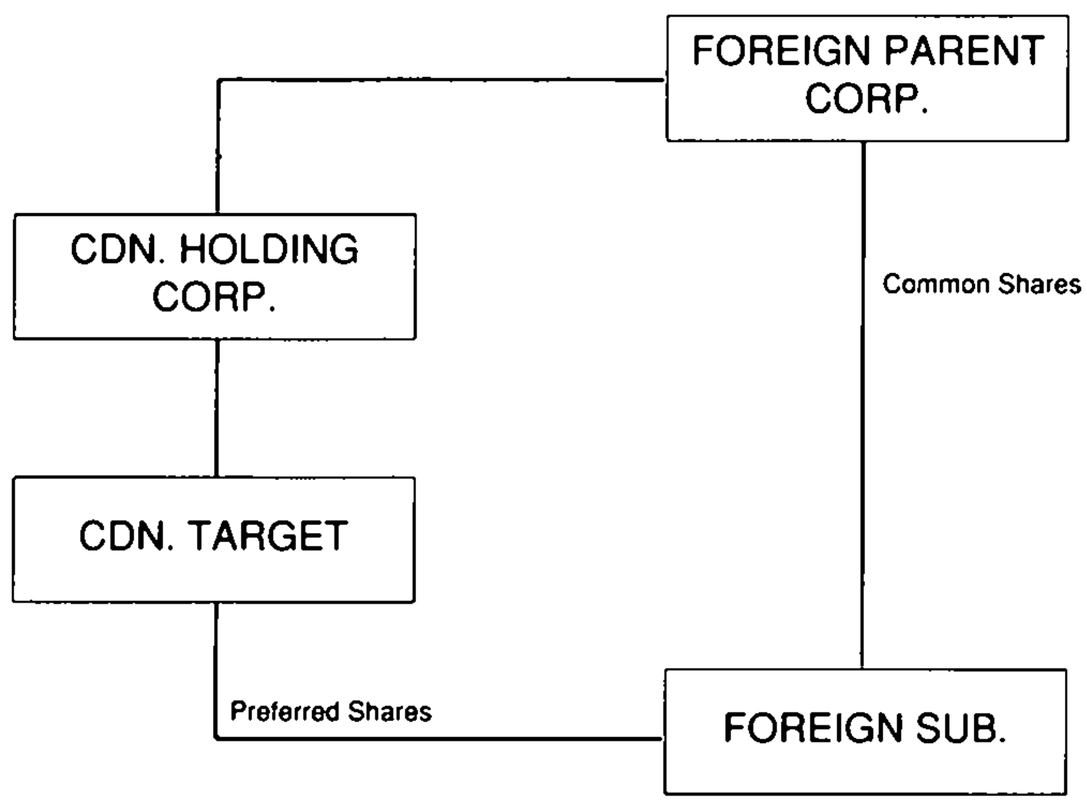
1. It is frequently advantageous for the foreign shareholder of a Canadian corporation to incorporate another Canadian corporation which qualifies as a "non-resident owned investment corporation" under Sec. 133 of the Income Tax Act (Canada) ("ITA") to acquire the indebtedness incurred by the Canadian acquisition corporation for the purchase.

© 1994 International Bureau of Fiscal Documentation

I. DISPOSITION OF THE FOREIGN SUBSIDIARY

The most obvious defect in the structure is the interposition of Canadian corporations between the foreign parent and the foreign subsidiary. The indirect holding of the foreign subsidiary by the foreign parent corporation could be avoided if the shares of the foreign subsidiary were sold or distributed to the foreign parent corporation. However, there does not appear to be any way that the "spin-off" could be accomplished on a "tax-free rollover" basis in Canada.[2]

The closest approximation there is to a complete "rollover" for Canadian tax purposes would be an "internal freeze" under the provisions of ITA Section 86 combined with a subscription by the foreign parent for common shares of the foreign subsidiary. The "freeze" would be accomplished by a conversion of the common shares of the foreign subsidiary held by the Canadian target into retractable redeemable preferred shares of the foreign subsidiary, thus limiting the increase in value which will accrue to the Canadian target. This revised structure is illustrated below:



There are, however, several possible difficulties with such an arrangement:

(1) The Canadian target is left with a large number of preferred shares which, if they are to have a fair market value equal to the value of the common shares of the foreign subsidiary at the time of the freeze, will likely have to be redeemable at the option of the holder, and may also be required to yield a dividend.[3]

(2) Dividends paid on the preferred shares will be subject to withholding tax in the foreign jurisdiction and subject to Canadian non-resident withholding tax when they are paid to the foreign parent, leaving to that extent the very tax problem which the reorganization sought to resolve.

(3) Even though redemption of the preferred shares will be regarded as a tax-free return of capital for Canadian purposes, the same treatment may not apply in the foreign jurisdiction.

Although there may be no express provision which will permit a tax-free or tax-deferred "spin-off" of the foreign subsidiary, the interplay of certain provisions of the Canadian tax legislation could operate to minimize or even eliminate Canadian tax on the disposition of the shares of the foreign subsidiary to the foreign parent.

The ITA contains a very specific set of rules[4] which apply when a wholly-owned Canadian subsidiary is wound up into its Canadian corporate parent. In general terms, these rules provide for a tax-free rollover as a result of the liquidation. However, in the case where the subsidiary distributes capital property to the parent, such as the shares of its own subsidiary, the parent by election can "bump" or "step-up" the cost base to it of such capital property to an amount not exceeding its fair market value. Accordingly, if the Canadian target corporation is liquidated into the Canadian holding corporation, the adjusted cost base to the Canadian holding corporation of the shares of the foreign subsidiary could be "bumped" to their fair market value. If the disposition of the shares of the foreign subsidiary were to occur immediately or shortly after the acquisition of the Canadian target, there would be no, or minimal, taxable gain realized by the Canadian holding corporation on the transfer to the foreign parent. In addition, since the Canadian holding corporation was capitalized by an amount equal to the consideration paid for the shares of the Canadian target, the full amount of the value of the shares of the foreign subsidiary may be paid to the foreign parent as a return of capital without the imposition of Canadian non-resident withholding tax under Part XIII of the ITA.

If some time has elapsed since the acquisition and it is determined that the fair market value of the shares of the foreign subsidiary has increased in value since the acquisition of the Canadian target, the objective of tax planning will be to reduce the proceeds deemed received by the Canadian corporation on the disposition of the shares of the foreign subsidiary to the foreign parent through an election under subsection 93(1) in respect of the "exempt surplus" of the foreign subsidiary.

In the broadest terms, the Canadian system of taxing foreign income permits a Canadian parent corporation to receive dividends from a foreign subsidiary free of Canadian tax to the extent that the dividend is paid out of the foreign subsidiary's

2. ITA Subsec. 69(4) provides as follows:
   (4) **Shareholder appropriations.**– Where at any time property of a corporation has been appropriated in any manner whatever to or for the benefit of a shareholder of the corporation for no consideration or for consideration that is less than the property's fair market value and a sale thereof at its fair market value would have increased the corporation's income or reduced a loss of the corporation, the corporation shall be deemed to have disposed of the property, and to have received proceeds of disposition therefor equal to the fair market value thereof, at that time.
3. The situation will have to be reviewed carefully to ensure that the preferred shares are not regarded as having been acquired "in the ordinary course of the business" of the Canadian target corporation in a case where the Canadian target corporation is a "specified financial institution" as defined in the ITA, since this would result in adverse Canadian tax treatment of dividends received.
4. Subsec. 88(1). In particular, para. 88(1)(d) provides for a "bump" in the cost basis of capital property.

© 1994 International Bureau of Fiscal Documentation

"exempt surplus".[5] The "exempt surplus" is, generally, the active business earnings of the foreign subsidiary in a country with which Canada has concluded a comprehensive tax agreement. The "exempt surplus" pool of the foreign subsidiary *vis-à-vis* the Canadian target is preserved on the acquisition of control by the foreign parent and survives as an "exempt surplus" account *vis-à-vis* the Canadian holding corporation on the liquidation of the Canadian target.[6]

The deduction which is permitted for a dividend out of "exempt surplus" may also be applicable to reduce the proceeds of disposition on the disposition of the shares of a foreign subsidiary by the filing of an election under subsection 93(1) of the ITA. If this election is made, an amount not exceeding the proceeds of disposition is treated as a dividend and not as proceeds of disposition. Thus, depending on the amount of the "exempt surplus" of the foreign subsidiary, Canadian tax on any increase in value of the shares since the date of the foreign parent's acquisition may be avoided or reduced by the filing of the election.

Again depending on the amount of the increase in value of the shares of the foreign subsidiary, it may be important to undertake a reorganization of the foreign subsidiary in order to maximize the "exempt surplus" of the foreign subsidiary available for election under subsection 93(1).

For example, if the foreign subsidiary itself were to have a foreign subsidiary, the subsection 93(1) election would deem the net surplus of the sub-subsidiary to have been distributed to its immediate parent (in this case, the foreign subsidiary of the Canadian holding corporation), and the election would allow the accumulated surpluses to be notionally distributed to the Canadian parent to reduce the amount of the gain. If the foreign subsidiary has exempt surplus, but the sub-subsidiary has an exempt deficit for Canadian tax purposes, no dividend is deemed to have been paid by the sub-subsidiary, and thus the exempt deficit in the sub-subsidiary would not erode the exempt surplus of its immediate parent. However, it is important to note that if the status of the surplus accounts in the foreign subsidiaries were reversed, the effect of the deeming rules for purposes of the subsection 93(1) election would be to erode the exempt surplus available for reduction of the capital gain.

In such circumstances, it would be advisable to liquidate the foreign subsidiary into a newly formed foreign parent holding corporation, and the combined effect of paragraph 95(2)(e.1) and Regulation 5905(7) would be to eliminate the exempt deficit in the foreign subsidiary and to allow the Section 93(1) election to reduce the gain by the amount of the "exempt surplus" of the foreign sub-subsidiary.

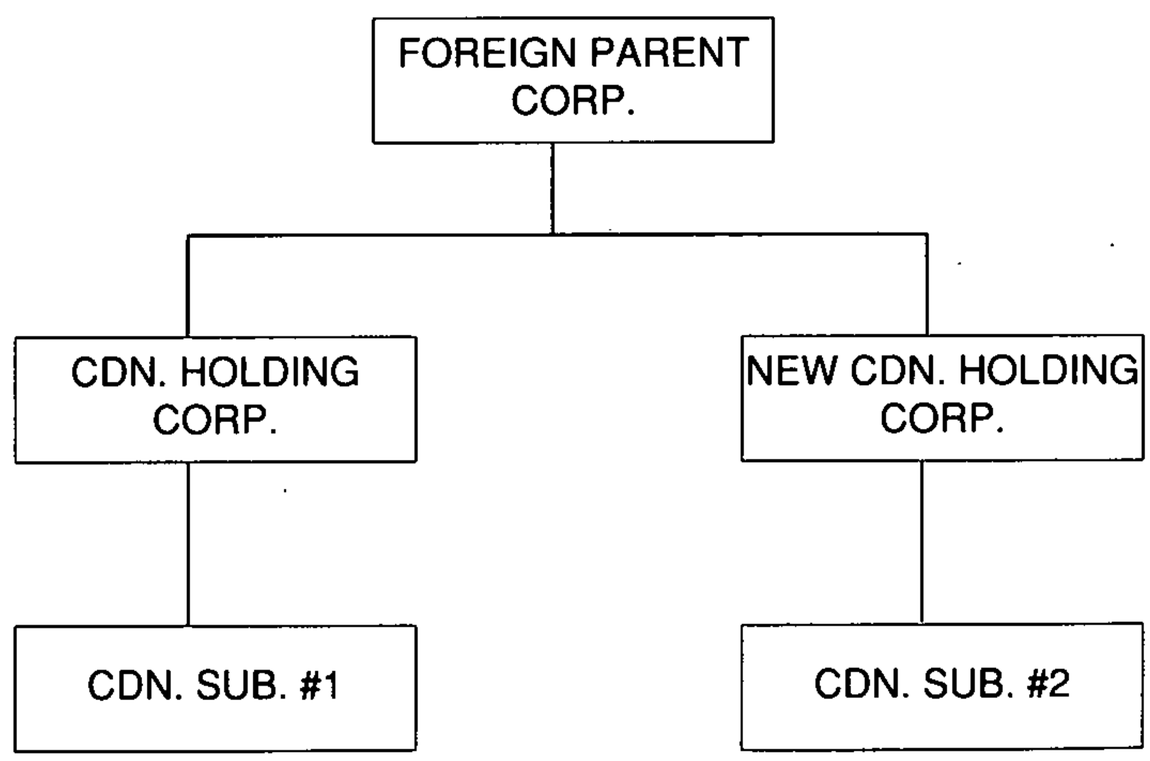
The following are some technical observations on the structuring of the transactions by which the shares of the foreign subsidiary are transferred to the foreign parent:

(a) The shares of the foreign subsidiary are "sold" to the foreign parent and the sale proceeds returned to the parent by way of reduction of capital. A sale is generally preferable over a reduction of capital since it would normally be advisable to include a price adjustment clause in the arrangements in the event that there is a dispute with the revenue authorities as to the fair market value of the shares of the foreign subsidiary. If the shares of the foreign subsidiary were transferred *in specie* to the foreign parent by way of a reduction of capital, as a matter of corporate law it would be difficult to have a reversible reduction of capital reflective of the amount that is ultimately determined to be the fair market value.

(b) If a subsection 93(1) election has been made, and subsequently the fair market value is found to be higher than the amount dealt with in the earlier election, Revenue Canada will permit a variation in the election if there was a bona fide attempt to arrive at values and to apply the full amount of the then "exempt surplus" in the foreign subsidiary to reduce the gain.[7] However, a penalty may be payable with respect to the amendment of the election.

II. RESTRUCTURING OF CANADIAN SUBSIDIARIES

In the structure under consideration, the Canadian target corporation held two Canadian subsidiaries. The foreign parent corporation may wish to have separate streams of ownership of the two Canadian subsidiaries, to allow it the flexibility in the future to sell one of the subsidiaries directly, rather than through the Canadian holding corporation. This is particularly true where the foreign parent is resident in a jurisdiction which exempts from tax the gain on the sale of the shares of foreign subsidiaries and has a tax treaty with Canada which prevents Canada from taxing any gain realized on the sale. The following could be a desirable structure:



It was possible until very recently to achieve the above structure free of Canadian tax through a divisive reorganization commonly referred to as a "butterfly". After completion of the "butterfly", shares of the newly formed Canadian holding

5. Subsec. 113(1).
6. Reg. 5905(5)(c) of the Income Tax Regulations.
7. Information Circular 77-9R.

© 1994 International Bureau of Fiscal Documentation

corporation were sold exempt from Canadian tax on capital gains due to a treaty exemption. This essentially allowed for an effective avoidance of Canadian tax on the sale of Canadian subsidiary #2. However, new rules[8] deny rollover treatment if a sale of the shares of either the old or new Canadian holding corporation to an unrelated party is contemplated at the time of the "butterfly". The actual test is whether the "butterfly" transactions were undertaken as part of a "series of transactions" in which the shares are disposed of to a person who deals at arm's length with the foreign vendor. There is a specific definition of "series of transactions" which deems the series to include "any related transactions or events completed in contemplation of the series".[9]

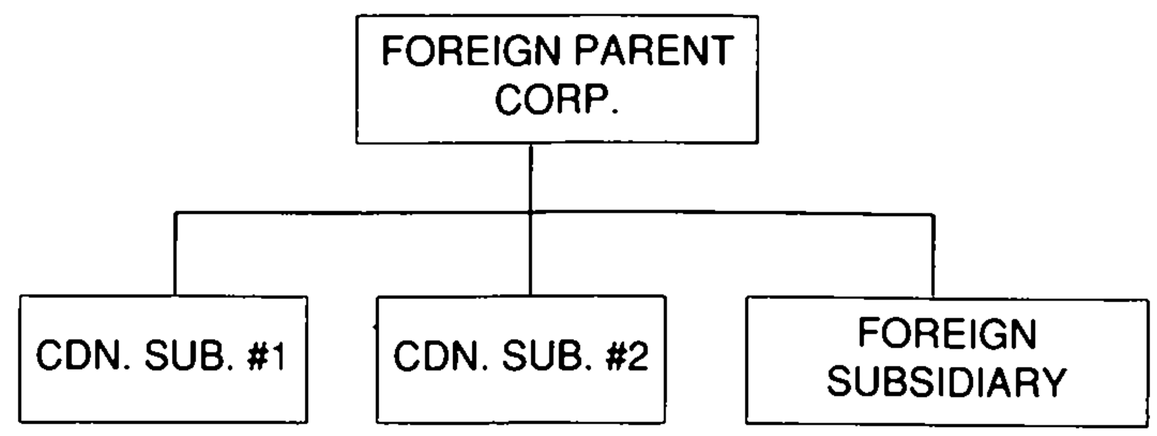
Given the recent restrictions imposed on the use of the "butterfly", it may be advisable and possible to spin off Canadian subsidiary #2 without significant Canadian tax by using the paragraph 88(1)(d) "bump" referred to above on the liquidation of Canadian target, and relying on high paid-up capital of the shares of the Canadian holding corporation to return the proceeds of a sale of Canadian subsidiary #2 on a tax-free basis very much in the same way as discussed above when dealing with the repatriation of the foreign subsidiary.[10] If a significant amount of time has elapsed between the acquisition and the sale of Canadian subsidiary #2, it may also be possible to reduce the gain on the sale of the shares of subsidiary #2 by pre-disposition inter-corporate dividends to the Canadian holding corporation, subject to restrictions which apply if the transactions are being completed in contemplation of a sale to an arm's length party to limit the amount of such dividends to the "safe income"[11] associated with the shares of subsidiary #2.

III. LIQUIDATION OF CANADIAN HOLDING CORPORATION

In the structure we have postulated, if there are tax advantages to be derived from the "spin-off" of the foreign subsidiary and the Canadian subsidiary, it may be of greater benefit to wind up the Canadian holding corporation just after the liquidation of the target so that the two Canadian subsidiaries and the foreign subsidiary will be directly held by the foreign parent.

Somewhat the same tax considerations are applicable in the case of liquidation as in the "spin-off" discussed above, except that the shares of the subsidiaries would be deemed to have been "sold" for their fair market value, and the difference between that amount and the paid-up capital of the Canadian holding corporation (if any) would be deemed to be a dividend subject to Canadian non-resident withholding tax.[12] Thus, if the share capital held by the foreign parent has paid-up capital attributable to it at least equal to the "bumped" basis of the shares of the subsidiaries, the liquidation should be capable of being effected without attracting Canadian tax at the level of the Canadian holding corporation or Canadian non-resident withholding tax on the distribution.

The corporate structure after completion of the liquidation of the Canadian holding corporation would be as follows:



If some time has elapsed since the original acquisition, there is the risk of an increase in values. The liquidation of the Canadian holding corporation will result in a deemed disposition at fair market value so that in addition to the possibility of gain at the corporate level, there could also be a deemed dividend to the extent that the liquidating distribution exceeds in value the amount of the paid-up capital of the Canadian holding corporation held by the foreign parent.[13]

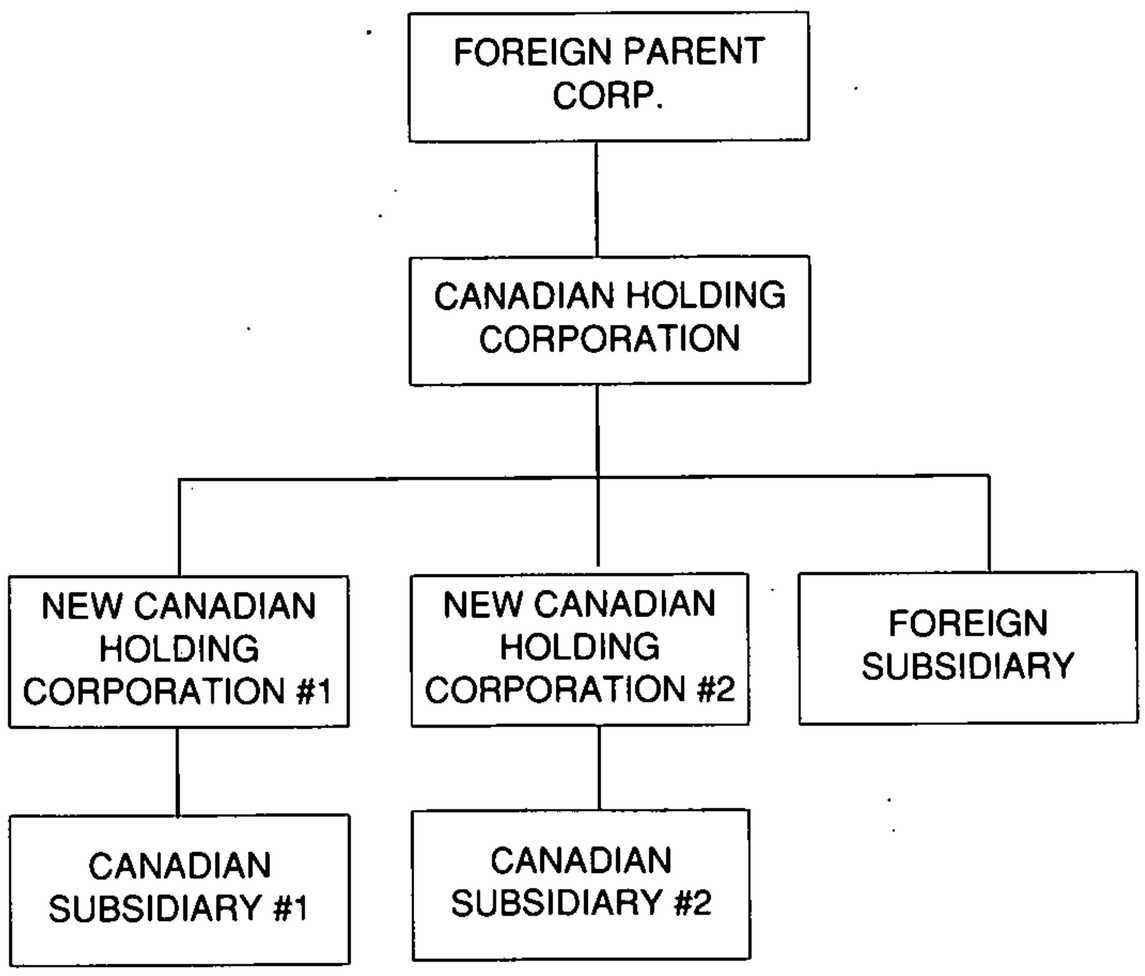
One disadvantage of direct ownership of the shares of the Canadian subsidiaries by the foreign parent is that these shares may have a lower paid-up capital than the shares of the Canadian holding corporation, thus limiting the ability of the Canadian corporations to return capital to the foreign parent free of Canadian non-resident withholding tax.

If the foreign parent were to create a separate Canadian holding corporation for each of the Canadian subsidiaries at some time after the liquidation of the original Canadian holding corporation, the paid-up capital of the newly formed Canadian corporations could not be "stepped up" to equal the fair market value of the shares transferred because of a specific anti-avoidance provision in the Canadian tax legislation[14] affecting non-resident transfers of shares to Canadian corporations.

One solution to the loss of paid-up capital may be to create two separate holding corporations for each of Canadian subsidiary #1 and Canadian subsidiary #2 prior to the liquidation of the Canadian holding corporation, that is, at a time when the shares are not held by a non-resident. The structure immediately before the liquidation of the Canadian holding corporation would be as follows:

8. Subsec. 55(3.1).
9. Subsec. 248(10).
10. In fact, if the transfer occurs immediately after the acquisition by the foreign parent and the liquidation of the target, the "butterfly" transactions may be substantially replicated and the structure described above achieved without offending the newly introduced rules restricting the use of cross-border "butterflies" since there will be no reliance on the tax-free intercorporate dividend dealt with in Sec. 55.
11. Subsecs. 55(2) and (5).
12. See subsecs. 69(5) and 84(2).
13. If the value of the shares of one subsidiary has decreased since the acquisition while another has increased, the loss sustained cannot be an offset against the deemed gain realized; subsec. 40(2).
14. Sec. 212.1.

© 1994 International Bureau of Fiscal Documentation



The effect of this reorganization would be to permit the foreign parent to hold the shares of the two new Canadian holding corporations with basis and paid-up capital equal to the fair market value of the shares of each of Canadian subsidiary #1 and Canadian subsidiary #2 while holding the shares of the foreign subsidiary directly. At some time after the liquidation of the Canadian holding corporation, Canadian subsidiary #1 and Canadian subsidiary #2 could be wound up into, or amalgamated with, their respective holding corporations on a "rollover" basis.[15]

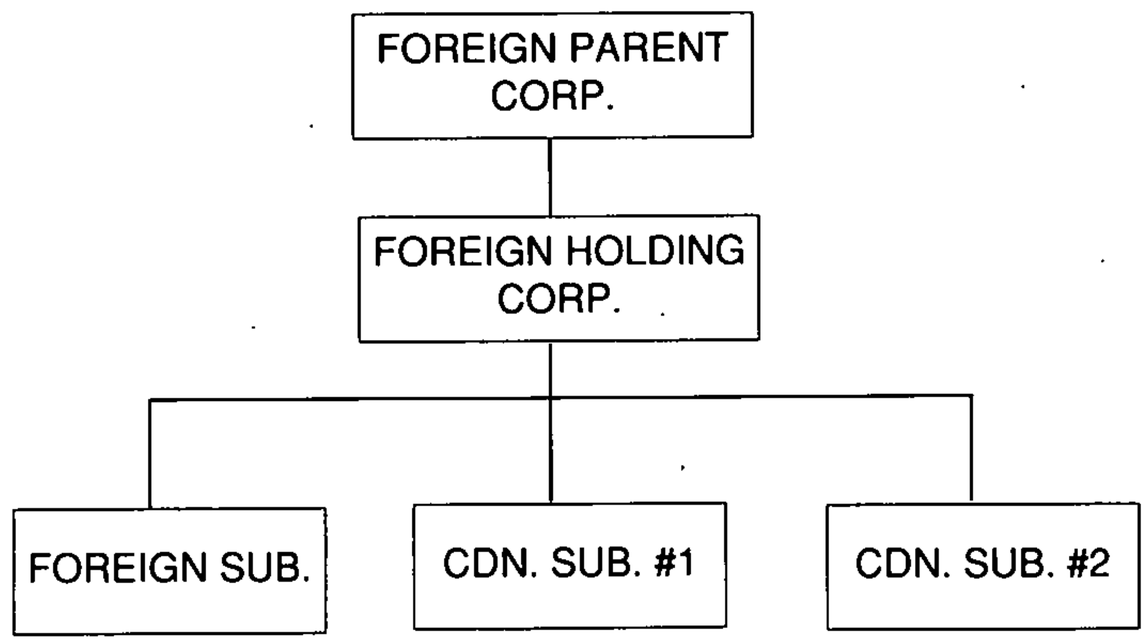
IV. EXPORT CONTINUANCE OF CANADIAN HOLDING CORPORATION

Instead of selective spin-offs of one or more subsidiaries of the Canadian corporation as described above, an alternative form of reorganization which could be considered is the transformation of the Canadian holding corporation into a foreign holding corporation. The intended result would be that the foreign holding corporation no longer be subject to Canadian tax on its profits and that no Canadian withholding tax apply on the payment of dividends by the foreign holding corporation to its shareholders.

Prior to 1980, it was possible in some special cases to achieve these tax objectives by moving the central management and control of a Canadian corporation to a location outside Canada, while the corporation itself was still governed by the Canadian corporate law. For example, Hunter Douglas Ltd. was a corporation incorporated in Canada which moved its central management and control from Canada to the Netherlands in 1970, and thereafter carried on no business in Canada.[16] Under the Canada–Netherlands Income Tax Convention, as it read at the applicable time, a corporation otherwise resident in both Canada and the Netherlands under the respective domestic laws was deemed to be resident in the country in which its business was managed and controlled. Accordingly, Hunter Douglas Ltd. became resident in the Netherlands for purposes of the Convention and was no longer subject to Canadian tax on its profits or to Canadian withholding tax on dividends paid to shareholders not resident in Canada.

The terms of most modern tax treaties entered into with Canada when combined with Canadian domestic rules concerning corporate residence will result in this approach not being feasible. Most Canadian tax treaties now have a "tiebreaker" rule which decides residence of a corporation otherwise resident in both countries under their domestic rules on the basis of either (i) the jurisdiction of incorporation,[17] or (ii) a mutual decision of the two competent authorities.[18] Therefore, a corporation resident in Canada under Canadian domestic rules will generally remain resident in Canada notwithstanding a change in the location of central management and control, unless a treaty tiebreaker provision is in fact applied in favour of residence in the foreign jurisdiction. Accordingly, in most cases the Canadian corporation will have to consider a corporate transformation into a foreign corporation in order to escape Canadian taxation on its future profits and dividends.

Most Canadian corporate statutes permit a corporation to "continue" in another jurisdiction as if it had been incorporated under the laws of that jurisdiction, using a statutory procedure referred to as "export continuance" or "discontinuance".[19] The export continuance of the Canadian holding corporation into the foreign jurisdiction in lieu of the disposition of the shares of the foreign subsidiary to the foreign parent corporation, would result in the following structure:



In order to effect an export continuance, the Canadian corporation would first have to select a foreign jurisdiction which provides for import continuance under the laws of the foreign jurisdiction under a procedure compatible with the Canadian

15. Subsec. 88(1) or Sec. 87.
16. See the case of *Hunter Douglas Ltd. v. The Queen*, 79 Dominion Tax Cases 5340 (Federal Court – Trial Division).
17. See, for example, the Canada–United States Income Tax Convention (1980).
18. See, for example, the Canada–Netherlands Income Tax Convention (1986).
19. See, for example, the Canada Business Corporations Act, Sec. 188.

© 1994 International Bureau of Fiscal Documentation

procedure. We understand that several states of the United States and European countries (for example, Luxembourg) have import continuance procedures, and the concept is becoming more common. The Canadian holding corporation will then have to seek authorization from its shareholders and permission from the Canadian authorities to effect the export continuance outside Canada. The Canadian authority will generally have to be satisfied that the export continuance will not adversely affect the creditors or shareholders of the corporation.

The Canadian tax consequences of an export continuance were, prior to very recent amendments to the ITA, frequently anomalous. Due to the Canadian domestic tax rules deeming a corporation incorporated in Canada in most cases to be a resident of Canada,[20] the difficulty normally encountered was that an export continuance into a foreign jurisdiction did not change the fact that the corporation had been originally incorporated in Canada. Therefore, the corporation remained a resident of Canada for purposes of the ITA, subject to the terms of any applicable treaty. In the case of a treaty with a tiebreaker rule based on the jurisdiction of incorporation, the corporation continued to be resident in Canada for purposes of the treaty notwithstanding the export continuance, and continued to be subject to Canadian tax on its profits and Canadian withholding tax on dividends paid to its shareholders. One way in which this problem could be dealt with in the case of some foreign jurisdictions was to effect a foreign merger of the continued corporation with a foreign corporation incorporated under the laws of the foreign jurisdiction in such a way that the surviving corporation was the foreign incorporated corporation, and the continued corporation was absorbed into the surviving corporation.

Under the tax rules dealing with corporate emigration first introduced in 1980,[21] there was a deemed taxation year-end and a deemed disposition and reacquisition of all assets of the corporation for their fair market value for Canadian tax purposes immediately prior to the change of residence, with the resulting Canadian tax consequences. Furthermore, the corporation was subject to an additional tax[22] of 25 percent on the excess of the deemed proceeds of disposition over the corporation's paid-up capital and debt. This additional tax was intended to be a substitute for the Canadian withholding tax which would have applied if the Canadian corporation had liquidated and distributed its assets to a foreign parent corporation; however, it was not always clear that the corporation would be entitled to a reduction in the rate of this tax to the corresponding rate applicable to dividends to a foreign parent corporation under the relevant tax treaty.

The recent amendments to the ITA[23] offer several forms of relief which may result in export continuance being more feasible in the future. First, the rules now allow Canadian corporations which continue under the laws of a foreign jurisdiction and move their management and control to the foreign jurisdiction to sever their links with the Canadian tax jurisdiction in a definitive way. A new provision[24] states that the continued corporation will be treated as if it had been incorporated in the jurisdiction to which it has continued. To ensure that the exported corporation is no longer resident in Canada for Canadian tax purposes, the central management and control of the corporation would also have to be moved to the foreign jurisdiction. Although this new provision generally applies after 1992 (subject to some grandfathering rules), a corporation which continued outside of Canada at any time before 1993 may elect to have the provision apply as of the time of its continuation.

Upon the continuance of the Canadian holding corporation outside Canada, it will, under new rules similar to the former rules, have a deemed taxation year-end immediately prior to the continuance, and each of its properties (including intangibles) will be deemed to have been disposed of for fair market value and reacquired for the same amount.[25] There is no ability to defer the deemed disposition or to pay any resulting tax liability over time. The corporation is also subject to a special additional tax (similar to the old rules) based on the excess of the fair market value of its assets over its paid-up capital and debt; this tax is intended to be a substitute for the withholding tax which would have been applicable had the Canadian corporation liquidated and distributed its assets to the foreign parent.[26] The new rules now confirm that the corporation will normally be entitled to the benefit of any reduced rate applicable to dividends paid to a non-resident parent which holds all of the shares of the Canadian corporation under the terms of any applicable tax treaty.

In the context of the fact situation we have been discussing, it will be recognized that under these new rules, the Canadian holding corporation could be continued outside Canada with little or no tax exposure in Canada because its adjusted cost base of its property would have been "bumped" to its fair market value and the paid-up capital of its shares would also be equal to that amount.

V. DIRECT MERGERS

Presumably, in recognition of the increasing frequency of cross-border mergers, plans of arrangement and similar reorganizations, new rules have been added to the ITA as part of the recent amendments to ensure that a Canadian corporation does not escape the consequences of an emigration out of Canada by participating in a form of direct merger with other corporations in different jurisdictions. A Canadian corporation which participates in a merger, plan of arrangement or similar reorganization resulting in a surviving corporation which is not resident in Canada will be subject to the corporate emigration rules described above.[27] While Canadian corporate law may not currently accommodate direct mergers of Canadian corporations with foreign corporations, except possibly by way of a court-approved plan of arrangement, the tax rules have been put in place to deal with this type of transaction if and when it occurs.

20. See subsec. 250(4).
21. See former Sec. 88.1.
22. See Secs. 219.1 and 219.2 as they read before recent amendments.
23. Amendments contained in Bill C-27, which became law on 15 June 1994.
24. Subsec. 250(5.1).
25. See subsec. 128.1(4).
26. See Secs. 219.1 and 219.3.
27. See Secs. 128.1 and 128.2.

© 1994 International Bureau of Fiscal Documentation

STRUCTURING INTERNATIONAL JOINT VENTURES: CANADIAN TAX ISSUES TO CONSIDER[1]

Gary J. Webb, C.A.

Deloitte & Touche, Toronto, Canada

I. OVERVIEW

For the purpose of this article, I have chosen a broad definition of joint venture and include any business venture inside or outside of Canada carried on by a Canadian entity in concert with a foreign entity. I have also assumed that at the time of formation of this joint venture, the Canadian participant has contributed an asset or assets of value. The asset of value that the Canadian brings to the joint venture could be supply of product, management know how, intangible property whether or not patented (but capable of being transferred through licensing or franchising arrangements), or operating businesses with or without their own goodwill.

The tax strategies involved in structuring foreign joint ventures have, as their objects, the same objects identified when commencing to carry on any business activities inside or outside of Canada:

- minimize the costs of transferring assets into any entity formed; and
- minimize total tax costs to be incurred on the profits to be distributed to the owners.

Before being able to set tax strategies, the parties must be fully aware of the Canadian tax regime applicable to any international business structuring. For this reason, I will review conceptually the basic Canadian principles to bear in mind in structuring international joint ventures. Like all conceptual overviews, it will lack the precision necessary to finalize structuring, but hopefully provide sufficient framework to stimulate planning.

II. CLASSIFICATION OF THE ENTITY

The Canadian tax structure deals principally with individuals, corporations, partnerships and trusts (trusts will not be dealt with in this article as they are seldom used by Canadians in business ventures due to legal liability and trustee issues). Many foreign entities do not fit neatly into these concepts as they are known in Canada. Thus, it is often necessary to determine how the foreign entity will be treated for Canadian tax purposes, or perhaps what foreign entity should be chosen to yield a particular Canadian tax result. Revenue Canada has indicated in IT343R:

> A corporation is an entity created by law, having a legal personality in existence separate and distinct from the personality in existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. As long as the entity has such separate identity and existence, the department will consider such entity to be a corporation even though under some circumstances or for some purposes, the law may ignore some facet of its separate existence or identity.

The interpretation bulletin goes on further to indicate a number of entities in foreign jurisdictions that are considered corporations for Canadian tax purposes. This list is not all inclusive, and thus doubt will exist over the characterization of a number of different foreign entities. To date, I am not aware of any Canadian court cases that would add clarity to this characterization issue. It seems that the only avenue to ascertain the status of a foreign entity for Canadian tax purposes is a ruling application.[2] For the purpose of this article, I will refer to the Canadian concepts of the corporation, or partnership, assuming that the appropriate categorization for Canadian tax purposes has been made.

III. TAXATION OF PARTNERSHIPS

A. Canadian partners

A commonly encountered form of international joint venture is the partnership. Canada does not recognize the partnership as a taxable entity, but recognizes it only as the level at which income is computed before the allocation to partners. The income for Canadian tax purposes of the Canadian partner is computed at the partnership level using the Canadian tax rules for income computation regardless of where the partnership itself is located or operates, and regardless of the fact that a separate and different income computation may be performed for the foreign jurisdiction. Income or losses will be recognized for Canadian tax purposes in the year in which the partnership's fiscal year ends.

1. This article is based on a previously published work by the author: "Structuring Foreign Joint Ventures: Canadian Tax Strategies To Consider," in Tax Planning for Canada–US and International Transactions, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 10:1-21.
2. See also comments provided by Revenue Canada in Question 5 of the 1992 Revenue Canada Round Table and Window on Canadian Tax, para. 1022 describing a technical interpretation issued by the reorganizations and non-resident division on 4 October 1990, as well as the paper delivered at this conference by Robin J. MacKnight, dealing with US limited liability companies.

© 1994 International Bureau of Fiscal Documentation

If significant start-up losses are expected, the Canadian partner can enjoy cash-flow advantages as a result of the ability to reduce Canadian taxes on other income by the application of the partner's share of the partnership loss rather than locking the loss in a foreign corporation. This in itself could be a motivation for partnership operation versus corporate operations. The argument having instead a foreign corporation is lower foreign tax rates compared to Canadian. For partnerships operating outside Canada the deferral or saving of Canadian tax may be an incentive for incorporation in a foreign jurisdiction to hold the partnership interest. The corporate tax saving may be in the jurisdiction of operations or a third country participant formed as a financial intermediary or other tax planning participant.

The partnership profits may also be subject to tax in a foreign jurisdiction, the country of formation or the country of operation. If Canadian tax principles do not recognize income or expenses at the same time as the foreign tax rules, it is possible that Canadian taxation can be out of synchronization with foreign tax. This can be most disadvantageous if, for example, Canadian rules recognize income much faster than the foreign rules, and thus, create tax liability in Canada in a year in which there is no tax liability in the foreign jurisdiction. This accelerates the payment of tax, and the lack of synchronization of foreign tax credits can result in a much higher effective rate of tax than would ever had been envisioned. Conversely, a loss for Canadian tax purposes in a year of foreign income could severely impact foreign tax credit. Although the ability to carry unclaimed foreign tax back three years and forward seven years may alleviate the timing difference problem, some additional tax planning may be required as a result of tax rate differentials.

B. Foreign partners

As indicated above, the Canadian rules compute income at the partnership level, but tax the income to the partner. A partner in a partnership carrying on business in Canada is deemed to be carrying on that business in Canada in that year for the purposes of the Income Tax Act. Thus a foreign corporation as a member of a Canadian partnership carrying on business in Canada, will be liable for Canadian tax at normal corporate rates, unless the income is exempt from Canadian tax by treaty. In most instances, the income would be exempt from Canadian tax only if it were not attributable to a permanent establishment and the applicable treaty required a permanent establishment in Canada to give Canada the right to tax.

In addition, a branch tax can apply to the non-resident partner, if the non-resident is a foreign corporation. Foreign corporations carrying on business in Canada and not exempt from tax by a treaty, are also subject to a branch tax. The branch tax is the equivalent to withholding tax on dividends, and thus is imposed at a 25 percent or lower level if reduced by treaty, and is imposed upon the after-tax profits minus a provision for net assets invested in Canada. The provision claimed in one year is subject to tax in the following year, with the opportunity to claim a new provision depending upon the net assets invested in Canada at the end of that year.

Where the partnership itself is carrying on business in several countries, the allocation of the income to the activities carried on in Canada is obviously a complex issue to resolve in many cases. Great caution must be exercised in this area to insure some clarity in income computation for Canadian purposes.

IV. TAXATION OF CORPORATIONS

A. Resident in Canada

Canada taxes corporations under domestic law on the basis of residency. The corporation resident in Canada is subject to taxation on its worldwide income. By definition, a corporation incorporated in Canada, after 26 April 1965 is a resident of Canada. The automatic residency issue is altered by the proposed subsection 250(5.1) which provides that a corporation continued into another jurisdiction and thus subject to their corporate legislation will be regarded as incorporated in that jurisdiction and not Canada. A non-Canadian corporation can be held to be resident in Canada under the domestic Canadian rules (subject to the treaty protection referred to in subsection 250(5)), if the central management and control is in Canada. The common law residency rules are therefore still applicable for corporations incorporated outside of Canada, foreign business corporations and corporations incorporated in Canada before 27 April 1965 which do not respectively meet the tests enumerated in paragraphs 250(4)(b) and (c).

Normally, the place where the directors exercise control is held to be the place of central management and control of the company as was decided in a UK tax case Unit Construction Co.

Residency of a corporation is often an unclear area. A simple example of a problem area, could be say a Bermuda corporation formed to be a partner in a foreign partnership. If the Bermuda corporation actually had its mind and management in Canada, even though an active business was carried on by the partnership, the Canadian tax authorities could subject the Bermuda corporation to Canadian tax on worldwide income as a resident of Canada. Thus, when using foreign entities for Canadian tax planning purposes, the mind and management concept must be addressed and carefully adhered to, so as to avoid immediate Canadian tax on any active business income.

Canadian residency can be overridden by tax treaty. Some treaties, e.g. Canada–United States, limit Canada's ability to tax income from that jurisdiction for companies incorporated in that jurisdiction.[3] This concept is extended by subsection 250(5) which has been interpreted as extending that type of

3. See for example Art. VII Canada–US tax convention which prohibits Canada's right to tax US source business profits earned in a US Corporation, even if it were also resident in Canada.

© 1994 International Bureau of Fiscal Documentation

treaty article into a non-resident status (in Canada) for the foreign corporation.[4]

B. Taxation of income of corporations resident in Canada

Corporations which are resident in Canada are subject to Canadian tax on their worldwide income. The basic corporate tax rate is 28.84 percent federal and a provincial tax rate which varies by province from 8.9 to 17 percent. Incentive rates apply for manufacturing income which can bring the federal rate to 22.84 percent and a small decrease in the provincial rate. Other incentives apply for Canadian controlled private corporations on small business income (income less than $ 200,000 per annum) and on investment income distributed by the corporation, neither of which are considered relevant for this article.

In addition, dividends paid from a corporation to non-residents are subject to non-resident tax of 25 percent, or lower if reduced by treaty. Dividends to Canadian corporations by a Canadian corporation are typically free from tax (portfolio holdings in a private corporation may be subject to a refundable tax). Dividends received by individuals resident in Canada are subject to a tax system which gives partial recognition for the corporate tax, which results in a rate of tax less than the full personal tax rate (approximately a maximum rate of approximately 25 percent compared to 52 percent).

C. Taxation of Canadian corporations earning dividends from foreign affiliates

Generally, a foreign affiliate is a foreign corporation in which a Canadian resident holds directly or indirectly 10 percent of any class of shares. The Canadian foreign affiliate rules are, in some situations, advantageous to the Canadian multinational (say for example, compared to US competitors) and at a disadvantage compared to some other competitors (for example, Dutch based multinationals), but often any competitive disadvantage can be mitigated through planning.

The Canadian model for taxation of income earned in foreign affiliates is based on a foundation of passive versus active income and treaty versus non-treaty jurisdiction.[5] Active income earned in a treaty location by a corporation resident in a treaty country[6] results in exempt surplus. Active income earned in a non-treaty location or in a treaty location by a corporation not resident in a treaty location results in taxable surplus subject to Canadian tax at the time of repatriation. Passive income may result in foreign accrual property income ("FAPI") and be taxed currently to the shareholder in Canada if the foreign affiliate is a controlled foreign affiliate.[7]

For foreign ventures, foreign affiliate status is a desired status. Dividends received from foreign affiliates by Canadian corporations, are generally granted specific deductions. Dividends from exempt surplus are included in income but then qualify for deductions under 113(1)(a) to arrive at taxable income. Thus, the foreign source income is effectively not subject to tax in Canada. Deductions in Canada for related expenses are still permitted despite this lack of taxation, subject to the normal restrictions on deductibility of expenses. For example, interest expense on debt incurred to acquire shares of the foreign affiliate is deductible provided the income earning test can be met. Similarly, other expenses in Canada of a holding company nature would continue to be deductible in Canada.

Canadian corporations may also obtain deductions related to the dividends from taxable surplus. These deductions are computed by reference to the underlying tax charged on that income. Paragraph 113(1)(b) permits a deduction relating to the underlying tax (i.e. that foreign tax applicable to that taxable surplus being distributed) and to the extent that there is any excess of the dividend over the 113(1)(b) deduction, 113(1)(c) permits a deduction with respect to foreign taxes withheld at source on the dividend. The net result of these deductions is that only to the extent that income within the foreign affiliate has not been subjected to an effective 38 percent tax, Canadian tax will apply.

It is important to recognize that exempt surplus can be created in a jurisdiction where an active business is not carried on by the foreign affiliate. Where a charge from one affiliate to another would reduce income that would otherwise be treated as exempt surplus in the paying foreign affiliate, the receipt will be treated as exempt surplus in the receiving foreign affiliate provided that the receiving affiliate is also a resident in a treaty jurisdiction. As commented upon later, this provides for a number of Canadian planning opportunities relating to foreign international joint ventures. Similarly, although not quite as attractive, is the fact that inter-affiliate charges which reduce active business income from one affiliate, will be treated as active business income of the receiving affiliate even though not related to treaty jurisdictions. This keeps the income out of the passive income category, which is taxed currently in Canada, and continues the Canadian tax deferral until the income is remitted to Canada via dividends. This again, can give planning opportunities to reduce active business income in a high tax jurisdiction and place the income into a low tax jurisdiction and is extremely beneficial where such planning will be effective in the high tax foreign jurisdiction.

Finally, it must be remembered that inter-affiliate dividends do not create taxable income in Canada. Exempt surplus passing as a dividend from one foreign affiliate to another retains its characteristic as exempt surplus despite the residency of the recipient foreign affiliate. Similarly, taxable surplus passing from one foreign affiliate to another retains its characteristics as taxable surplus. This then permits surpluses to be moved from one foreign affiliate to another without the necessity of paying Canadian tax, if the actual funds remain outside of Canada. Significant tax deferral opportunities can

4. See technical notes to the introduction of the section.
5. Technically, listed versus unlisted jurisdictions see Reg. 5907(11), although most listed jurisdictions are treaty partners.
6. Regs. 5907(1)(b) and 5907(1)(d).
7. Defined para. 95 (1)(a).

© 1994 International Bureau of Fiscal Documentation

arise through this particular aspect of our foreign affiliate system.

V. CANADIAN TAX-FREE ROLLOVERS

A final aspect of the basic Canadian tax system which must be understood for structuring joint ventures is the Canadian rollover rules.

The basic Canadian tax-free rollover is created where assets are transferred to a Canadian corporation[8] for consideration which includes shares. Gains need not be recognized if the parties jointly elect to treat the transaction at a lower value and the share consideration is equal to or greater than the non-recognized gain. Liabilities may be assumed by the transferee provided that the value does not exceed the elected transfer price of the assets. The rules usually permit a Canadian entity to transfer assets to the "joint venture" corporation without triggering a tax liability.

A non-resident with assets subject to Canadian tax may also obtain a rollover on transferring the assets to a Canadian corporation for shares. Typically this could be used for business assets connected with a Canadian permanent establishment, but is restricted for Canadian real property. Only real property that is capital property to the non-resident and used in a business carried on in Canada qualifies, and then only provided that all or substantially all of the property used in the business was being transferred to the corporation at the time, and control of the business or corporation did not change as a result of the transaction.[9]

Often on forming a joint venture, assets will be transferred from the Canadian operating entity into a foreign corporation. These assets could be intellectual property, Canadian physical assets, foreign assets owned by the Canadian entity directly, or shares of a foreign affiliate owned by the Canadian entity. In these situations, the Canadian tax-free rollover rules can be restrictive, and must be reviewed. Assets other than shares of foreign affiliates can be transferred tax-free only to another Canadian corporation. No similar rollover provision applies for that wide category of assets transferred to a foreign corporation. However, shares of foreign affiliates can be transferred on a tax-free basis to another foreign affiliate utilizing the provisions of 85.1(3) provided that shares are received as partial consideration from the transferee foreign affiliate, and the remaining requirements of that subsection are met.

Another rollover permitted in the Canadian tax legislation that could be applicable in the formation of a joint venture is the transfer of property to a Canadian partnership.[10] A "Canadian partnership" is defined to mean a partnership, all the members of which were at the relevant time, resident in Canada[11]. To qualify for the rollover, the partnership must be a Canadian partnership of which the transferor is a member immediately after the transfer. It is therefore possible for the Canadian partners to transfer assets on a rollover basis to a Canadian partnership prior to non-residents becoming partners.[12] In addition, the tax deferral is only effective provided that under the terms of the partnership agreement and the relevant partnership law, the partnership continues to exist upon the admission of the non-resident partner (i.e. avoiding a dissolution of the old partnership and the formation of a new partnership).[13]

VI. FORMING THE JOINT VENTURE

A. No assets transferred, one country location

Certainly the easiest place to begin to analyse the tax issues in structuring foreign joint ventures is the joint venture with only one country location, and no existing assets to be transferred into the joint venture. Here all the issues involved relate to structuring the most tax efficient organization to route profits from the host country to the participant joint venturers, one of whom is in Canada and the other of whom could be in the host country or a third country.

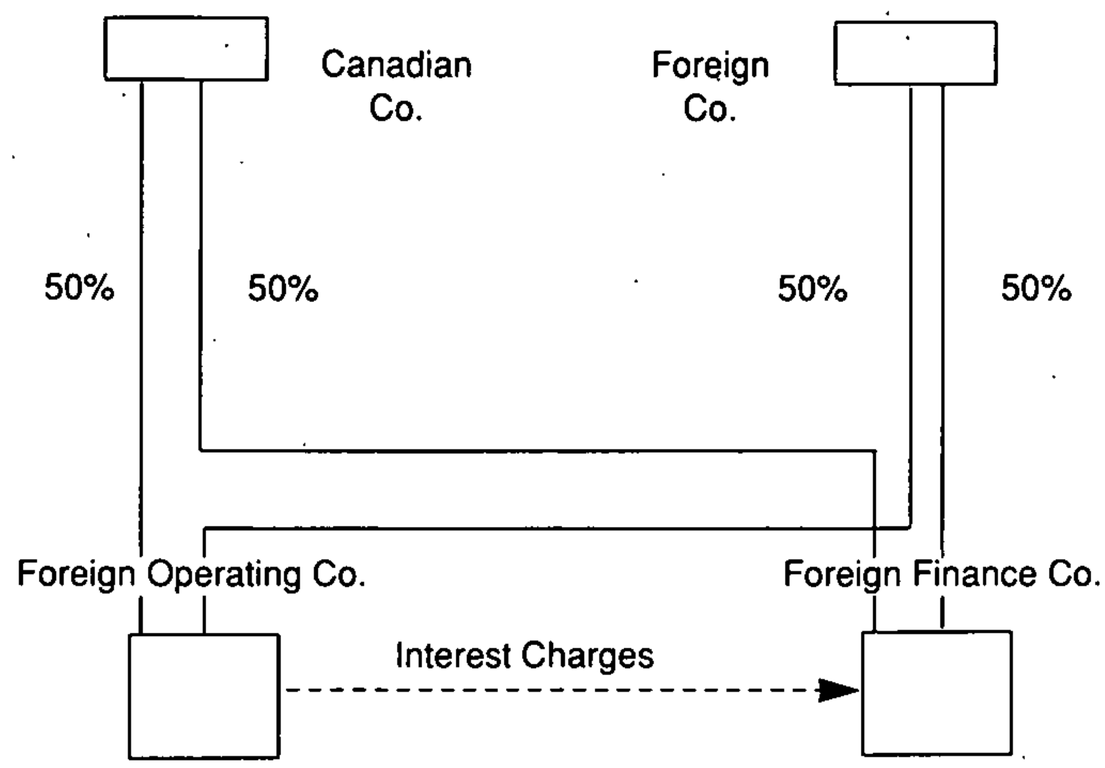
The typical international structure for a Canadian business includes an operating subsidiary and often a financing or other entity to try to reduce tax in the host country. If the host country has a tax treaty with Canada, active business income can be repatriated to Canada as a dividend with no further Canadian tax (exempt surplus). Similarly, interest paid by that foreign entity and received by a financing affiliate will also be eligible for exempt surplus treatment if the interest charge reduces active business income of the payor. If this can be structured to reduce the overall tax costs outside of Canada, e.g. by using a low tax, treaty country finance company such as a Dublin docks Irish company, a better after-tax yield can be earned by the Canadian co-venturer.

8. Sec. 85(1).
9. Para. 85(1.1)(h).
10. Sec. 97(2).
11. Sec. 102.
12. See "Revenue Canada Round Table", 1987 Conference Report, Question 5.
13. If it was found that a new partnership was formed the Canadian partner would be considered to have disposed of its interest in the old partnership for proceeds equal to fair market value of the new partnership interest. This would nullify the tax effectiveness of the rollover. As well, subsec. 98(2) deems the old partnership to have disposed of its property to its partners for fair market value.

© 1994 International Bureau of Fiscal Documentation

Such a structure would appear as:

Illustration I



A similar structure could be advantageous to the Canadian co-venturer even if no tax treaties are applicable, if the operating company is in a high rate jurisdiction.

B. No existing assets transferred into joint venture, operations in two or more country locations

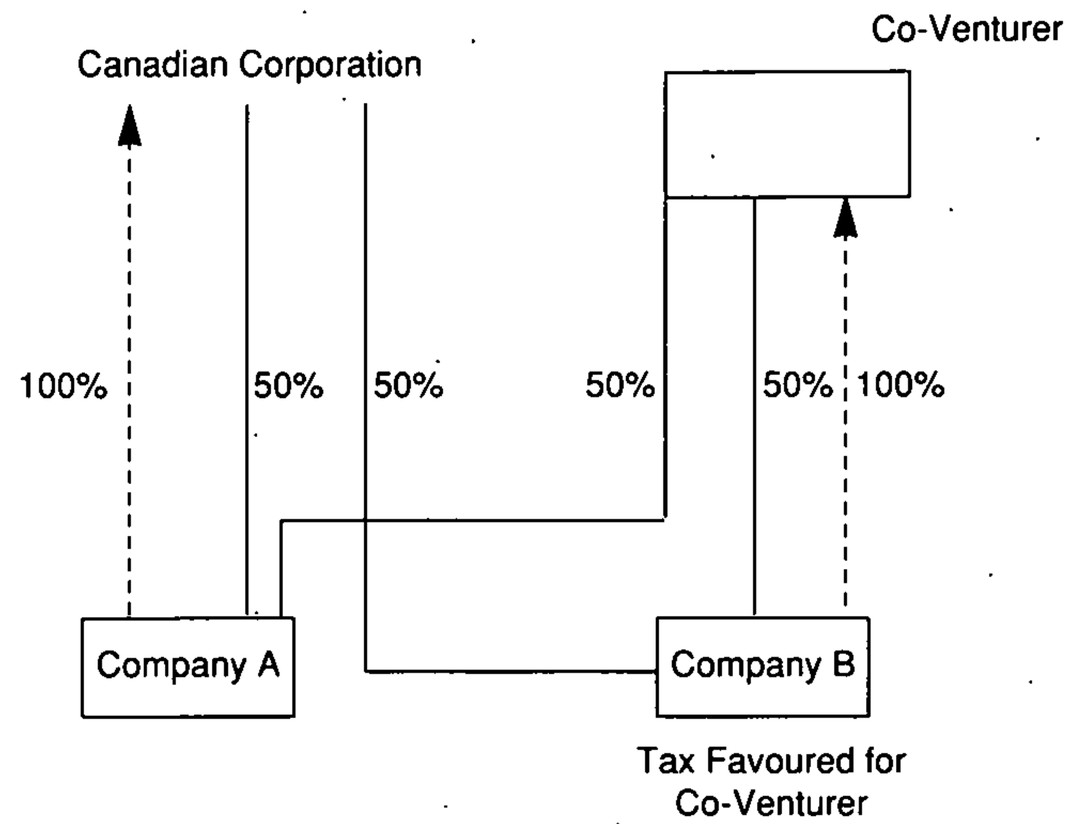
This particular fact pattern builds on the complexities of the one country alternative. All of the issues to be addressed in the one country alternative remain in existence, and must be dealt with, but a further layer of complexity arises. Income from one of the jurisdictions where the joint venture operates may produce higher after-tax results to one participant than the other. Disproportionate distributions from various business locations may be an attractive tax strategy.

This particular issue has been dealt with in a variety of situations, not just joint ventures. The issue is that income earned in a particular country may be taxed in a preferential way to a shareholder resident in a particular jurisdiction as compared to a shareholder in another jurisdiction. A classic example of this is income earned in a Canadian corporation and distributed to a Canadian corporation as a dividend. The Canadian recipient will typically receive the dividend tax-free, whereas a non-resident of Canada would be subject, at a minimum, to Canadian withholding tax on the dividend. Similarly, a Canadian corporation can receive a dividend from active business income earned in a treaty jurisdiction free of Canadian income tax, whereas a US joint venturer would be subject to US tax on the dividend receipt under the US gross-up and foreign tax credit mechanism. Tax strategy would indicate that this low tax treaty income should be routed to Canada and high tax income to the United States.

This is best illustrated by illustration II. A joint venture between a Canadian company and a foreign co-venturer Company A may be located in Canada, and company B located in a jurisdiction, the profits from which are favourably taxed in co-venturer's own country.

The after tax returns of the structure may very well be enhanced if the income flow of Country A went to the Canadian corporation and the income of Company B went to the foreign investors.

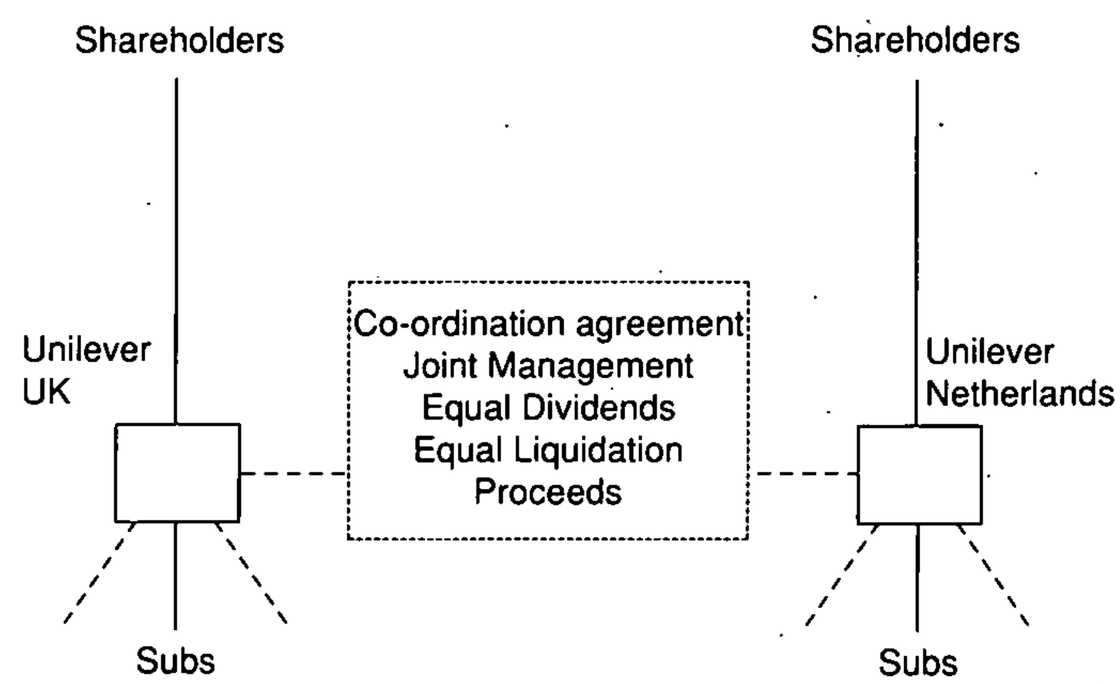
Illustration II



Assume Company A profits equal Company B profits.
- - - - - - - - Desired income flow
———— Desired effective equity ownership

Unilever Model:
This particular issue was addressed by Unilever in the 1930s which gave rise to a simple structure as follows:

Illustration III



Although the Unilever shareholders acquire shares of either a Dutch company or a British company at their option, ignoring tax considerations the economic considerations are expected to be neutral. This economic neutrality is achieved

© 1994 International Bureau of Fiscal Documentation

by the coordination agreement between the two Unilever companies which provides for joint management, equal dividends per share and equal liquidation proceeds per share of each company.

This model, has the beauty of simplicity in that profits from Unilever UK (and its subsidiaries) are distributed to its shareholders and correspondingly Unilever Netherlands pays dividends to its shareholders. This gives shareholders the right to choose the preferred country of source for dividends with presumably the investment decision being neutral in all aspects but tax.

If one were to attempt to put this structure into the Canadian example in Illustration II say substituting Unilever UK with "Unilever Canada", the Canadian tax consequences might be as follows:

1. As a result of the coordination agreement, some issues regarding residency of Unilever Canada and Unilever and Unilever Netherlands may result.

2. If the shares of "Unilever Canada" are held to be taxable preferred shares, the company will be subject to part VI.I tax of 25 percent (or 40 percent with an election) or higher if short-term preferred shares with corporate recipients being subject to a 10 percent part IV.I dividend received tax (or zero percent with a corporate election). Although the payor tax is deductible at a 9/4 rate in arriving at Part I tax, this share structure is probably unacceptable for the long run and would likely be avoided unless the Canadian shareholder owned a substantial interest and therefore the tax related to taxable preferred shares would not apply.

   Taxable preferred shares achieve that status by, among other things,[14] having a person (say Unilever Netherlands) effect an undertaking to ensure that the shareholders' (say of "Unilever Canada") loss is limited in any respect. It would appear that the Unilever agreement to equalize liquidation proceeds would constitute such an undertaking and therefore make the shares taxable preferred shares. This particular issue could be circumvented if the undertaking were limited to the liquidation entitlement of the common shares of a parent corporation (provided those shares themselves are not taxable preferred shares).[15]

   It is also possible that the Unilever type shares could be taxable preferred shares by virtue of their dividends being established by formula to be not less than a minimum,[16] i.e. the dividends paid on Unilever Netherland's common shares. However, this is more interpretive, and also may be avoided by restructuring the dividend rights to common shares of a parent (again provided they are not taxable preferred shares themselves).[17]

   In our example of the Canadian shareholder owning 100 percent of all shares (which qualifies as a substantial interest), the taxable preferred share rules would not appear to be a stumbling block as the dividends to a shareholder with a substantial interest are not subject to the Part VI.I tax.

3. It is likely that the shares could be structured so that they are not term preferred shares, (i.e. particularly that no rights of redemption or cancellation, etc. are provided to any party). Thus, the term preferred share rules should presumably be avoided by this structure. This would only be of consequence to a purchaser that is a specified financial institution anyway. Dividends on term preferred shares are taxable for specified financial institutions[18] unless acquired outside of the ordinary course of their business.[19]

4. The shares issued by the "Unilever Canada" may, however, be guaranteed shares as that term is used in Section 112(2.2). This would only become the case if Unilever Netherlands were a specified financial institution, a condition that could be caused by it or a non-arm's length corporation having a principal business being the lending of money to, or purchasing of debt obligations issued by, arm's length persons. It would not be uncommon in a large corporate group to find such an entity, and thus caution is necessary. (Even if one does not exist today, it may exist in the future and create an issue.) The consequences of the shares being guaranteed shares is that Canadian corporate shareholders would not receive a deduction for dividends from taxable Canadian corporations if Unilever UK was replaced by a Canadian corporation, "Unilever Canada".

5. The taxable preferred share rules are not of concern if the Canadian corporate shareholder holds shares of a foreign affiliate rather than a Canadian Company. However, both the guaranteed share and the term preferred share rules have their equivalent[20]in the foreign affiliate structure, and therefore caution must be exercised in this area. In the foreign affiliate area, dividends on the equivalent status shares are deemed to be interest received rather than dividends unless the shareholder meets the "substantial interest" or "ordinary course of business" test.

6. Perhaps a more significant issue is the protection mechanism to equalize dividends and liquidation proceeds. How does one mechanically provide for the equalization mechanism in the Canadian legal environment? Would such guarantees, etc. be permissable under corporate law? Fortunately, for me the legal community won't let me answer that question, nor can I cite examples of it being done as I am not aware of any examples in Canada. If a payment were required to be made out of a Canadian company to a foreign company (the other Unilever) under such a structure, would that payment, or some rights surrounding that type of payment be considered a benefit to the Canadian corporation's shareholders (or benefits conferred on the other shareholders), taxable to

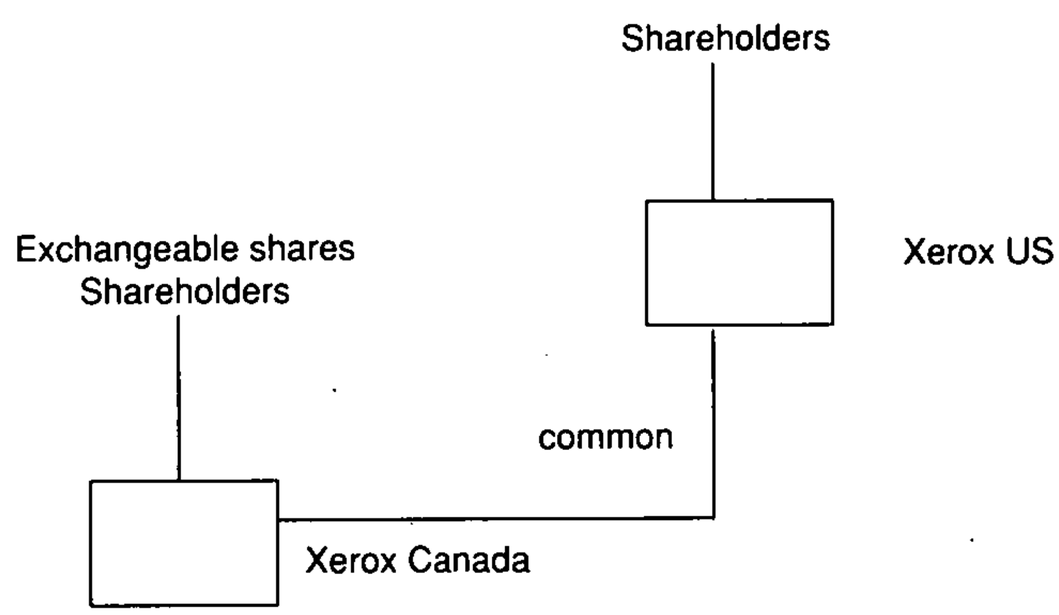
14. See sub-para. (b)(iv) of the definition of taxable preferred shares in subsec. 248(1).
15. *Ibid* para. (d).
16. *Ibid* sub-para. (b)(ii).
17. *Ibid* para. (c).
18. Defined Sec. 248.
19. Subsec. 112(2.1).
20. See subsecs. 258(3)-(5).

© 1994 International Bureau of Fiscal Documentation

the shareholders under a combination of 56(2) and 15(1) with no corresponding dividend deduction to a corporate shareholder. This would presumably be a significant exposure for this particular structure. If the payments themselves were merely subject to withholding tax as a dividend to a non-resident, the parties could presumably live with such an exposure. This may suggest then a modification of the Unilever structure to issue a further class of shares from "Unilever Canada" to the shareholders of "Unilever Netherlands" which shares are entitled to dividends or liquidation proceeds should there be unequal funds in "Unilever Netherlands" to provide sufficient distributions to the two parties. This would presumably provide a class of shareholdings entitled to such dividends. Whether such share structure would remove the benefit type of issue depends upon one's interpretation of the McClurg decision[21], as to whether it requires financial and other contributions to "Unilever Canada" and a reasonableness of the compensation received or if the decision supports payment of dividends in an arm's length case to be beyond 56(2). Strong arguments can be made that the share rights can overcome any 56(2) conflict and that the necessary support for the structure, if required by McClurg exists in any event. The tax issue with these shares would be in the area of valuation of these shares at the time of issuance and benefit problems at that time.

Xerox Model:
Another version of attacking this problem of advantageously routing dividends to shareholders is the exchangeable shares model as illustrated by the Xerox Canada shares.

Illustration IV



The Xerox structure was actually designed not to serve a joint venture, but to take a Canadian subsidiary which had public shareholders in Canada back into the integrated realm of Xerox worldwide. One of the expressed reasons[22] was to enable management to make global decisions which may independently not be the best for any particular entity in the group, but best for the global entity. To achieve this goal, the publicly held common shares of Xerox Canada were converted into non-voting exchangeable class B shares. The dividends on the class B shares were to be computed by reference to dividends paid on the US parent company's common shares. Shareholders of the exchangeable shares of Xerox Canada have the right to request an exchange of the class B common shares for a pre-set number of common shares of the parent. The exchange itself is to be achieved by delivery of the class B shares to Xerox Canada who will purchase common shares of Xerox Corporation from the corporation or the public market, and exchange the shares on the basis of one Xerox Corporation share for each 3.75 shares of Xerox Canada exchanged (cash would be given instead of fractional shares).

The Xerox model does not have any direct support for value of the exchangeable shares for the Canadian company, and thus, should the Canadian company enter into hard times, it is conceivable that sufficient value may not exist for it to actually complete the exchange. It is possible for the Canadian shareholders to be prejudiced in relative value. The market did not seem to be concerned about this investment, presumably due to the significant value of Xerox Canada in excess of the value of the exchangeable shares held by the public (i.e. the common shares held by Xerox US provided a significant comfort zone).

The Xerox model by avoiding the "guarantee" of the share value automatically avoids the issue "guaranteed share" of Section 112(2.2) to preserve deductibility of the dividends for corporate shareholders.

This model could be used in a joint venture, but would be difficult to use in a 50/50 joint venture. The protection for the Canadian joint venturer of his value is difficult in a 50/50 joint venture where the Canadian equivalent of Xerox Canada would start off with a small equity value and grow disproportionately to the foreign entity. If, for example, the foreign entity tripled in value and the Canadian entity merely retained its value, the Canadian company could not meet the exchange obligation. Much more room for asset coverage exists if say the Canadian venturers share in the joint venture is only 20 percent, which would remove a large piece of the concern for not continuing to proportionately share in value but it does not eliminate the issue. At least with this ratio there should be enough value coverage for the Canadian participant that he should have significant warning that the economic benefits from the "income access shares" are over and it is time to protect his business position more so than his tax position, and convert into the shares of the global joint venture.

It is interesting to note that this type of approach was also taken by ADT Finance Inc. in a financing venture to obtain equity financing by Canadians for use in an international operation. Again, guarantees were not given, but asset coverage was such as to give Canadian shareholders presumably sufficient warning to convert their exchangeable shares

21. See *The Queen v. McClurg* 1991 DTC 5001 (SCC) and Revenue Canada Round Table Question 22, 1992 Conference Report.
22. Xerox Canada Inc. information circular dated 10 October 1989.

© 1994 International Bureau of Fiscal Documentation

rather than suffer the consequences of a disproportionate equity loss.

A point to note of course, is that the Xerox approach provides that at the time of the exchange, a deemed dividend will occur if the value of the distributed shares exceeds the paid up capital of the exchangeable shares. With a Canadian corporate shareholder, this deemed dividend should not be an issue, if the distributed shares continue to be held. Should the distributed shares be sold, the possible application of Section 55(2) should be considered.

This deemed dividend treatment could be avoided by the exchange going directly to the other company "Xerox US". This right could recharacterize the shares. The shares would be further away from term preferred status but the exchange right with the parent corporation could likely re-activate the "guaranteed share" rules of subsection 112(2.2) if the exchange could happen at a higher value than the issuer "Xerox Canada" could sustain.

The Xerox model avoids the term preferred share rules by being exchangeable into common shares of Xerox Corporation (presumably not a term preferred share), and avoids the taxable preferred share rules by tying the dividend rights to a class of shares of the parent that are not taxable preferred shares. This exemption from the taxable preferred share rules requires a dividend entitlement to be determined by reference to a dividend entitlement of a share of a corporation that controls the issuer.[23] This may or may not be accessible in a joint venture situation particularly if the Canadian participant is to be a 50 percent participant. If the Canadian participant is to be less than 50 percent it is quite easy to have the "Xerox US" corporation as the controlling shareholder of the entity from which the Canadian participant is to receive his dividends.

C. Existing assets transferred into joint venture operations in one country location

This particular scenario, i.e. the transfer of assets into the venture at the time of formation adds complexity to the already complex. Not only must all the issues addressed previously, i.e. that of protecting the ongoing operations and sharing of future growth and income be addressed, but now a mechanism must be found to transfer assets from the Canadian joint venturer to the new joint venture entity on a tax efficient basis.

This is probably more complex if the operations are only carried on in one jurisdiction, and that location is outside of Canada. If the assets held by the Canadian are already used in a foreign operation, and are in a foreign corporation, the transfer itself can be achieved in a tax free manner:

(i) if a new joint venture is to be a corporation, shares of the existing foreign affiliate could be transferred into the new foreign affiliate (provided the Canadian company receives 10 percent or more of the shares of any class) utilizing the rollover sections of 85.1(3);

(ii) the foreign corporation could itself transfer its assets into the joint venture foreign affiliate as it is not subject to Canadian tax. The disposition of assets used in a business are excluded property[24] for the purposes of FAPI determinations, and therefore do not create a taxable income for the Canadian shareholder;

(iii) the foreign corporation could transfer the business assets to a foreign partnership again relying on the fact that it itself is not subject to Canadian tax and the transfer of business assets should not produce FAPI.

The bigger issue in this particular event is the foreign country tax planning that may be necessary for the particular transfer of these assets, a subject that is beyond the scope of this article.

Where the assets (other than shares of a foreign affiliate) are held directly by the Canadian participant, there is no way to transfer the ownership into a foreign corporation on a tax deferred basis. The only entity that could be formed would be a partnership with all Canadian partners, and then admit the foreign participant into the partnership (see comments under the "Canadian Tax Free Rollover" section).

The resulting partnership will then be treated as any foreign (or domestic) partnership, i.e. the Canadian partner will be taxable on his share of the income of the partnership, while non-residents will be taxable on their share of Canadian-source income.

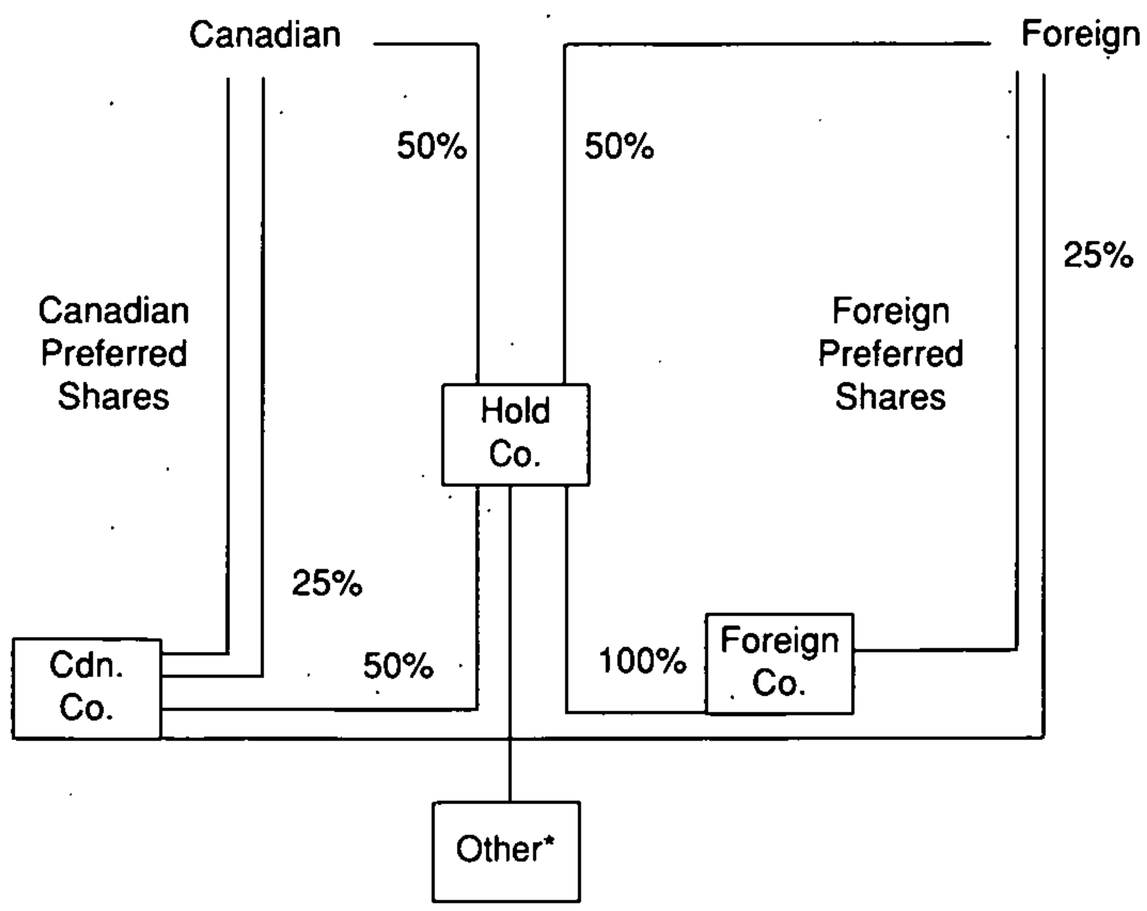
D. Existing assets transferred into joint venture operations in Canada and one or more other countries

This particular transaction brings more issues into play in terms of the rollover provisions, and the motivation behind the income access shares. That is the Canadian joint venturer will wish to continue the advantages of income receipt from a Canadian location, while at the same time sharing in the benefits of growth from the foreign joint venture. An illustration of the type of structure that may evolve is as follows:

23. Para. (c) of the definition of taxable preferred shares in Sec. 248.
24. Clause 95(1)(b)(ii) and para. 95(1)(a.1).

© 1994 International Bureau of Fiscal Documentation

Illustration V



* Non tax preferred subsidiaries

Highlights of this structure are:

(i) the Canadian preferred shares could be structured both for the rollover and as income access shares. The redemption value could be set at the value of the assets transferred (to avoid indirect benefits and issues under 85(1)(e.2)) and the dividend rights could be all profits of the Canadian company but limited if equal dividends could not be paid on the co-venturer's income access shares, the foreign preferred shares;

(ii) the foreign preferred shares would represent the initial value contributed by the co-venturer. These shares would also have full dividend rights, but the dividend rights would be limited if equal dividends could not be declared and paid on the Canadian preferred shares;

(iii) as the Canadian preferred shares are taxable preferred shares, the co-venturers would prefer to issue some shares that are not taxable preferred shares directly to the Canadian co-venturer to ensure that the Canadian has a substantial interest.[25] This will then avoid the Part VI.1 tax otherwise applicable.

These common shares will increase in value if the preferred shares no longer represent the full value of the company. This could occur if the dividend rights or redemption rights were impaired due to insufficient earning power or equity in the foreign company (i.e. as dividend rights drop, the possibility for the common shares to receive a dividend increases, hence the common share value increases to a point where combined, the preferred and common shares equal the value of the Canadian company).

To equalize value, Foreign Co-venturer will need some balancing value, either a direct 25 percent interest in Canadian company or a call on 1/2 of the common share interest held by the Canadian, or a balancing type of share from Hold Co. or another entity. This will depend upon the economics of the situation.

(iv) The co-venturers will also require protection around the redemption values of the preferred shares to provide for the eventuality of one or the other losing value below their redemption value. This can be structured in a number of ways depending upon the particular fact pattern. Caution must always be held for the guaranteed share rules in the event that co-venturer is, or might become in the future, a specified financial institution.

(v) Other structures are obviously available to meet the particular needs of the parties and economic circumstances. This particular structure is merely indicative of the issues to consider.

VII. CONCLUSION

There is no clear cut preferred form to structure international joint ventures. The variables that exist are too numerous to be set out in any written format capable of being technically up to date by the time it is published. Each issue relevant to the particular facts must be reviewed at the time of structuring to ensure that the immediate and possible long term objectives are dealt with for likely tax and business scenarios. The area is dynamic, exciting and a place where planning makes a difference.

25. See subsec. 191(2).

© 1994 International Bureau of Fiscal Documentation

TRANSFER PRICING: CURRENT CANADIAN PERSPECTIVE

Nathan Boidman

Goodman Phillips & Vineberg, Montreal, Canada

I. INTRODUCTION: PARAMETERS OF ARTICLE

This article is *not* a detailed statement of the nature and status of transfer pricing in Canada. That topic has been comprehensively reported elsewhere, with there being no radical or substantial overall changes in the Canadian transfer pricing system since the time of such reports or articles.

This article reviews and discusses:

(1) The nature of the arm's length principle (underlying transfer pricing in most countries, including Canada) and the unavoidable controversies and malaise which are inherent in and arise from transfer pricing law based on the arm's length principle.

(2) The interrelated effects, in Canada, of the basically futile attempts by the United States to fit a square peg into a round hole, by legislating the arm's length principle, and the specific reaction thereto by Canada.

(3) The obvious and inevitable solution to the unavoidable malaise, namely, the initiative by the same country which has caused the controversy, the United States, with respect to advance pricing agreements and the current status thereof in Canada.

(4) Another solution, at least for some multinationals, to the problem, namely, the IFA sponsored "Arm's Length Bargaining Process" pre-emptive rule of transfer pricing, developed during the panel discussions and working sessions (organized and chaired by this author) at the 1992 Cancun IFA Congress.[1]

As well, there is a brief review of the parameters of Canadian transfer pricing law including a February 1994 anti-avoidance proposal respecting offshore transshipment companies.

II. THE ARM'S LENGTH PRINCIPLE – THE BASIC CONUNDRUM

A. Overview

In September 1992 a US Treasury Department spokesman said, in signalling the US government's retreat from efforts to legislate that which cannot be (legislated) – and in particular the retreat from the mandatory use of the comparable profit method):

> Mogle said he has 'a few ideas' as to what might replace CPI, but gave no details. The right answer, he believes, is 'a great deal more flexibility and broad principles from which you can then go to a *fact and circumstances analysis*.'[2] (emphasis added)

The author of this article, in preparing the discussions for Subject I at the Cancun IFA Congress,[3] set out (in the outline of the segments into which the topic was delineated for purposes of the panel discussion and the general working session) the following:

> A second sub-question ... is the extent to which, if any, the factors arising from a discussion of the first two questions may, unavoidably, lead to the concern that in the absence of comparable market prices the search for pricing methodology which comport with the arm's length principle is a futile exercise and that in such circumstances there may be only three possibilities:
>
> 3.1 where transfer prices are not be agreed upon by the parties, they are to be decided by the courts on the basis of the *particular facts and circumstances* (perhaps in light of the German standard of the prudent businessman, acting in his own separate interest); or
>
> 3.2 transfer prices are to be determined by adopting mechanical, arbitrary formula approaches; or
>
> 3.3 the deficiencies in the first two approaches (including uncertainty) are to be eliminated by moving towards pricing agreements between taxpayers and the tax authorities.
>
> 3.4 (In other words, should the search for alternative pricing methods, in the absence of comparables market prices be abandoned on the grounds of being inherently in conflict with the requirements of the arm's length principle?).

The IRS states in the introductory portion of the Proposed and Temporary Code Section 482 Regulations issued on 13 January 1993 with respect to the best method rule:

> In response to comments, the strict priority of methods in the proposed and current regulations has been abandoned. Rather, *a much more flexible* approach has been adopted. While the problems with a strict priority of methods are acknowledged, the drawbacks of

1. "Transfer Pricing in the Absence of Comparable Market Prices", *Cahiers de Droit Fiscal International (Studies on International Fiscal Law)*, Vol. LXXVIIa, Subject I, IFA, 46th Congress, Cancun, 1992. The Cahiers contain 26 country reports and a general report (prepared by Guglielmo Maisto). The panel discussions and general working session stemmed from and were based on the general and country reports.
2. "Final Section 482 Rules Likely This Year, Will Not Require Use of CPI Test, Mogle says", *BNA Daily Tax Report*, (No. 184) 22 September 1992, at G-1.
3. See *supra* note 1 and related text.

© 1994 International Bureau of Fiscal Documentation

> such rigidity must be balanced against the need to provide some guidance as to which methods are most appropriate for particular cases. The best method rule attempts to achieve this balance by recognizing that the method that provides the most accurate determination of an arm's length result *will vary depending upon the facts and circumstances of the transaction under review.* (emphasis added)[4]

The foregoing comments reflect the inevitable and unfortunate consequence of the fundamental nature of pricing law which is based on the "arm's length principle" ("ALP") (as it is in Canada, the United States and most other countries). The requirements of the ALP can only be *objectively* met in two limited circumstances, and in the preponderance of circumstances the requirement raised by the ALP is undermined by unavoidable *subjectivity* and uncertainty.

B. Objective basis for applying the ALP

The ALP can be applied objectively in only two situations or circumstances.

1. Comparables

The first circumstance is familiar. The transaction to be priced is identical or very similar to a transaction that has in fact been carried out between unaffiliated[5] parties (whether one such party is a party to the affiliated party transaction to be tested or not) *and* somebody, whether it is the taxpayer, tax authority or a court, identifies such a transaction, which then can become the standard against which the actual affiliated party price is to be tested. This, of course, is the comparable uncontrolled price method ("CUP") as that terminology has been developed in the United States and copied word for word in other jurisdictions or reflected by similar language.

2. Internal arm's length bargaining – a pre-emptive transfer pricing rule?

The second circumstance is *not* familiar. The requirement (of the ALP) is objectively met if it can be shown that the affiliated parties established their price through an "arm's length bargaining process", that is, notwithstanding their relationship, they established the price strictly according to their separate interests and in accordance with the same business considerations which would have been obtained had they been dealing with unaffiliated parties.

At this time this is *not* an accepted or recognized rule of law in the United States, Canada or any other country, although it has been sponsored (as a pre-emptive rule) by the IFA as a result of its deliberations at Cancun in 1992 (*supra* note 1 and related text) and the resolutions which were adopted and agreed to by that Congress.

In particular Resolution No. 7 reads as follows:[6]

> 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.

An interesting question is whether the absence of specific legislation (adopting Resolution No. 7) precludes reliance on (by taxpayers) or use of (by tax administrators or the courts) the concept. Given the flexibility (and uncertainty) – discussed next – of the ALP, it is suggested that the answer is negative. After all, what better evidence can there be of the essential requirement of the ALP than a price resulting from an actual bargaining process?

The fact that in most cases there is no such process and, where there is, it may be difficult to prove same (to the satisfaction, ultimately, of a court) should not serve to reject the essential validity of the concept.

For example, if it can be shown that the senior management is remunerated strictly by reference to the separate bottom line profitability of their units in a multinational and, in pursuit of their own separate economic interests, transactions with other units in the group have been priced by a normal business-like bargaining process, acceptance of such prices as pre-emptively arm's length would not only seem reasonable, but compelling. There are at least some (informal studies suggest 10-15 percent[7]) instances of such situations which should be served by such a rule.

---

4. Department of the Treasury, IRS, "Internal Revenue Service Temporary Regulations (TD8470), Intercompany Transfer Pricing Regulations Under Sec. 482, Issued 13 January 1993", published in *Federal Register* of 21 January, 26 CFR Parts 1 and 602. See also IRS Notice of Proposed Rulemaking (IL-21-91), Imposition of Accuracy-Related Penalty Under Secs. 6662(e) and 6662(h), Relating To Transfer Pricing Misstatements, issued 13 January, and IRS Notice of Proposed Rulemaking (IL-401-88), Intercompany Transfer Pricing Regulations Under Sec. 482, issued 13 January (both also published in 21 January *Federal Register*, at 12 and 13).

5. The words "affiliated" and "unaffiliated" are used herein in a general sense. In Canada, affiliated parties for purposes of the ALP are those who "do not deal at arm's length" within the meaning of Sec. 251(1) of the Income Tax Act (Canada), R.S.C. 1985, Chap.1 (5th Supp.), as amended (hereafter "ITA") and the latter always include those who are "related" within the meaning of ITA Sec. 251(2) and can, depending upon the facts and circumstances, include those who are not related.

6. Resolution 7 of Resolutions, "Subject I: Transfer Pricing in the Absence of Comparable Market Prices", (*supra* note 1) and H. Hamaekers, "The Arm's Length Principle And The Role Of Comparables", 46 *Bulletin for International Fiscal Documentation* (December 1996.), at 602. Resolution No. 7 was formulated by the author of this article, based on the (underlying) identification and discussion of the principle by Mr Hamaekers in his work for the panel discussions of Subject I.

7. See Professor L. Eden, "Multinationals and Transfer Pricing – Reference Manual (Part I)", (prepared for a five-day workshop on Multinationals and Transfer Pricing, presented to senior Revenue Canada international tax auditors (Center for Career Development, Revenue Canada Taxation) 6-10 December 1993, Toronto (copyrighted by Carleton University)), who cites (in Table 1) M. Al-Eryani, R. Alam and S. Akhter, "Transfer Pricing Determinants of US Multinationals", 21 *Journal of International Business Studies* (1990), at 4009-25, whose study shows that 13% of US multinationals with affiliates primarily in developed countries established prices through negotiation (i.e. an arm's length bargaining process), while US multinationals with affiliates primarily in developing countries negotiate prices 16% of the time and US multinationals with affiliates in all host countries negotiate prices 15% of the time. Professor Eden then cites (in Table 2) R.Y.W. Tang, "Transfer Pricing in the 1990s: Tax and Management Perspectives" (Westport, Connecticut: Quorum Books, 1993), at 71. This table revealed that 12.7% of international transfers by 157 Fortune 500 companies were priced by way of a negotiation (i.e. an arm's length bargaining process).

© 1994 International Bureau of Fiscal Documentation

C. Subjectivity and uncertainty in the ALP

Where neither of the two foregoing circumstances arise, then (as reflected by the foregoing quoted comments) the legal requirements of the ALP cannot be complied with in an objective fashion and, conversely, the parties (whether taxpayers, tax authorities or courts) are left with no choice but to "estimate", "approximate", "simulate" or otherwise "guestimate" at the amount to be used by the taxpayers in determining their accounts under the ALP.

This inescapable conclusion means that, in the absence of comparables (or of the adoption of an arm's length bargaining rule, or even, if adopted, of arm's length bargaining) every country (which at present includes Canada) which requires accounting for intercompany transactions for income tax purposes on the basis of the ALP is accepting (and must accept) that the "guestimating" (which must axiomatically be utilized in order to complete tax returns or assessments by government or determinations by a court) will, by its very nature, mean that there is substantial room for disagreement between the parties.

This follows simply because the essence of a guestimate is subjectivity and uncertainty (who is to say their "guestimate" is better than that of another person) with the result that transfer price issues (even with the best of intentions of all parties) must, perforce, where the parties have arrived at different "guestimates" become a contest of "guestimates".

III. THE ARM'S LENGTH PRINCIPLE – THE CANADIAN PERSPECTIVE

That the foregoing is the essential nature of determining intercompany transactions under the ALP is, as already suggested, absolutely inescapable and, given that Canada requires pricing based on the ALP,[8] that is the basic nature of transfer pricing law in Canada as it is in all other countries based on the ALP. In Canada transfer pricing will be determined as follows:

(1) If there are valid comparables, then they will govern or should govern because they do reflect what the parties would have done had they not been affiliated with each other.

(2) If there are no comparables (and subject to the role of the "arm's length bargaining process" approach, which has not been seen, per se, in Canada to this point) the matter is to be decided through a duel of "guestimates".

To be clear, all transfer pricing methods or procedures or approaches (whether used proactively by a taxpayer to establish a price or reactively by a tax authority to evaluate a price used by a taxpayer or a court to test both taxpayer's and tax authority's determinations) will, in the absence of comparables (or the arm's length bargaining process approach), be nothing more or less than an attempt to "guestimate" at what the parties would have done. Such "guestimate" characterization applies to the so-called secondary methods (the cost-plus method or the resale price method) or, obviously to "other" or "fourth" methods, (whichever of the 15 to 20 which have been identified to this point[9]).

IV. THEMES AND PARAMETERS OF CANADIAN TRANSFER PRICING LAW

A. Overview

For the reasons stated above the substantive legal requirements for establishing transfer pricing in Canada are not and cannot be any different than those seen in every other country where the arm's length principle governs.

The essential "facts and circumstances" nature of the "guestimating" process can only be given some meaningful focus, shape and delineation by court decisions. Thus, similar to any tax or other legal issue requiring decisions based on determinations of fact, certain reoccurring fact patterns or situations may arise where the courts' decisions provide some guidance as to the "law" with respect to the subject matter. Unlike some other countries (particularly the United States) in Canada there have been very few court decisions and, therefore, little guidance to give shape or focus to the guestimating exercise.[10]

It is only in the area of (i) ancillary considerations or matters, such as the nature or mechanics of "secondary" adjustments or sourcing (and related withholding taxes) or (ii) procedural matters (including penalties) where there can be some substantial differences between the law in Canada and that found in other countries. Some of the factors are reviewed below.

B. Parameters

Parameters of transfer price law in Canada are as follows:[11]

(1) There is a statutory basis for the ALP (see ITA Secs. 69(2) and (3)) which is couched in brief and broad terms.

(2) There are no (sub-statutory) regulations or comparable "law".

(3) It was noted above that the body of case law is very small (note 10 and related text) and except for two cases (*Hofert*[12] and *Central Canada Forest*[13]) involved more

8. See ITA Secs. 69(2) and (3).
9. See *supra* note 1.
10. Furthermore, of the only seven reported cases in Canada on transfer pricing matters, five have involved tax motivated structures where offshore subsidiaries have been interposed to import goods into Canada by a Canadian company and where the courts' decisions in respect thereof can hardly be expected, and generally do not, provide much guidance which would be relevant to a transfer pricing dispute involving more orthodox transactions between related parties. The one exception is the decision in Indalex Limited v. The Queen, 86 DTC 6039 (F.C.T.D.) and 88 DTC 6053 (F.C.A.). See N. Boidman, "An Offshore Transshipment Company Case: *Indalex v. The Queen*", 42 *Bulletin for International Fiscal Documentation* (May 1988), at 202.
11. For a full statement of many of the points which follow, see Boidman and Lawlor, "Canada: Transfer Pricing in the Absence of Comparable Market Prices", *Cahiers de Droit Fiscal International*, Vol. LXXVIIa, at 323 (IFA, Subject I, Cancun, 1992).
12. *J. Hofert Ltd. v. M.N.R.*, 62 DTC 50 (T.A.B.)
13. *Central Canada Forest Products Ltd. v. M.N.R.*, 52 DTC 359 (T.A.B.)

© 1994 International Bureau of Fiscal Documentation

issues of tax avoidance than of transfer pricing (see note 20).

(4) In light of such limited "law" on point, the Canadian tax authority seeks to provide guidance through a (non-legally binding) "Information Circular", No. 87-2[14] (hereafter "IC-87-2"). This basically reflects the 1979 OECD transfer price report[15] (itself based on the 1986 IRC Section 482 regulations).

(5) IC 87-2 is neither industry nor transaction specific.

(6) The case law has only dealt with the transfer of goods, not services or intangibles.

(7) The tax avoidance character of most of the transfer price cases to date has brought into play certain statutory rules of a domestic, anti-avoidance nature, i.e. ITA Section 245 (as it read prior to amendment in 1988) dealing with the artificial reduction of income as well as case-made doctrines such as sham and agency.

(8) Sections 69(2) and (3) – embodying the ALP – applies only to transactions between legal entities, and not to intra-company (branch to branch, etc.) transactions.[16]

(9) Although the (ten) provincial governments of Canada generally take roughly between 30-40 percent of tax revenue with respect to income earned by corporations, the provinces do not really have separate law on point.[17] Although none of the provinces are party to Canada's federal double tax agreements with other countries, in the case of Alberta, Ontario and the other seven provinces referred to above, the incorporation of federal law, in the case of transfer pricing matters, effectively makes relevant aspects of the federal tax agreements applicable.[18]

(10) There is little in the other fields of Canadian taxation which is helpful in dealing with the arm's length principle for income tax purposes. In this regard Revenue Canada states at paragraph 21 and 22 of IC 87-2:

> It has been suggested that the Department should accept the 'value for duty', established for imported goods in accordance with the Customs Act, as representing a reasonable arm's length price for purposes of the Income Tax Act. This is not always possible for a number of reasons, including the obviously different contexts in which valuation of goods is required by the respective Acts.
>
> The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. Value for duty may now be closer to transfer prices acceptable for income tax purposes; however, differences do remain and the Department is under no obligation to accept the established or reported value for duty when considering the income tax implications of a non-arm's length importation.

There is no Canadian provision comparable to IRC Section 1059A, enacted in 1986, which would preclude a price for income tax purposes which exceeds the corresponding price for custom duty purposes. Finally in this context, no guidance appears to arise out of the provisions of federal or provincial sales tax legislation, including the recently enacted VAT-type "Goods and Services Tax" (brought into force at the federal level in Canada on 1 January 1991) in dealing with transfer pricing issues for income tax purposes.

(11) Where there has been a transfer pricing adjustment for overcharge to a Canadian member of a foreign owned multinational group, a "secondary" adjustment in the form of treating such overcharge as a disguised distribution and taxable as a dividend pursuant to the provisions of ITA Part XIII may arise. Administratively, Revenue Canada is prepared to forego the secondary tax if the excess charges are repaid by the foreign entity to the Canadian entity.

(12) The difficulties of stating with precision the law respecting any particular situation is exacerbated by the fact that, unlike, for example, the United States, there are no written materials which deal in a quantitative fashion with audit experience or government or taxpayer approaches. There are no reports along the line of that published by the IRS respecting the manner in which and on what basis transfer pricing disputes have been settled with taxpayers nor are there any published guidelines respecting the situation referred to above concerning intracompany as opposed to intercompany transactions.

(13) Because Canada has been a capital-importing country (with more Canadian companies being subsidiaries of foreign (often US) companies than vice versa), the current concerns in the United States respecting earnings stripping by foreign based multinationals through abusive transfer pricing of goods or services into the United States has long been a preoccupation of the Canadian tax system, both in the development of its law and its administration. Notwithstanding its relatively small size, Revenue Canada has over the years developed some degree of proficiency and experience in dealing with inbound transfer pricing into Canada including the full range of concerns, attitudes and predilections which stem from approaching the assessment of a Canadian subsidiary of a foreign-based multinational with a view that they are likely to "find" overcharges in relation to the arm's length standard. In this respect Revenue Canada has participated closely in cooperative programmes with the IRS, the OECD and other multinational intergovernmental groups (PATA, CIATA, etc.) with a view to continu-

14. Information Circular No. 87-2, "International Transfer Pricing and Other International Transactions", 27 February 1987.

15. OECD, "Transfer Pricing and Multinational Enterprises", *Report of the OECD Committee on Fiscal Affairs, 1979* (Paris: OECD). IC 87-2 does not fully reflect the follow-up OECD Report of 1984 ("Transfer Pricing and Multinational Enterprises – Three Taxation Issues" (Paris: OECD, 1984).

16. See ITA Sec. 4 and the decision in *M.N.R. v. Imperial Oil Limited*, 60 DTC 1219. Treaty provisions may import notions of intercompany rules; see "Subsidiary Doing Business In Canada – Transfer Pricing": Revenue Canada Memorandum, Rulings Directorate, 1 December 1992, as reprinted in CCH Canadian Limited, *The Tax Window*, Report No. 27, at 11.

17. In the case of seven provinces, the federal law is adopted on the basis that the provincial income tax is determined by applying a statutory rate determined under each separate provincial statute to the income base as determined for federal income tax purposes. Alberta, Ontario and Quebec have separately administered statutes with the first two adopting, by cross-reference, federal law relevant to transfer pricing, while Quebec's is essentially identical.

18. Quebec unilaterally provides some of the benefits which arise under Canada's federal treaties. See Sec. 488R1(e) of the Regulations made pursuant to the Taxation Act (Quebec). Such would not serve to effectively deal with transfer pricing issues. However, note that Quebec does have its own, direct, treaty with France.

© 1994 International Bureau of Fiscal Documentation

ously upgrading its information, knowledge and techniques respecting transfer pricing.[19]

(14) The controversial spotlight thrown on transfer pricing by US initiatives since 1986 (and the adoption/enactment of super royalty and all that followed) has had some fallout in Canada. As discussed in detail below, US initiatives have prompted procedural developments in Canada including the adoption of an Advance Pricing Agreement ("APA") procedure. Revenue Canada is also striving to build up data banks of information which might be helpful in either developing useful comparables and/or other data which can help in the "guestimating" process, and to determine the role that economists may play in sorting out facts and functions, etc. (in doing a facts and circumstances inquiry which can lead to a best "guestimate" of what the transfer price would have been had there in fact been an unaffiliated party transaction).

(15) The "inbound" orientation of Canadian transfer pricing matters, and related preoccupation and focus of Revenue Canada, was noted earlier. In recent years Revenue Canada has begun focusing on outbound transactions as Canadian based manufacturers and developers of high tech-computer based products (hardware and software) successfully expand into the US and other foreign markets through marketing-distributing subsidiaries. Paradoxically the interests of the Canadian-based multinational and Revenue Canada, from the transfer pricing perspective, are often the same. For example, in relation to the United States, comparative tax rates would often make it desirable if profit allocation to Canada is maximized. Furthermore, Revenue Canada's attitude in these situations hardens where the US marketing subsidiaries are relatively thinly staffed and to a large extent really run out of or by the Canadian parent company. This is a new and emerging aspect of Canadian transfer pricing practice which runs headlong into US initiatives respecting (US) inbound transactions.

(16) A major difficulty in dealing with Canadian transfer pricing experience is that it generally has remained confidential to the parties involved – regard being had to the paucity of court decisions. This has stemmed in substantial part from the fact that most disputes have been resolved through competent authority procedure. Not only are such procedures confidential, but often the taxpayers involved (and their professional advisors) are largely excluded from the process.

In summary of the foregoing:

- Canadian transfer pricing law (particularly the substantive law) is not much different, if at all, from that found in other countries.
- Its very nature is such that, in the absence of comparables (and of the adoption of an arm's length bargaining process rule), the matter unfortunately descends into subjective and uncertain "guestimating" and, where issues arise, a contest of "guestimates".
- Revenue Canada is, given its size, as knowledgeable, experienced and competent as are tax administrators of other countries.
- Canadian transfer pricing issues often are resolved by competent authority procedure (and just about never go to court).
- It is not likely that the Canadian system will substitute for the ALP any kind of mechanical or formulary approaches which would eliminate the subjectivity and uncertainty inherent in the arm's length principle (and all the taxpayer/government issues and hassles which can arise) but which would necessarily result in determinations which often/invariably are arbitrary and less appropriate than those which arise under the imprecise but conceptually sound ALP.
- The advent of APAs may further ameliorate the subjectivity and uncertainty usually found in transfer pricing arrangements.

V. THE EXACERBATING EFFECTS OF THE PRESUMPTION OF PRICE MANIPULATION

A. Overview

The simplicity and uncertainty of transfer pricing law based on the arm's length principle becomes particularly troublesome where taxpayers are viewed as deliberately using the uncertainty as a means of improperly reducing taxable income by shifting, through price manipulation, profit to affiliates operating in low tax jurisdictions. In Canada this is evidenced by the fact that of the seven transfer price cases since 1950 five have involved what Revenue Canada considered blatant arrangements involving offshore affiliates established to purchase goods or product from third parties foreign suppliers and resell same at inflated transfer prices to Canadian affiliates, where the interposed transshipment company served no real business role in the operations of the group.[20]

B. Proposed Canadian rule respecting offshore transshipment arrangements

It is precisely this type of arrangement which the Department of Finance now intends to counter statutorily. In particular, the 22 February 1994 Budget proposes to treat the profits of an offshore transshipment company – at least with respect to inbound transactions, i.e. purchases by a Canadian of goods manufactured by third parties through an offshore affiliate – as a component of Foreign Accrual Property Income ("FAPI")[21] and thus taxable on an attribution basis in the

19. However, unlike the United States, Canada has made no attempt to legislate rules which are designed to eliminate the uncertainty of operating under the arm's length standard. (See, however, the 22 February 1994 proposals discussed below.)

20. *Dominion Bridge Co. Ltd. v. The Queen*, 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.); *Indalex Limited, supra* note 10; *Irving Oil Limited v. The Queen*, 88 DTC 6148 (F.C.T.D.), 91 DTC 5106 (F.C.A.), the Crown's leave to appeal in respect of which was rejected by the Supreme Court in September 1991; *Redpath Industries Ltd. et al. v. The Queen*, 83 DTC 5117 (Quebec Court of Sessions of the Peace) and 84 DTC 6349 (Quebec Superior Court); and *Spur Oil Ltd. v. The Queen*, 80 DTC 61065 (F.C.T.D.) and 81 DTC 5168 (F.C.A.).

21. ITA Secs. 95(1) and (2).

© 1994 International Bureau of Fiscal Documentation

hands of the Canadian parent shareholder.[22] New ITA paragraph 95(2)(a.1) would read as follows:

> (a.1) in computing the income from a business other than an active business of a foreign affiliate of a taxpayer for a taxation year there shall be included the income of the affiliate for the year from the sale of property where
>
> (i) it is reasonable to conclude that the cost to any person of the property is relevant in computing the income from a business carried on by the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length or is relevant in computing its income from a business carried on in Canada by a non-resident person with whom the taxpayer does not deal at arm's length, and
>
> (ii) the property was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed or organized,
>
> unless more than 90% of the gross income of the affiliate for the year from the sale of property is derived from the sale of property (other than a property described in subparagraph (ii) the cost of which to any person is a cost referred to in subparagraph (i)) to persons with whom the affiliate deals at arm's length and, where this paragraph applies to include income of the affiliate from the sale of property in the income of the affiliate from a business other than an active business, the sale of such property shall be deemed to be a separate business, other than an active business, carried on by the affiliate and any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business.[23]

C. Other countries

In the United States such "tax planning" initiatives have been much more sophisticated and complex, although in the view of the IRS no less egregious.[24] As well, Revenue Canada and in recent years the US government may have been concerned that, even in the case of ostensibly straightforward business dealings between units of a multinational (both of which are based in high tax jurisdictions) there is tax incentive (generally of a less substantial nature than in the first case) for transfer price manipulation. This may turn either on "tax rate arbitrage" or other factors such as excess current expenditures or loss carry-overs.[25]

VI. TAXPAYERS' CONCERNS ARISING FROM THE UNCERTAINTIES IN TRANSFER PRICING

Taxpayers on the other hand are often concerned that tax authorities may use the inherent uncertainty in transfer pricing law to raise assessments which are ill founded – perhaps as an attractive means of simply increasing tax revenues. Taxpayers are also increasingly exposed to onerous requirements for information and information reporting respecting transfer pricing spawned by the government concerns referred to above or simply government concern that uncertainty of transfer pricing law can lead to inadvertent understatement of income by domestic taxpayers.

VII. CANADIAN REACTION TO RECENT US INITIATIVES

A. Overview

The foregoing concerns, from a government standpoint, have been viewed with alarm, particularly by the US government, beginning in the early 1980s – initially in response to *Eli Lilly* type situations and then later in the eighties to concerns that Japanese and other foreign-owned groups were overcharging their US marketing subsidiaries for products developed and manufactured abroad.

As a result, the United States has spawned several important transfer pricing developments in the past ten years:

- the 1986 enactment of "super royalty";
- the 1988 "White Paper" setting out preliminary proposals for implementation of super royalty;
- 1989 and 1990 legislation of certain onerous procedural and reporting requirements relative to "inbound" transactions (by foreign based groups with US marketing sub-

22. See ITA Sec. 91.

23. "Tax Measures: Supplementary Information (Tabled in the House of Commons by the Honourable Paul Martin P.C., M.P. Minister of Finance, 22 February 1994", accompanying 22 February Budget Speech) at 78. Finance's Explanatory Notes respecting this proposal at 87 of the Supplementary Information reads as follows:

"Proposed new paragraph 95(2)(a.1) of the Act, which applies to taxation years that begin after 1994, includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the sale of property where

* the cost of the property is relevant in computing the income from a business carried on by a taxpayer or persons resident in Canada that do not deal at arm's length with the taxpayer or a business carried on in Canada by non-resident persons that do not deal at arm's length with the taxpayer, and
* the property was not manufactured, produced, grown or extracted or processed in the country under whose laws the affiliate was formed or organized.

The rule does not apply where more than 90% of the gross income of the affiliate from the sale of property is derived from sales of property (other than property the cost of which falls within the rules described above) to persons that deal at arm's length with the affiliate. Where the rule applies to the foreign affiliate of the taxpayer, the sale of such property is deemed to be a separate business other than active business of the affiliate. Any income that pertains to or is incident to that business is deemed to be income of the affiliate from a business other than an active business of the affiliate.

This new rule will discourage the establishment of a foreign subsidiary by a corporation for the purpose of purchasing goods for resale and use in a business carried on in Canada either by the corporation itself or by any person with whom the corporation does not deal at arm's length."

It should be noted that under a revised numbering system under ITA, brought into force 1 March of this year, the "(a.1)" will be dropped from the statutory reference.

24. See for example *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 877 (7th Cir. 1988); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987); *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), aff'd, 933 F.2d 1084 (2d Cir. 1992); *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991); and *Sundstrand Corp. v. Commissioner*, T.C. Memo 1993-86, 63 T.C.M. (CCH) 2043 (1992) (collateral estoppel prevents government from raising certain transfer pricing issues).

25. The 1962 decision in *J. Hofert v. M.N.R.*, *supra* note 12 – one of the few Canadian cases not involving offshore transshipment companies – may have involved "tax rate arbitrage". This decision in fact made clear that fair value or transfer pricing is a question of commercial reality and not legal science, thus opening the Canadian system to the basic overall situation set out above.

© 1994 International Bureau of Fiscal Documentation

sidiaries) *as well as* onerous transfer pricing penalties for substantial understatement or overstatements of income under IRC Section 6662;
- the introduction of proposed regulations under IRC Section 482 in January 1992 intended to finalize the implementation of super royalty; and
- then in 1993 the introduction of temporary and proposed regulations under IRC Section 482 as well as enactment of beefed-up Section 6662 penalties.

As well, there have been aborted attempts (see, for example, the 1992 Congressional Bill H.R. 5270) to institute semi-formulary or minimum profit reporting requirements with respect to inbound (into the US) transactions.

As each development in the United States unfolded, the international business and tax community and foreign tax authorities reacted with a blend of harsh criticism and much concern resulting in enduring controversy in the international tax community. It was not for nothing that an international tax journal noted that:

> Transfer pricing issues continue to be the hottest topic in international taxation these days, and the United States continues to be the country most responsible for fanning the flames.[26]

B. Conflict in substantive law

The basic uncertainty and issues noted above are not new, the arm's length principle comprising the approach of Canada, the United States and other countries for many years.

Without much fanfare (and certainly not in the spotlight of the current controversy surrounding transfer pricing matters) the inevitable disputes arising from the uncertainty of the arm's length principle have generally been resolved through negotiation between taxpayer and tax authority and/or between the two tax authorities involved (of the two countries – from a Canadian perspective, usually with the United States) through competent authority procedures. This is evidenced by (1) the simple fact that in Canada there has been no conventional transfer pricing litigation since 1962 – *Hofert*, *supra* note 12 – (all litigation since then involving, as noted earlier, offshore transshipment company arrangements – *supra* note 10); and (2) constant statements by Revenue Canada that issues (particularly with the United States) are almost always resolved through competent authority procedure.

However, the era of tranquil resolution of transfer pricing issues involving Canadian companies, particularly in Canada and US situations, may have ended as a result of the particular form that the various US initiatives noted above have taken and, in particular, the basically futile attempt by the US government to legislate what cannot be legislated, namely objective or precise methods for determining transfer prices (in the absence of comparables).[27]

1. The 7 January 1994 Canadian reaction

Although the January 1993 Temporary and Proposed Regulations are in many respects a retreat from the more radical proposals of the White Paper and the January 1992 proposals,[28] certain aspects (discussed below) of the latest round of regulations are viewed, at least by Revenue Canada and the Department of Finance, as departing from the requirements laid down by the arm's length principle.

This is reflected in Department of Finance Release No. 93-003, "Transfer Pricing Rules and Guidelines Clarified", issued 7 January 1994, which has served notice that the hitherto reliable approach to resolving disputes, through competent authority procedure, may not in fact be available to Canadian taxpayers caught up in issues involving the United States.

The 7 January statement takes exception to the "comparable profits method"(CPM) and to "periodic adjustment"(PA). The government said:

1. With respect to CPM:

   > The Ministers noted that difficulties may arise where a foreign jurisdiction adopts another approach – such as the 'comparable profits method' set out in the new US regulations – which may generate transfer prices that do not conform to the arm's length principle and, hence, would not be acceptable for Canadian tax purposes.

2. With respect to PA, the statement noted:

   > As the OECD Tax Force Report stated, 'There is a fundamental contradiction between the arm's length standard which depends on evaluating transactions at the time they take place and the commensurate with income concept to the extent that it involves a year-by-year retrospective reappraisal based on profits'. When such a situation arises, Revenue Canada will not automatically provide a corresponding adjustment where the United States applies this rule.

As discussed below, an advance pricing agreement can avoid double tax that may arise as a result of this new era of poten-

26. John G. Goldsworth, "Transfer Pricing: American Tax Institute Conference Focuses on Recent Transfer Pricing Developments", 3 *Tax Notes International* (9 August 1991), at 28-30. Some anecdotal evidence respecting the current role of the United States in the area may be gleaned from the statistics contained in "Ernst & Young Fact Sheet on IRS Examination of Foreign Controlled Organization", 2 *Tax Management – Transfer Pricing Report* (9 June 1993), at 74 and "Nearly $10 Billion in Allocations Disputed in 87 Transfer Pricing Cases", 2 *Tax Management – Transfer Pricing Report* (20 October 1993), at 328.

27. The difficulty in legislating the arm's length principle is clearly seen in the comments by James Mogle, then Acting International Tax Counsel to the US Treasury, *supra* note 2.

28. Senior US government officials have hinted that an even more flexible approach to the matter is now being considered by widening the scope of comparables. An item entitled "IRS's Culbertson Says Transfer Pricing Penalty Regs Due This Month", 24 *Tax Notes International* (13 December 1993), at 1478 (Herman Ayayo) indicates that the IRS and Treasury did not have the intention of giving the comparable profit method (CPM) a higher status than any other and, perhaps more importantly, that the scope of CUPs will be extended:

> "A second substantive issue the upcoming 482 regs. will address concerns the scope of the comparable uncontrolled price (CUP) method, which in theory should be the best reliable method available, said Culbertson. The temporary regs disqualify from consideration as a CUP any transaction that requires a 'material adjustment'. The transfer pricing regs to be released next year, he said, will either 'take the thumb off the scale for CUP and just have CUP operate under the general analysis of the best method rule' or 'keep a thumb on the scale' in favour of CUPs and create a fourth category of inexact comparables. He noted that a decision has yet to be made on this point."

© 1994 International Bureau of Fiscal Documentation

tial conflict between transfer pricing law as viewed in the two countries – Canada and the United States.[29]

C. Conflict arising from impact of procedural/penalty provisions on substantive law

A second problem is the interrelationship between the substantive US transfer pricing rules and the effect (the distorting effect) thereon which may arise from the recently enacted IRC Section 6662 penalty rules for misstatements of transfer pricing matters.

The rules may force US taxpayers to adopt those aspects of the "new" Section 482 regulations which are most offensive from the standpoint of Revenue Canada and the Department of Finance – namely the "comparable profit method" and the "periodic adjustment" with respect to licences of intangibles, referred to in section (a).

This issue can also be resolved with an APA, permitting, for example, a Canadian based multinational with US subsidiaries to avoid being caught in the following dilemma:

(1) should the US subsidiary of a Canadian based multinational comply with US transfer pricing rules in a fashion which may come into conflict with Revenue Canada in order to avoid IRC Section 6662 penalties, and thus risk double tax, as between the two countries; or
(2) should the US subsidiary apply US transfer pricing rules in line with Revenue Canada's view thereof but risking condemnation by the IRS as not complying with the requirement in such a fashion as to give rise to application of Section 6662 penalties (and thus another form of double tax).

The APA solution to the problem is specifically advocated in the 7 January statement.

D. Summary

The effect of the US initiatives in Canada may therefore be summarized as follows:

(1) Transfer pricing law in Canada, the United States and most other countries is inherently uncertain and can give rise to disputes between taxpayer and tax authority.
(2) This state of affairs has endured for many years.
(3) Until recently the foregoing situation has not raised substantial risk of double taxation for the simple reason that the bona fide situations (that is not involving tax-motivated arrangements) have involved affiliates in the United States or other countries where disputes would generally be settled through agreement between the two countries (on an agreed single price, etc.) so as to avoid double tax.
(4) Recent US initiatives may, however, undermine the efficiency of competent authority proceedings – where Revenue Canada for example views the pricing methodologies insisted upon by the United States as not complying with the pre-existing, internationally recognized "arm's length principle".
(5) The issue is exacerbated by the *in terrorem* effects of the IRC Section 6662 penalty rules which may, in the first place, drive the US–Canada multinational to use methodologies unacceptable to Revenue Canada.
(6) In the foregoing circumstances agreement in advance between all parties (the US–Canada multinational, the IRS and Revenue Canada) to an agreed transfer pricing methodology obviously can eliminate this potential "rock and a hard place".
(7) Conversely, at this point the unified opposition in most other countries to US initiatives would indicate that the preexisting (relatively risk-free) situation should enure where an APA may be useful in eliminating hassles or costs but probably is not necessary as a means of avoiding true double taxation and/or burdensome penalty results.

VIII. ADVANCE PRICING AGREEMENTS IN CANADA

A. Nature of APAs

In general terms an APA is either a two-party agreement (between a Canadian taxpayer (usually a corporation) and Revenue Canada) or a four-party agreement (e.g. between a Canadian corporation, its US parent or subsidiary and both Revenue Canada and the IRS) as to the manner in which transfer prices (i.e. the pricing methodology) will be established between a Canadian corporation and a foreign-related party. (Revenue Canada refers to the latter as a bilateral agreement.)

The APA does not establish a specific price or prices for the transactions but rather a pricing method to be employed (e.g. comparables or, instead, resale-minus or cost-plus, etc.) and in some fashion or other the manner in which the particular agreed to pricing method is to be applied.

B. The initial US initiative

As discussed above, the United States has been criticized for singlehandedly raising transfer pricing controversy, first through its basically unsuccessful initiatives (having due regard to the essential retreat to pre-existing principles reflected by the January 1993 Section 482 Temporary Regulations, particularly when read in light of more recent developments[30]) to add more specificity to the substantive rules and second through the very troublesome interrelated penalty rules under Code section 6662 which will tend to distort orthodox analysis of substantive transfer price law.

29. This observer does not in fact believe that the US rules, as manifest by the January 1993 Temporary and Proposed Regulations, comprise a true departure from the arm's length principle. See N. Boidman, "Canadian Perspective on 1993 US Transfer Pricing Proposals", 22 *Tax Management International Journal* (April 1993), at 201.
30. See *supra* note 28.

© 1994 International Bureau of Fiscal Documentation

However, the United States has *also* been the leader in the development of pre-transaction agreements between taxpayers and tax authorities designed to take the uncertainties and controversies out of the equation. As is well known by now, the US APA programme provides (at least for the larger players in the field) a vehicle to (apparently) eliminate uncertainty, controversy and dispute between taxpayer and tax authority by agreeing in advance to pricing methodologies (but not to specific prices) and to do so on a bilateral basis, bringing into overall agreement two or more units of the multinational involved and two or more tax authorities relevant to the multinational involved.

The logic of the APA programme has not been lost on other governments and Canada is following suit.

C. Canadian APAs

1. Background

It is somewhat ironic that Canada now is adopting an APA programme because it steadfastly refused to consider such a procedure in the late 1980s, when approached by certain taxpayers, on the grounds that such an approach would somehow hamper the competent authority procedure in respect of issues which arise after the fact. The Revenue Canada position was somewhat arbitrary and the fact that its objections were not truly valid is reflected by the government's acceptance now of the US initiative.

Revenue Canada has tested the APA concept in two situations and indicated as early as mid-1992 that a comprehensive programme would be adopted. Following through in June 1993, Revenue Canada made available an "Exposure Draft Document" respecting the "Proposed Procedures and Guidelines For The Advance Pricing Agreement (APA) Service Announced Recently By Revenue Canada ..."[31] The lead sheet notes that until feedback and further review have been considered "... the terms, provisions and conditions set out in the Exposure Draft do not necessarily reflect the policies and practices which we will ultimately follow". However, discussions with Revenue Canada indicate that there will be no substantial changes in the final Circular.

2. When will Revenue Canada provide an APA?

The draft Circular indicates that APAs will be available on a unilateral basis, that is simply between Revenue Canada and the Canadian member of a multinational group (regardless of location of the other members of the group) or (and preferably in the view of Revenue Canada) on a bilateral basis, that is involving two or more members of a multinational group and their respective tax authorities (together with Revenue Canada).

In theory, therefore, an APA could be sought from Revenue Canada in any of the following circumstances:

- the Canadian company is a subsidiary of a foreign parent located in a treaty country;
- the Canadian company is a parent of a foreign subsidiary located in a treaty country;
- the Canadian company is a parent of a foreign company located in a non-treaty jurisdiction (perhaps a tax haven);
- the Canadian company is a subsidiary of a foreign based group based in a non-treaty country or where the intercompany transaction involves a non-treaty country member of the foreign based group (including a tax haven).

3. Review of APA factors

(a) Scope and nature

The APA will confirm a transfer pricing methodology but not specific prices. As there appears to be no experience yet under the US APA as to issues which can arise respecting compliance and non-compliance by a taxpayer with the agreed "TPM", obtaining an APA will not absolutely eliminate issues with Revenue Canada upon audit.

As in the United States, the APA is to arrive at an appropriate TPM as well as the expected results stemming therefrom.

Bilateral APAs, that is, entailing an agreement with the tax authority of the other country involved are encouraged and where the other country has a treaty with Canada "... the Canadian competent authority will seek an appropriate agreement with that treaty partner for the APA". However, the other country need not be a treaty country, allowing for APAs involving tax haven or quasi-tax haven situations.

Paragraph 15 of the draft Circular notes that manpower may limit the number of APA requests accepted. Paragraph 15 notes the discretion to decline an APA request and priority or preference will be accorded APA requests displaying a "preponderance of the following key characteristics":

- the TPM complies with the Canadian law and practice;
- the situation is best dealt with through an APA rather than post-transaction "normal audit process";
- the matter is "ongoing in nature and has long term implications";
- the APA covers all cross-border dealings between the particular parties;
- the proposed transactions are neither completed nor near completion nor those which are "not seriously contemplated or that are of a hypothetical nature";
- major industries involved in the APA will have wider application;
- the other country is a treaty partner whose tax authorities would enter into a bilateral agreement.

(b) Costs and experts

Charges by Revenue Canada for APAs will be limited to "out-of-pocket" costs and there will be no charge for staff time (paragraph 16). The United States, by contrast, charges $ 5,000 in smaller cases and, pursuant to an announcement on 3 January 1994, $ 10,000 in the case of companies with annu-

31. See Revenue Canada Release, 29 July 1993 (respecting "International Transfer Pricing: Advance Pricing Agreements (APA) Procedures and Guidelines", Exposure Draft Document – Proposed Procedures and Guidelines for the Advance Pricing Agreement, Revenue Canada Taxation, 21 May 1993).

© 1994 International Bureau of Fiscal Documentation

al sales revenue of more than $ 100 million (see Rev.Proc. 1994-1).

Independent experts may but not necessarily be required and the costs thereof will be borne by the taxpayer (paragraph 17).

(c) Contents

The APA submission will have the following key requirements (as set out in paragraphs 18-20):

- illustration of the proposed TPM by its application to the three prior years and to the projected operations of the periods to be covered;
- extensive and detailed information respecting the group and its operations and its financial data including functional analysis, profitability measurements, economic studies, general industry trends, and available information on competitors and comparable or similar business;
- a set of critical assumptions under which the proposed TPM would operate:

> Critical assumptions are objective business and economic criteria that are fundamental to the application of the taxpayer's proposed TPM, i.e. any fact that would significantly affect the substantive terms of the APA if the critical assumption changed, whether or not the change is within the taxpayer's control.

(d) Procedural aspects

The taxpayer will be required to file annual reports demonstrating compliance with the APA. APA compliance will be audited by District Office "... as part of the regular audit cycle" (paragraph 22).

Revenue Canada may revoke an APA:

> Under the provisions of the APA program, we *may cancel* an APA at *any time* and retroactively if, for instance, there is fraud or misrepresentation in providing information during the APA process, or taxpayers do not comply with the terms and conditions of the APA. (paragraph 23)

Reviewing and revising APAs will be done in "light of changed facts and circumstances" or "changing critical assumption, tax law or treaty provision". (There are no fixed limitations to the term to be agreed to, for the APA.)

(e) Confidentiality

The information provided under an APA application will be "subject to the normal confidentiality safeguards of ITA Section 241 and, where relevant, the confidentiality provision contained in Canada's tax treaties will also apply".

4. The difference between an APA and an advance income tax ruling

An APA will not, as a matter of its basic nature and the terms under which it is granted, provide to a taxpayer, in advance, the certainty of results associated with a normal advance ruling.[32]

In the latter case (advance rulings), provided that the specific transaction contemplated by the ruling is carried out in the fashion represented in the rulings application, the tax effects thereof are fixed, clear and final. This is not the nature of an APA and taxpayers, conditioned to the certainties resulting from the ruling process as developed over the last 20 years or so, must be alert to the fundamentally different nature of an APA.

The uncertainty of result cannot be reduced by reference to the US experience where some APAs have now been out for two or three years but there is no (at least public) knowledge of whether or not issues arise upon assessment by the IRS of taxpayer's compliance with the APA.

While it is clear that an APA should eliminate most of the potential for dispute, issue and controversy between taxpayer and Revenue Canada, it cannot be viewed as an absolute bar against same.

5. Issues and risks in the APA process

In general terms the Canadian tax community has reacted favourably to the proposed APA procedure.

Some of the concerns expressed (including those in two submissions to the government) are summarized herein.[33]

(1) In general some would like the government to provide more guidance by way of definitions (e.g. of the term "TPM"), or by way of hypothetical/numerical examples or by way of more detailed vigorous discussion of certain factors (e.g. the ambit of the underlying law).

(2) Some would like more specificity respecting the term of an APA, with a three to five year period being seen as appropriate.

(3) Several observers attach substantial importance to the "suitability factors" element – noted above – and see many deficiencies therein. For example, the Joint Committee Submission makes five objections, the most emphatic in relation to the preference (as a suitability factor) that the taxpayer be part of a major industry with many participants so that there can be wide use of the conclusions reached under the particular APA:

> We take strong objection to this characteristic, and recommend that it be deleted. In our view, each taxpayer has the right to have its transfer pricing issues evaluated based on their own merits, and it is unacceptable to suggest that an APA entered into with one, specific taxpayer may be used as a type of industry standard or norm in respect of other taxpayers. (at paragraph 10 of the submission)

Similarly the TEI submission states:

> TEI believes that the circular should confirm that the TPM of one group of companies under an APA will not necessarily be

32. Revenue Canada Taxation, Information Circular 70-6R2, "Advance Income Tax Rulings", 28 September 1990.

33. See the Joint Committee on Taxation of the Canadian Bar Association and Canadian Institute of Chartered Accountants, "Advance Pricing Agreements, Comments on Revenue Canada Exposure Draft Dated 21 May 1993" (issued on 18 August 1993), published by CCH Canadian Limited, Canadian Tax Reports, Special Report No. 1124 Extra Edition, September 1993; and comments by the Tax Executives Institute, "Comments on Proposed Canadian Advance Pricing Agreement Information Circular", 29 July 1993, as reproduced in the *Tax Executive* (September–October 1993), at 417.

© 1994 International Bureau of Fiscal Documentation

applied to the industry as a whole. In our view, any policy (or methodology) that Revenue Canada desired to apply to an entire industry should be developed in consultation with the members of that industry. The first company in an industry to the APA finish line should not be able to impose its TPM on its competitors. Accordingly, this characteristic should not be a major factor in determining whether a particular APA request will be reviewed. (TEI, at 419)

(4) Some would like the Circular to provide much more detail and guidance respecting annual reports (and TEI questions its necessity).

(5) The language of paragraph 23 respecting cancellation or revocation of APAs – see above – is considered by many to be unduly provocative and unclear.

(6) Some are concerned – as discussed above – that the business community not equate an APA with a normal (administratively) binding advance ruling. In the latter case, the exact tax consequences of a (more or less) exact transaction are locked in (by the ruling) in advance. An APA locks in a TPM, but not specific prices, and cannot provide the same degree of certainty.[34]

(7) Much concern has been expressed respecting the absence of specific language regarding Revenue Canada's intentions respecting *retroactive use for audit of prior years of the TPM agreed to*. As well, any retroactive audit use should be specifically agreed to in the APA. In this respect the TEI submission questions the necessity or appropriateness of testing the proposed TPM by applying it to operations of the three previous years. This of course underlies the concern just noted and, at minimum, TEI recommends that the look-back be limited to one year.

(8) Some suggest that the APA procedure be extended to customs duty matters (having due regard to, *inter alia*, the absence in the Act of any provision comparable to IRC 1986, Section 1059A, as amended).

(9) The TEI submission advocates that the Circular address the procedure for a taxpayer to voluntarily withdraw from the APA process, citing Section 6.07 of the US Rev. Proc. (Rev. Proc. 91-22, 1991-1 CB 526).

(10) There is some concern respecting the requirement to provide projected financial results of operations for the period to be covered by the APA – both on practical and conceptual grounds.

(11) Finally, it has been suggested that there be substantial elaboration in the Circular respecting confidentiality of information and safeguards afforded by section 241 of the Act and Canada's tax treaties.

6. When would a taxpayer seek an APA?

Leaving aside the case of the United States (where, as dealt with earlier, an APA may often be desirable to eliminate the real risk of double tax), assessing the desirability of an APA will vary according to the particular circumstances.

In cases of treaty country situations, presumably involving transactions between units of the multinational both in relatively high tax jurisdictions (where there may be no particular overall group benefit to any sort of "transfer price manipulation"), an APA may be desirable simply to avoid costly hassle with Revenue Canada, notwithstanding that, presumably, issues will continue to be workable (resolvable) under competent authority procedures. Undoubtedly Revenue Canada will welcome APAs in such circumstances, particularly where it also involves an APA in the other country.[35]

An APA may be particularly desirable where either there is absolutely no evidence of comparable-type third party arrangements or transactions available to test the intercompany transfer price and the risk of dispute over subjective "guestimating" is at its greatest.

Or, in the latter context, perhaps the activity of the Canadian member of the group is considered to be relatively narrow, undertaking perhaps a low risk subcontracting task for the multinational with, however, a concomitant concern that Revenue Canada will see more value in the Canadian subsidiary's activities as they relate to the establishment of the transfer price. A good example of the foregoing would be a planned establishment of a Canadian subsidiary to provide specific captive subcontract manufacturing services for a group which has developed a valuable product outside of Canada and intends to market the finished product outside of Canada but wishes to have the product or a component manufactured in Canada. In such case the Canadian subsidiary undertakes no entrepreneurial initial risk with respect to the development of the product or its marketing (the product to be re-exported to the foreign group); one can easily conjure up a pricing methodology based on a long term take or pay contract basis where the Canadian company can almost be seen to be providing a combination of a financing and predetermined service function, which should be priced in accordance with the principles for long term debt financing and result in a transfer pricing methodology based on financing principles (probably cost-plus or a variation thereof).

In non-treaty country situations, perhaps tax-havens (where there may be some tendency to seek the higher or lower range of possible price determinations to in fact optimize overall group profit) query whether one would dare approach Revenue Canada for an APA and, if so, would they grant it, or at least grant it on terms which accord with the overall tax objectives of the group? Or is this the type of situation where a taxpayer should decidedly stay clear of Revenue Canada and APAs?[36]

34. See N. Boidman, "The Role of Advance Rulings in International Transfer Pricing", 39 *Canadian Tax Journal* (June 1991), at 1563.

35. The latter factor is specifically emphasized in para. 15, in dealing with APA applications which will be encouraged:

"The other country involved in the APA request is a treaty partner, and that country is favourable to considering an APA request and entering into a bilateral APA with Canada."

36. Of course, if the situation contemplated involved a transshipment company, reference is required to the aforementioned 22 February Budget proposals (proposed ITA para. 95(2)(a.1)), *supra* note 23 and related text.

© 1994 International Bureau of Fiscal Documentation

7. When should an APA be avoided?

Given the basic nature of an APA, the risks and issues noted above, and having regard to the preceding discussion, the circumstances in which an APA may not be particularly attractive or advantageous to a taxpayer may be clear by this point. The circumstances and/or factors may be delineated as follows:

- concerns respecting prior years;
- concerns respecting "opportunity cost";
- concerns respecting confidentiality of information;
- is there a real need in the non-US context?;
- concerns respecting cost and hassle.

It was noted above that the necessity of demonstrating the appropriateness of the proposed APA "by applying it to the operations of the previous three years ..." (paragraph 18) has been labelled "excessive". However, that criticism does not deal with the question of whether the process would or could, in and of itself, lead to audit, hassle and reassessment of prior years, particularly where same may not arise in the absence of applying for the APA.

Nothing in the draft information circular addresses this question and given the basic and inherent uncertainty in transfer pricing matters, delineated above, taxpayers intending to apply for APAs will have to carefully assess the risk that the APA application process would have the unintended result of raising re-assessments that may not otherwise occur.

It is quite possible that the detailed information and analysis required to provide Revenue Canada with the basis to issue an APA may, in many cases, equip Revenue Canada to reassess prior years in a fashion which would not arise in the course of an ordinary audit of prior year transfer prices.

Referring back to the discussion in the preceding section, it is clear that there are certain situations where taxpayers may, based on the inherent uncertainty in establishing transfer prices, develop aggressive positions – ones which may be sustainable before a court but yet which may well be challenged by Revenue Canada upon audit, particularly in the light of the presumption of transfer price manipulation which may underlie Revenue Canada audit in such situations. It could be difficult for taxpayers to lock in such pricing methodology by way of an APA and, instead, an APA application could not only be rejected but "red flag" the file so as to pre-empt use of the proposed method and/or lead to reassessment of prior years if the method has been used previously.

The latter two risks, fostered by the "guestimate" nature of transfer pricing in the absence of comparables, comprises the "opportunity cost" of an APA.

The exceedingly full and frank discussions and disclosures required by Revenue Canada respecting matters relevant to an APA, including business plans, economic analysis, etc., may well raise concern, notwithstanding the confidentiality requirements of ITA Section 241, that prejudicial results from a purely business or market competitiveness standpoint could arise.

The concerns (noted above) respecting Revenue Canada's preference to focus on APAs which may have wide application to major industries may reflect a concern of a risk of inadvertent disclosure of confidential information resulting therefrom.

Taxpayers may have a perhaps ill defined or vague sense of unease that the disclosures required under an APA may find their way into a competitor's hands and of the obvious prejudice that can arise therefrom.

It has already been stated above that APAs would be particularly desirable to deal with Canada–US issues, particularly for Canadian based multinationals with US marketing subsidiaries, but that, as a general proposition (and leaving aside the costs and hassle involved) the effective operation of competent authority procedures for transfer pricing issues between Canadian companies and affiliates in treaty countries other than the United States may often render relatively unimportant the use of APAs.

Finally, it is clear that there will be a not inconsiderable amount of costs and hassle involved in applying and working through an APA and a part of the exercise, in assessing the desirability of an APA, will be to compare same to that involved in disputes which arise upon audit (particularly in the non-US context).

© 1994 International Bureau of Fiscal Documentation

THE CONDUIT REGULATIONS: CANADIAN INVESTORS BEWARE![1]

Marianne Burge

Marianne Burge, Price Waterhouse, New York, is a co-author of the current revision of the *Handbook on the 1989 Double Taxation Convention between the Federal Republic of Germany and the United States of America*, published by the IBFD. She is also a co-author, with Cym H. Lowell and Peter L. Briger of a two-volume treatise: " US International Transfer Pricing" being published by Warren, Gorham & Lamont, in September 1994.

I. INTRODUCTION

Canadian multinational investors have generally been disappointed in the new US–Netherlands income tax treaty, which in effect forces them to re-think their strategies for investment into the United States. Although in the same trade zone, the United States and Canada charge each other higher dividend withholding taxes (10 percent) than they charge to countries in other areas. Interest withholding rates of 15 percent are quite impossible in practice. It is to be hoped that a protocol to the US–Canada income tax treaty will be forthcoming soon to reduce these rates. In the meantime, Canadians are forced to look at other possibilities. The Canada–Netherlands connection goes back a long way, to the days when the Canada–Netherlands treaty exempted Dutch dividends from withholding altogether. These friendly relations are supposedly at least in part due to the fact that the Dutch royal family took refuge in Canada during World War II. A tradition of investing into the United States (and elsewhere) via a Dutch holding company grew up and that route was even used by the Canadian government for its investment in a major US oil company! But now the US government's preoccupation with treaty shopping is putting an end to that structure and Canadian investors are reviewing their options.

In considering the question of where to go, investors need to be mindful of a small piece of new legislation that found its way into the 1993 US tax legislation and threatens to override not only tax treaties, but most other domestic transactions in the United States.

Section 7701(l) is a new provision, enacted as part of OBRA '93.[2] It consists of one sentence.[3] The section was stated to have a revenue impact of $ 63 million. In spite of this minor impact on the country's revenues, the writing of these regulations has been the number one priority of the Treasury and IRS in 1994. They were supposed to appear at the end of April, but had not appeared at the time this article was written (20 June 1994).

The big discussion since the enactment of this little sentence has been whether it really authorizes the regulation writers to recharacterize every multiple-party transaction affecting every nook and cranny of the Internal Revenue Code ("IRC") and its decades of case law, or whether it should be strictly limited in scope, as this article recommends, based on the legislative history, including the revenue estimates.

The legislative history suggests that the section should apply in a limited type of transaction in the area of international tax planning. Nevertheless, there has been speculation that some of the regulation writers take a much broader view of its scope. An analysis of the legislative history strongly leads me to conclude that the scope should be extremely narrow. It should in effect be limited to transactions that fall within the case law cited, i.e. *Aiken Industries*.

Section 7701(l) was enacted specifically in answer to what is described, in the legislative history, as "unwarranted" tax avoidance. According to the legislative history, the targeted transactions involve international tax matters, such as withholding taxes on interest paid abroad (Sections 1441 and 1442), and investments by controlled foreign corporations in US property (Section 956). Other regulations already exist to deal with situations subject to other sections of the IRC, and there appears to be no reason whatsoever why these should not be allowed to continue to work effectively, or be addressed, as necessary, by Treasury and IRS specialists in those fields. To expand the scope of Section 7701(l) to other situations would only create confusion, complexity and uncertainty in the administration of the tax laws, both for taxpayers and the IRS.

II. STATED PURPOSE AND SCOPE OF THE LEGISLATION

The single sentence of the statute is sparse and general and *permits* rather than *requires* the Secretary to prescribe regulations. The stated subject matter is "multi-party financing transactions" ("MPFTs") where there are two or more parties and where recharacterization is appropriate "to prevent avoidance of any tax imposed by this title".[4]

1. This article is based on comments made by the US Council for International Business to the Treasury and IRS in April 1994. By the time the article appears, the regulations may have appeared. It will be interesting to see whether they espouse a broad approach, a narrow approach (incorporating the Revenue Rulings in a literal manner), or, as this writer advocates, a narrow approach based on the five-point conclusion set forth in the text.
2. HR 2264, PL 103-66, signed into law 10 August 1993.
3. "The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title."
4. See *supra* note 3.

© 1994 International Bureau of Fiscal Documentation

It is noted that the wording of the statute regarding its purpose is extremely general and refers to tax "avoidance". It has been a long-established principle of US tax law that it is the right of every taxpayer to arrange his affairs in such a way as to keep taxes as low as possible. Tax planning to reduce one's taxes to the legal minimum is normal practice and there is no moral obligation to arrange one's affairs so as to maximize one's taxes.[5]

Section 7701(l) is also broad in terms of the taxes to which it applies, which is *all* the taxes imposed by the title. This suggests that it could apply to every part of the IRC, including areas which already have their own more specific regulations, rulings and practices, which have been the subject of court review for decades.

To establish the intended scope of Section 7701(l) (because of its brevity), it is necessary to examine the legislative history. The Committee Reports, indeed, shed considerable light on what was really intended. As stated in the House Report's "Reasons for change", the intention was to bolster the Treasury's ability to prevent "*unwarranted*" avoidance of tax through MPF engineering, *and*, "to provide a mechanism for issuing additional guidance to taxpayers entering into financial transactions". Thus the scope is considerably narrowed by limiting the right to recharacterize cases where the avoidance is "unwarranted", a term undefined in the statute but having the dictionary meaning of unjustified. Since proper tax planning is justified according to *Gregory v. Helvering*, for example, the new provision should only be applied in the very rarest of cases. The intention is also to provide taxpayers some guidance on the subject matter. This suggests that the regulations should be "user friendly" and should tell taxpayers not only what they cannot do, but also what they can do.

A further reading of the Committee Reports clarifies the principle area of concern to be the use of "conduits" by foreign (and, in two examples, US) corporations in international financing transactions. In particular, mention is made of the 30 percent US withholding tax on gross interest, and the importance of substance over form. The case of *Aiken Industries, Inc.*[6] is given as an example of the Tax Court's view of "dominion and control" of income in a treaty context. The footnotes refer to one other case, the landmark *Court Holding Co.* case,[7] standing here for substance over form, to Rev. Ruls. 84-152[8] and 153,[9] standing here for an extension of the "dominion and control" holding in *Aiken Industries*, to Rev. Rul. 87-89,[10] on situations involving bank loans and corresponding deposits, and finally to one technical advice memorandum,[11] seeking to extend the *Aiken Industries* concept to dividends paid by a finance company out of interest earnings.

The specific footnote citations are an indication of the intended subject matter of the legislation, in the total absence of statutory guidance. However, in the Committee Reports, there is no detailed discussion of the facts and holdings contained in those rulings. Accordingly, it should not be assumed that the regulations were intended to make the precise facts and holdings of these rulings the law of the land. Since they were not discussed in detail and were in fact relegated to footnote references, they provide guidance on the scope of the intended regulations, but are not themselves blueprints for the regulations.

Finally, the Committee Reports, in their closing paragraphs, and almost as an afterthought, then go on to say that it would be within the scope of the regulations to deal with "debt guarantees or equity investments". These last two subjects are not even covered by any of the footnoted or cited cases or other matters and appear to be entirely extraneous to the wording and plain meaning of the Section 7701(l).

Furthermore, as a general principle, Section 7701(l) cannot be read as overriding all pre-existing case law and the principles established over many decades. It is, therefore, suggested that the Treasury avail itself of its option to exclude or reserve on these two topics from the regulations.

The inclusion of guarantees within the ambit of the regulations would seriously impede transactions in which banks lend funds to subsidiaries of multinational groups. It is a well known business practice that banks almost always seek a parent company guarantee for loans made to subsidiaries. Any type of recharacterization of such transactions would create uncertainty with regard to the application of thin capitalization case law and Section 163(j) to such arrangements. For example, should interest and repayments of principal to an unrelated foreign bank be subjected to withholding tax on the grounds that it has been recharacterized as a loan to the parent and a contribution of capital to the subsidiary?

The IRS has sought to regulate the tax treatment of guarantees for decades. Attempts were made in proposed regulations to Section 385, but the regulations were withdrawn because of the pervasive effects of such regulations on domestic and international transactions. Attempts have more recently been made to write regulations encompassing guarantees under Section 163(j) in its original version, but again these have not been forthcoming, presumably because of the difficulties involved in attempting to cover all reasonable possibilities. The OBRA 1993 amendments to Section 163(j) have now specifically added guarantees, and it will again be necessary to attempt to write regulations. It would appear that Section 163(j) is a more appropriate place to start because there is a statute on point, rather than the more general conduit regulations.

As regards the extension of the treatment of "transactions" to equity investments, it is not at all clear what is meant in the Committee Reports by "equity investments" in this context. While the making of a loan in exchange for certain specified compensation can be regarded as a "transaction", the holding of an investment of share capital is not a transaction, but

5. *Gregory v. Helvering*, 293 U.S. 456 (1935).
6. *Aiken Industries, Inc. v. Commissioner*, 56 T.C.925 (1971) 1972-C.B.383. This is the only case actually mentioned in the Reports. The other items cited are in the footnotes.
7. *Commissioner v. Court Holding Co.*, 324 U.S.331 (1945).
8. 1984-2 C.B.381.
9. 1984-2 C.B. 383.
10. 1987-2 C.B. 195.
11. Tech. Adv. Mem. 9133004 (3 May 1991).

© 1994 International Bureau of Fiscal Documentation

more in the nature of a continuing ownership of an asset. Since it is supposed to go beyond the situation in the cited technical advice, it presumably means direct equity investments by US or foreign shareholders in foreign or US subsidiaries, respectively. By even the limited terms of Section 7701(l), the inclusion of such equity investments is clearly beyond the scope of the regulations.

It would cause enormous uncertainty and confusion in everyday structuring of ownership, domestically and internationally, if an equity investment could be "looked through". It would, indeed, make a mockery of incorporation and is nowhere sanctioned in the IRC or US case law. In fact, case law on taxation is replete with examples of the courts' respect for the corporate veil and for the distinction between the corporation and its shareholders.[12] Section 482 itself is based on the concept of allocating income and deductions to separate though related corporations.

Derivative financial instruments such as swaps, forward rate agreements, intercompany financings through an international bank and other financing arrangements such as leases should also be excluded. For example, swaps are between two parties based on a nominal amount and arranged through an intermediary. If these transactions were considered as conduits between the parties, then the entire swaps market would be affected.

A further problem arises as a result of the limited number of income tax treaties concluded by the United States and major areas of the world. For example, the United States has not a single treaty in effect with the countries of South America and only recently concluded a treaty with Mexico. Similarly, the United States has relatively few treaties with countries of East Asia, a rapidly growing area of trade and investment. In considering the distinction between tax planning and unwarranted tax avoidance, one needs to consider the relative paucity of the US tax treaty network, by comparison with some of our major competitors in the industrial world.[13] If a company from a non-treaty country wants to make an equity investment in the United States, to either acquire or capitalize a subsidiary, the US tax burden on its income is: 54.5% (35 + 30% x 65), which added to, say, a net after tax state and local rate of 6 percent, makes a US effective rate of 60.5 percent. It is in fact only by the use of a third country treaty that such an investment could be made in the United States.

III. RECOMMENDED SOLUTIONS TO THE PROBLEMS OF EXTENSION OF SCOPE

The following solutions to the problems discussed above are suggested:

- Limit the scope of the regulations to situations which are consistent with the cited case law and rulings, which are analysed further below.
- Deal with guarantees under Section 163(j), because that is a specific statute requiring regulatory support and guidance.
- Omit the treatment of direct equity investments in US subsidiaries from the regulations, on the basis that these might be beyond the scope of the statute and could conflict with long-standing case law. Such omission would seem to be perfectly in conformity with the permissive nature of Section 7701(l).
- Cover only transactions of a kind similar to those cited in the legislative history, omitting other types of transactions since in any event there are more specific statutes and regulations applicable to them.
- Apply the regulations prospectively (in order to prevent the disruption and unfairness of retroactively applying a Draconian regulation) to transactions entered into on or after the date that final regulations are promulgated. This would permit existing financial arrangements that were entered into on the basis of settled law and principles to remain unaffected. New regulations would then cause less disturbance to the efficient operation of worldwide capital markets. There is a precedent in a related area, in the case of the 1984 rulings and Rev. Rul. 85-163.[14]

IV. ANALYSIS OF THE CASES AND RULINGS

Let us now go through the cases and rulings cited and try to determine the scope and tests that could be included in the regulations.

Based on such an analysis of each of the cases, rulings and technical advice, the writer concludes that the regulations should be based on the only decided case that is relevant, i.e. *Aiken Industries, Inc.* In particular, the regulations should focus on:

- the substance of the transaction, with special emphasis on the risks taken;
- the rewards available to any intermediary entity in the transaction;
- whether there is dominion and control over the funds by the intermediary; and
- whether there is valid economic or business purpose to the transaction.

A. The cases and rulings cited

1. *CIR v. Court Holding Co.*

Court Holding is cited in a footnote by the Committee Reports in support of the concept that the incidence of taxation depends on the substance of a transaction as a whole. This landmark case involved the planned sale of assets by a corporation, at a gain which would have been taxable to the corporation. Instead, a tax-free liquidation of the corporation

12. See, for example, *Eisner v. Macomber*, 289 U.S. 670 (1933), at 213-214.
13. With the exception of Mexico, the United States has no treaties with any Latin American country. In terms of numbers of treaties, the United States stacks up as follows with some of the major countries:

France	84	Canada	55
United Kingdom	83	United States	43
Germany	62	Japan	39

(Source: *Price Waterhouse Information Guide: Corporate Taxes – A World Wide Summary*, 1993 ed.).
14. 1985-2 C.B. 349.

© 1994 International Bureau of Fiscal Documentation

was undertaken and the assets to be sold were transferred to the shareholders, who in turn sold the assets. The corporate level tax on the gain was thereby avoided. The court recharacterized the transaction as a sale by the corporation, mainly on the grounds that the sale negotiations of the assets were always conducted by the same people and that the distinction between the corporation and the shareholders was blurred, principally by the way the shareholders themselves conducted their affairs.

2. *Aiken Industries, Inc.*

The *Court Holding* case stands for the supremacy of substance over form, but in a rather general way and thus does not provide any specific guidance with respect to Section 7701(l) financing situations. However, when considered in conjunction with *Aiken Industries, Inc.* a more specific link emerges. Both *Court Holding* and *Aiken* deal with business transactions which were completed or partly completed and then restructured by the parties to take advantage of a tax provision (in the case of *Court Holding*) and a tax treaty (in the case of *Aiken*). The tax planning might be thought to have been done as something of an afterthought and thus might be considered as "unwarranted" tax avoidance, to use the phrase of the Committee Reports to Section 7701(l). In both of these cases, the intent of the taxpayers in undertaking the respective restructurings was clear.

In *Aiken*, an existing note was transferred from a non-treaty company to a new Honduran (treaty) company, whose only income was interest from the note, and which was obligated to pass the entire amount of the interest received to its lender, retaining no profit for its trouble. Why did the taxpayer in *Aiken* lose? The court held that the company did not exercise sufficient "dominion and control" over the interest received and therefore was a mere collection agent for its parent. The court also noted that the company "obtained exactly what it gave up...and was committed to pay out exactly what it collected...and made no profit...for its own..." On this basis the court found that there was "no valid economic or business purpose" for the transaction.

On the other hand, if the company had earned a profit, for example, in the form of a normal arm's length spread, it would have been difficult for the court to disregard the Honduras company as a "conduit", because it would have had an obvious business purpose and a beneficial interest in the income. It would have been difficult to say that the company did not exercise dominion and control over the interest income, merely because the income was used in part to pay its obligations. This is, after all, the way all borrowing and lending is done by financial institutions and others. It is only the spread that is retained and the rest is usually the subject of a further obligation. If there had been a spread in *Aiken*, it would seem that the only way the court could have then ruled against the taxpayer would have been to disregard the existence of the company as a separate entity, which the court specifically did not do. We know that the courts are loath to ignore the existence of a corporation except in the most egregious of cases. It is possible that the clear intent of the parties, i.e. the assignment of an existing loan, coloured the court's decision and made it rule in a way that glosses over the issue of the normal borrower/relender situation. This may be the reason why one does not see *Aiken Industries* (a 1971 case) quoted on this issue in any other court decision.

A regulation based on *Aiken Industries* would require the following steps and analysis:

1. Identify the MPFT and consider whether a distinction should be made between a single purpose company (the situation in *Aiken*, which may have influenced the court) and a company with multiple activities.
2. Consider the purpose and reasons for the lending by the finance company. Consider the facts and circumstances of the MPFT, the timing of the loans, e.g. whether or not there was an assignment of loans as in *Aiken Industries*, the conduct of the parties in acting as independent entities, e.g. whether the proper formalities were observed.
3. Consider whether avoidance of US withholding tax on interest payment to the finance company is "unwarranted". Consider whether a treaty between the ultimate parties already contains an anti-treaty shopping clause. If so, an exception should be made for some or all of such treaties, since the taxpayer has already surmounted the obstacles contained in the treaty and should perhaps not be subjected to a "double jeopardy".[15]
4. Consider whether there is a treaty between the countries of first lender and the ultimate borrower, which provides similar withholding rates to the treaty between finance company and the ultimate borrower. This would suggest that the avoidance of US withholding tax on the interest in question was not the motive for the transaction.
5. Examine the economic and business purposes of the MPFT:

   An absence of profit in the form of a spread or otherwise suggests that the finance company has no economic or business purpose and falls within the *Aiken* principle. If there is a profit in the form of a spread or otherwise, the situation differs so fundamentally from that in *Aiken*, that it should not fall within the *Aiken* principle.
6. Examine other possible motives for the MPFT and the structure chosen, e.g. foreign tax or business reasons or US business reasons for the existence and use of the finance company in the transaction. These might include legal liability, parent company (foreign) tax issues, financial statement presentation, currency exposure matters, etc. If such other economic or business purposes exist, the situation could also be distinguishable from the *Aiken* principle.
7. Rulings regarding contemplated or existing transactions: consider whether there should be a procedure to rule on transactions, in accordance with the Committee Report's stated aim to provide guidance to taxpayers entering into transactions. This would be particularly important in marginal cases and those involving a "facts and circum-

15. The whole question of how these regulations should interrelate with treaties needs careful consideration. Sec. 7701(l) is silent on this matter, but the cases and rulings cited generally deal with transactions involving treaties. Treaty partners might consider that the statute is targeted against foreign-owned capital and thus discriminates in a way which is contrary to treaties and US tax policy.

© 1994 International Bureau of Fiscal Documentation

stances" decision as suggested in the six points enumerated above.

B. Revenue Rulings 84-152 and 153 (the 1984 rulings)

The difficulty of reconciling the 1984 rulings with *Aiken* is that they target transactions that do not fall within the principles on which the *Aiken* case was decided. It is thus difficult to find the appropriate support in US case law for the positions taken, and to draw any "bright lines" of guidance for the IRS and taxpayers.

The companies in the rulings seem to have done everything correctly: they were adequately capitalized, they earned a one point spread, they demonstrated a business and economic purpose. Under these facts, the court in *Aiken* would probably have found for the taxpayer. The holdings themselves ignore the spread retained in the finance company, and, instead, subject the entire US source interest to the parent company's treaty withholding rate for reasons not given. It was clear that the issuance of the rulings was intended to deter such transactions, although the issues have not been litigated to date.

The difficulty, therefore, is to reconcile the rulings cited in the footnotes with US case law, not only *Aiken Industries*, but also long-standing principles established in Supreme Court decisions.[16] These include such principles as:

- the respect for separate entities;
- the clear reflection of income in each separate entity;
- the respect for transactions undertaken for business purposes, which include foreign business and tax reduction purposes; and
- in the case of US treaties, the need to deal in good faith with countries with which the United States has negotiated a treaty agreeable to both parties at that time.

In principle, the problem of reconciling these matters with the desire of the Committee to bolster the Treasury's ability to prevent "unwarranted" avoidance of tax through MPFT "engineering" might be tackled by defining the outer limits of what is unwarranted avoidance, so as not cause confusion in other areas of the IRC and not completely inhibit desirable investment flows internationally. Based on the only specific decided case cited in the Committee Reports, it would seem that *Aiken Industries* defines the outer limit of what is unwarranted, combining as it does not only the lack of economic and business purpose, but also a colourable motive, because of the assignment of the original loan from one company to another.

In order to define such limits, the authors of the regulations may need to place themselves in the position of the Tax Court considering situations somewhat like those in the above rulings. It may well be impossible to give a bright line definition in the regulations, and it may, therefore, be necessary to leave the decision to a review of each situation's facts and circumstances.

It should also be noted that, when issued, the 1984 Rulings were retroactive. Subsequently, the Treasury recognized that the Rulings represented a departure from existing tax law, and made the rulings apply prospectively only, i.e. with respect to new loans entered into after the 14 October 1984 effective date in the rulings.[17] It is important to note that the rulings as such represent questionable authority upon which to base an important set of regulations, a set of regulations which will have a profound impact on cross border transactions.

A regulation based on *Aiken Industries*, but extended by the 1984 Rulings, should go through the review steps as are needed under *Aiken Industries*.

If the facts and circumstances of a case are such that *Aiken* would not have applied, for example, because the treaty in question contains an anti-treaty shopping clause, or provides similar tax benefits to those provided by the treaty between the US borrower and the indirect source of the funds, or because there is a spread in the finance company and other business purposes, the regulations should provide for consideration of such facts and circumstances.

C. Reconciling the Technical Advice Memorandum with *Aiken Industries*

In the 1991 technical advice memorandum ("TAM") a Dutch finance company was entirely capitalized with equity and equity equivalents. The finance company made loans to a US affiliate and received interest on the loans. The finance company then declared and paid almost 100 percent of its current earnings from the interest income to its parent company in dividends. The view taken by the IRS was that the business purposes of the finance company did not overcome the conduit nature of the transactions and that a primary purpose of the arrangements was to avoid the US withholding tax on payments made to the foreign common parent.

The IRS then concluded that the finance company "failed to demonstrate a sufficient business purpose to overcome the conduit nature of these transactions", and held that the interest paid by the US affiliate should be subject to the interest withholding tax rate under the parent company country's treaty with the United States.

There was no discussion of the fact that the finance company paid dividends (rather than interest, as in the 1984 rulings and *Aiken Industries*), and that the finance company had the "dominion and control" to declare a dividend or not to do so. In effect, to reach the conclusion that a properly constituted company did not have the right to declare or not declare a dividend, the very existence of the finance company has to be ignored. Being a TAM, rather than a published ruling, the reasons for the conclusion are not spelled out in detail. However, it seems clear that the IRS was much influenced by the almost 100 percent distribution of the income received in the same year as it was received.

Furthermore, the taxpayer was denied relief under Section 7805(b) to have the ruling apply prospectively only. Thus, the IRS position was that the TAM did not depart from existing tax law and practice, that the profit earned and employees

16. See, for example, *Gregory v. Helvering*, *supra* note 5; ***Moline Properties, Inc. v. Com.***, 43-1 USTC Para 9464, 319 U.S. 436 (1943).
17. Rev. Rul. 85-163, C.B. 1985-2 CB 349.

© 1994 International Bureau of Fiscal Documentation

maintained and the lack of obligation to pay a dividend did not distinguish the taxpayer from *Aiken Industries* or even the 1984 rulings.

The TAM is really impossible to reconcile with *Aiken Industries* and with the Supreme Court decisions that the legal entity must be recognized if it is properly constituted and conducts at least some business. The taxpayer in the TAM employed people to take care of its financing business and entered into contracts with banks as well as affiliates. The finance company was adequately capitalized and had an independent board of directors. It has to be assumed that the dividends were properly declared and all the legal formalities were observed.

It is, moreover, difficult to fit the equity ownership of the finance company into a definition of a multi-party financing transaction, as required by the statute, even though the Committee Reports states an intention to include "equity investments". This statement is rather unclear, i.e. whether it refers to the TAM situation or to a direct investment by a foreign company in a US subsidiary, as already discussed.

It is virtually impossible to reconcile the TAM with the cited case law and the 1984 rulings, unless one assumes that Congress intended to treat regular corporations as, in effect, "S corporations", which are treated more or less as partnerships for US tax purposes, if the shareholder so elects. This is a big assumption, based merely on a footnote in the legislative history. If it was not intended to make such a massive change in the tax laws, one can only accept the TAM treatment of a US taxpayer as occurring on the rarest occasions.

It is suggested that if any reference to the TAM type of structure is included in the regulations, it should be done on the basis of a facts and circumstances examination of the taxpayer's situation. These should then be reviewed in light of the case law precedents for ignoring the existence of a company and its treatment as a pure conduit. One would expect a recharacterization under Section 7701(l) to occur only in the rarest of cases, reflecting a similar rarity in the judicial precedents.

D. Revenue Ruling 87-89

Rev. Rul 87-89 does not rely for its conclusions on any specific decided case, but merely cites the principle that the substance of a transaction takes precedence over its form, based on the principle of *Gregory v. Helvering*. The three examples involve deposits made by company A to a bank or other intermediary, which in turn makes a loan to company B. Companies A and B are related and the interposition of the bank results in favourable tax consequences to the related party group. The first two examples deal with foreign parent companies making loans into the United States; the third deals with a US parent and a potential Section 956 situation. Rev. Rul. 76-192 is also referred to in connection with Section 956.

In all three situations, the facts state that the bank or other intermediary would not have made the loan to the affiliate of the parent "but for" the deposit made by the parent. The linkage means that the transactions are not independent and therefore the loans are recharacterized as made directly by the parent to the subsidiary. The ruling specifies that in order to avoid recharacterization, the deposits and loans must be independent transactions and whether this is so depends on the facts and circumstances. A key factor is that the loans must be made or maintained on the same terms, irrespective of the deposit.

It is noted that the example concerning Section 956 is only one of two which involves a US parent. Furthermore, even in the case of investments in US property, the ruling might be considered of lesser importance in view of other more significant changes in the statute and regulations affecting such investments. Most other situations in the footnoted items involve foreign-based companies making loans to their US affiliates. As noted previously this may not only appear to be discriminatory under our tax treaties, but might be objected to on general principles by foreign investors.

The difficulty with the ruling is that it is not based on any decided case and that it involves loans secured by compensating deposits, a common occurrence in international bank financing. A regulation based on the ruling should again permit a review of the facts and circumstances of each case in order to distinguish compensating balances which occur in the ordinary course on a worldwide basis and those which might constitute unwarranted tax avoidance.

V. CONCLUSION

This analysis of the legislative history was undertaken in the hope of developing examples which would provide precise guidance to taxpayers and the regulation writers alike. All such efforts lead back to the solitary case of *Aiken Industries, Inc.* and the basic principles of US case law. There is no evidence in the legislative history that the Congress intended to override all these and gave the regulation writers a complete free hand to do so. To attempt regulations which codify rulings based on questionable principles which have not been reviewed by the courts, will be extremely difficult and could be embarrassing to the IRS in the long run.

In conclusion, a reading of the statute and legislative history leads to the view that there are compelling reasons for limiting the scope of the regulations:

1. The legislative history expresses the intent to prevent "unwarranted" tax avoidance. It does not seek to recharacterize every transaction or structure undertaken for legitimate tax planning purposes.

2. The new statute cannot be read as overriding all preexisting case law and principles established over decades, regarding the recognition of separate entities formed for various business reasons and their intercompany transactions.

3. The scope of the regulations is narrowly defined in the legislative history, which discusses specific situations occurring in footnoted rulings, etc. The cited case and rulings deal with inbound investment situations and in particular withholding taxes, with two exceptions. In writing regulations,

© 1994 International Bureau of Fiscal Documentation

the Treasury should be mindful of the non-discrimination clauses in tax treaties, the general attitude of foreign governments to the US tendency to override existing tax treaty obligations, and the risks of retaliation.

4. Under the "*eiusdem generis*" concept, the regulations should cover only those transactions that are of a kind similar to those cited in the legislative history. Other transactions should be omitted, since they are covered under other statutes and regulations. Section 7701(l) is not a mandate to overhaul the entire US tax law and recharacterize contractual arrangements at will.

5. The statute is vague and gives no indication of its practical application, thus deferring entirely to regulations. Accordingly, the regulations should apply prospectively to transactions entered into after the date the final regulations are promulgated.

IBFD INTERNATIONAL TAX ACADEMY is pleased to announce...

AUTUMN SEMINARS FOR YOUR DIARY

Transfer Pricing: A New Consensus for the Future?

This joint IBFD International Tax Academy / Price Waterhouse seminar brings together expert comment on:

- the first part of the new draft OECD Guidelines on Transfer Pricing;
- and the final US Section 482 Regulations which replace the January 1993 regulations.

ONE DAY: Amsterdam, 23 September 1994

The Taxation of International Partnerships

It has been said that international partnerships are loved by the international tax planner and hated by the under-advised taxpayer. This seminar will provide expert insight into:

- legal forms of partnership, applicable national and international tax rules and related pitfalls and planning opportunities.

ONE DAY: Amsterdam, 21 October 1994

The International Taxation of Services

The provision of international services has become a fact of life for multinational enterprises – even those operating outside the service sector. Leading experts will discuss important new developments on:

- international financial, agency and construction services, including indirect taxation issues.

ONE DAY: Amsterdam, 11 November 1994

For further information please contact: Ms Anselien School
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam
The Netherlands – Tel: +31 20 626 7726, Fax: +31 20 620 9397

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

Nigeria

INVESTMENT IN NIGERIA.
Amsterdam, KPMG Peat Marwick. 1993, pp. 80.
Overview of the economic and social background of Nigeria. Discussion of the legislation relating to companies, taxation, investment, labour and social welfare.
(B. 13.485)

ASIA & THE PACIFIC

Bangladesh

GUIDE TO INVESTMENT IN BANGLADESH.
Dhaka, Government Printer. 1993, pp. 39.
Information guide on improvements in policy and investment procedures.
(B. 57.983)

China (People's Rep.)

AGARWALA, Ramgopal.
China: Reforming intergovernmental fiscal relations.
Washington, The World Bank. 1992.
World Bank Discussion Papers, No. 178, pp. 76.
(B. 57.976)

Hong Kong

HONG KONG MASTER TAX GUIDE 1993/94.
North Ryde, CCH Australia Limited. 1993, pp. 529. £ 30.70.
The guide examines the taxes imposed in Hong Kong under the Inland Revenue Ordinance: property tax, salaries tax and profits tax. Special chapters are also devoted to stamp duty and estate duty.
(B. 57.986)

India

BHARGAVA, Rakesh; BHARGAVA, Ashok.
Taxmann's yearly tax digest and referencer 1994.
New Delhi, Taxmann Allied Services Ltd. 1994, pp. 1400.
Complete record of legislative, administrative and judicial changes made in 1993 direct tax laws.
(B. 57.989)

Indonesia

KELLY, Roy.
Implementing property tax reform in developing countries: Lessons from the property tax in Indonesia.
Cambridge, Harvard Institute for International Development. 1993.
Development Discussion Paper No. 450, pp. 24.
(B. 57.942)

KELLY, Roy.
A collection-led property tax reform strategy: The case of Indonesia.
Cambridge, Harvard Institute for International Development. 1993.
Development Discussion Paper No. 449, pp. 30.
(B. 57.940)

KELLY, Roy.
The evolution of a property tax information management system (SISMIOP): the case of Indonesia.
Cambridge, Harvard Institute for International Development. 1993.
Development Discussion Paper No. 458, pp. 30.
This paper reviews the Indonesian experience in applying information technology to property tax administration.
(B. 57.943)

BUSINESS PROFILE SERIES: INDONESIA. 7th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1993, pp. 48.
Introductory guide to the Indonesian economy, also discussing facts and figures, business ventures, taxation and travelling conditions etc. for businessmen.
(B. 57.981)

KELLY, Roy; BASTIN, Johan; SURYOWIBOWO, Karsono.
Regional government finance in Indonesia. An examination of ongoing reforms.
Cambridge, Harvard Institute for International Development. 1993.
Development Discussion Paper No. 461, pp. 40.
This paper describes the regional government structure, provides up-to-date regional finance statistics and analyses the ongoing regional government finance reforms.
(B. 57.941)

Macau

SECTORIAL POLICIES INVESTMENT plan (public sector) 1993. Analysis of the economic and financial situation of the Territory.
Macau, Government Printing House. 1993, pp. 210.
Governor speech of the 1993 budget proposals, accompanied by government action plan for 1993, analysis of the economic and financial situation of Macau and investment plan for 1993.
(B. 57.991)

Taiwan

BUSINESS PROFILE SERIES: TAIWAN. 5th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Ltd. 1994, pp. 47.
Information booklet on the economic and investment climate in Taiwan. Taxation is covered.
(B. 57.990)

CARIBBEAN

Cayman Islands

FOCUS ON THE CAYMAN ISLANDS. 2nd Edition. An international offshore financial centre.
Grand Cayman, Darryl Myers and Michael Alberga, One Regis Place, P.O. Box 472, Grand Cayman, BWI. 1993, pp. 77.
(B. 18.820)

EUROPE

NAAR EEN EUROPESE ECOTAX. HET voorbeeld van de energieheffing. Editors H. Taselaar, R. Wit and P. van Driel.
Amsterdam, Wiardi Beckman Stichting. 1993, pp. 123.
Compilation of articles by various authors on the European measures for environmental protection (eco-tax). The Netherlands environment policy is compared with international and European policies.
(B. 113.524)

© 1994 International Bureau of Fiscal Documentation

SMITH, S.; VOLLEBERGH, H.
The European carbon excise proposal. A "green" tax takes shape.
Rotterdam, Erasmus University. 1993.
Research Memorandum 9305, pp. 21.
(B. 113.458)

BOVENBERG, A. Lans; MOOIJ, Ruud A. de.
Environmental policy in a small open economy with distortionary labour taxes. A general equilibrium analysis.
Rotterdam, Erasmus University. 1993.
Research Memorandum 9304, pp. 26.
(B. 113.459)

Austria

HOFIANS, Robert.
Immaterielle Werte in Jahresabschluss, Steuerbilanz und Einheitswertermittlung.
Vienna, Anton Orac Verlag. 1992.
Schriften zum österreichischen Abgabenrecht, Band 32, pp. 346. 960.- S.
Intangible assets in year-end closing, fiscal balance sheet under the Valuation Law. The book describes the treatment of intangible assets from the view of the year-end closure for income tax purposes. The author discusses problems arising under the amended provisions and proposes solutions.
(B. 112.638)

KOLACNY, Peter; MAYER, Leopold.
Umsatzsteuergesetz 1972.
Vienna, Manzsche Verlags- und Universitätsbuchhandlung. 1992, pp. 760. 1270.- S.
Commentary on the Austrian VAT Law of 15 June 1972, last amended in 1992. The book also contains related laws and decrees in the appendix.
(B. 113.127)

Belgium

FISCOLEX – INKOMSTENBELASTING.
Actualisering 93/3 en 94/1. (Bijgehouden t/m B.S. 31 januari 1994.)
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 71.
Booklet containing new and amended income tax provisions published after January 1994 in the Belgian Official Gazette.
(B. 113.626)

PEETERS, G.; BAERVOETS, Ph.; LEJEUNE, I.; WILLE, P.
B.T.W. Praktijkboek '93. De leidraad voor de ondernemer en zijn adviseur.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 564. 8850.- Bfrs.
Practical guide on VAT in Belgium (with monthly updates).
(B. 113.562)

Eastern Europe

MINTZ, Jack M.; TSIOPOULOS, Thomas.
Corporate income taxation and foreign direct investment in Central and Eastern Europe.
Washington, The World Bank. 1992.
Foreign Investment Advisory Service, Occasional Paper No. 4, pp. 18.
(B. 113.485)

EEC

VAT AND CHARITIES IN THE European Community. Report of conference organized by the European Committee of the Charities' Tax Reform Group with the support of the Commission of the European Communities, 20/21 October 1992, Brussels.
London, Charities' Tax Reform Group, 12 Little College Street, London SW1P 3SH. 1992, pp. 17.
(B. 113.621)

GINSBERG, Anthony.
International tax planning. Offshore finance centres and the European Community.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 374. 170.- Dfl.
Explanation of the importance and uses of offshore finance centres. The book is divided into three sections. Section One focuses on the general elements comprising the offshore finance system: the various techniques, structures and advantages available, as well as the importance of offshore finance centres in international business. Section Two discusses the representative offshore finance centres (and tax havens) and their attributes. Section Three examines the effect of the European Community in international tax planning and how this might effect the use of offshore financial centres.
(B. 113.545)

THEMANUMMER BTW BRIEF 1994: Jurisprudentie Hof van Justitie van de Europese Gemeenschappen 1991-1993. Onder redactie van S.T.M. Beelen en J.L.M.J. Vervloed.
Deventer, Fed. 1993, pp. 145.
Summary of VAT cases currently pending before and cases decided by the European Court of Justice from 1 July 1991 to 1 December 1993.
(B. 113.514)

France

MEMENTO PRATIQUE FRANCIS
Lefebvre: Fiscal 1994. A jour au 10 février 1994.
Paris, Editions Francis Lefebvre. 1994, pp. 1300. 408.- Ffrs.
Annual guide for 1994 with explanation of the French tax laws as of 10 February 1994.
(B. 113.551)

LAMY FISCAL. TOME 1: IMPOT SUR les sociétés. Impôt sur le revenu. Impôts divers d'Etat. Impôts locaux. Impôt de solidarité sur la fortune. Tome 2: TVA et taxes indirectes. Enregistrement et timbre. Contrôle fiscal et contentieux. Recouvrement de l'impôt. Conventions internationales.
Paris, Lamy S.A. 1994, pp. 3100.
Annual updated edition in 2 volumes explaining the individual and corporate income taxes, net wealth tax, VAT, registration and stamp duties, local taxes, succession and gift duties, tax administration and tax control, with a comparative survey of France's double taxation treaties. The material will be kept up-to-date by information bulletins on recent developments.
(B. 113.623)

MEMENTO PRATIQUE FRANCIS
Lefebvre: Social 1994. Droit du travail, sécurité sociale. A jour au 10 février 1994.
Paris, Editions Francis Lefebvre. 1994, pp. 1273. 406.- Ffrs.
Annual updated guide for 1994 containing explanation of French labour and social security legislation effective as of 10 February 1994.
(B. 113.549)

Georgia

IMF ECONOMIC REVIEWS NO. 9, 1993: Georgia.
Washington, IMF International Monetary Fund. 1993, pp. 91.
(B. 113.560)

Germany

DEBATIN, H.; KORN, R.
Doppelbesteuerung.
Munich, Verlag C.H. Beck. 1994.
Loose-leaf publication in 4 binders (supplemented twice a year), updated as per March 1994, providing a general commentary on international tax aspects in Germany, as well as the texts of all comprehensive and limited double taxation treaties concluded by Germany (with detailed comments). Text of OECD Draft Convention is appended.
(B. 113.569)

Guernsey

A GUIDE TO THE INTERNATIONAL company.
St. Peter Port, Guernsey Financial Services Commission. 1994, pp. 12.
An introduction to the Income Tax (International Bodies) (Guernsey) Law, 1993.
(B. 113.594)

Isle of Man

TAX EXEMPTIONS FOR COMPANIES and trusts.
Douglas, IFG International Limited., 36 Finch Road, Douglas, Isle of Man. 1990, pp. 28.
(B. 112.768)

Lithuania

IMF ECONOMIC REVIEWS NO. 7, 1993: Lithuania.
Washington, IMF International Monetary Fund. 1993, pp. 102.
(B. 113.558)

© 1994 International Bureau of Fiscal Documentation

Netherlands

LOON, P.M.F.van; BIKKER, A.C.; VLIET, A.J. van.
Elseviers almanak voor de vennootschapsbelasting 1994. Handleiding voor de aangifte vennootschapsbelasting 1993. 24th Edition.
Amsterdam, Bonaventura. 1994, pp. 220. 49.50 Dfl.
Annual updated guide for filing 1992 corporate income tax return.
(B. 113.659)

DE MANAGEMENT BUY-IN IN Nederland.
Een bundeling van economische, juridische, fiscale en financiële beschouwingen. Editors: B.T.M. Steins Biscchop and S.W. Douma.
Schoonhoven, Uitgeverij Academic Service, Postbus 81, 2870 AB Schoonhoven. 1993, pp. 260. 39.50 Dfl.
Management buy-in in the Netherlands. The book describes the practical aspects of take-overs and mergers of enterprises from the fiscal, financial and legal point of view. The book also considers the consequences for the MBI entrepreneurs, shareholders, buyers and sellers.
(B. 113.520)

BELASTINGWETTEN 1994. MET EEN inleiding van Prof. Mr Ch.P.A. Geppaart. 25th Edition.
Deventer, Kluwer. 1994, pp. 808. 42.50 Dfl.
Annual updated edition containing texts of tax laws for 1994 assessment year. An introductory note is appended as well as the texts of some pending bills.
(B. 113.645)

VOORSTELLEN COMMISSIE VOOR DE Belastingherziening (Commissie Stevens).
Zoetermeer, Sociale Verzekeringsraad, Postbus 100, 2700 AC Zoetermeer. 1993, pp. 210.
Advisory report considering the "Rapport Stevens" on the reform of individual income tax.
(B. 113.557)

KLUWERS TABELLENBOEK 1994.
Inkomstenbelasting 1994, premie volksverzekeringen 1994, gecombineerde heffingstabellen.
Deventer, Kluwer. 1994, pp. 472. 47.- Dfl.
Tables for 1994 individual income tax amounts combined with social security contributions.
(B. 113.586)

ELSEVIERS AANGIFTE HULP 1994.
Bestemd voor het invullen van de aangiftebiljetten A, E en T over 1993.
Amsterdam, Bonaventura BV. 1994, pp. 272. 18.90 Dfl.
Annual information guide for filing your 1993 income tax return.
(B. 113.592)

DIETVORST, G.J.B.; LANGE, P.M.C. de; SMITTENAAR, G.V.
Pensioenmemo.
Deventer, Kluwer. 1994, pp. 225. 27.75 Dfl.
Summary of relevant regulations and related matters and considerations of all aspects of pensions (Brede herwaardering, VUT regulation, life insurance, social security payment) effective in 1994.
(B. 113.604)

BIJL, D.B.; NORDEN, G.D. van.
Kluwer BTW-gids 1994. Handleiding voor de aangifte omzetbelasting.
Deventer, Kluwer. 1994, pp. 367. 46.- Dfl.
Revised and updated annual guide to value added tax. (With reference to European VAT.)
(B. 113.561)

ENVIRONMENT AND TAXATION: the cases of the Netherlands, Sweden and the United States.
Paris, OECD Organisation for Economic Co-operation and Development. 1994, pp. 143.
Case study on the use of environmental taxes in the Netherlands, Sweden and the USA.
(B. 113.597)

HUND, D.; LUCAS LUIJCKX, B.J.J.M.
Internationaal fiscaal memo.
Deventer, Kluwer. 1994, pp. 246. 42.- Dfl.
Relevant data on double taxation treaties concluded by the Netherlands. Summaries of social security contributions and other domestic tax laws are appended.
(B. 113.544)

DE MACHT VAN MINISTERS VAN financiën. En hoe collega-ministers de schatkist ledigen. Onder redactie van J.M.M.J. Clerx, P.G.T.W. van Griensven en R.J.J. Stevens.
The Hague, SMO Stichting Maatschappij en Onderneming. 1993.
SMO Informatief 93-5, pp. 105.
Description presented by the former Ministers of Finance: Hofstra, Zijlstra, Andriessen and Ruding about how budgetary policy and norms are influenced by politics. The main problem relates to the question whether the strict budgetary agreements can and may be maintained due to the consequences of European integration.
(B. 113.547)

ELSEVIERS ALMANAK VOOR DE sociale verzekeringen 1994. Sociale zekerheid van geboorte tot overlijden. 12th Edition.
Amsterdam, Bonaventura. 1994, pp. 329. 49.50 Dfl.
Annual updated edition of guide explaining the social security laws for 1993 with examples of calculation and addresses.
(B. 113.646)

Norway

SKATTELOVSAMLINGEN 1993/94.
Edited by Ole Gjems-Onstad.
Oslo, Ad Notam Gyldendal Forlag AS. 1994, pp. 1262.
Bound compilation of Norwegian tax laws and regulations enacted by 4 February 1994. The laws relate to income and net wealth tax, income tax on foreign artists, petroleum tax, social security contributions, VAT, investment tax, local income and net wealth tax, inheritance and gift tax, excise taxes and assessment and collection of taxes. Tax tables for 1993 final tax and social security contributions and 1994 advance payments, list of tax offices, tax return forms, case register and a chronological index and index by topic are included. In addition, the texts of the Company Law and Accounting Law are reproduced. The book also contains a list of effective tax treaties and the texts of the Nordic income, mutual assistance, inheritance and gift (draft) and social security treaties, as well as selected EC related documents.
(B. 113.585)

Portugal

BRAS CARLOS, A.; ANTUNES ABREU, I.; RIBEIRO DURAO, J.; EMILIA PIMENTA, M.
Guia fiscal 1993.
Lisbon, Edifisco Ltda., Rua Jose Ricardo 5, 2 piso, 1900 Lisbon. 1993, pp. 585.
Tax guide 1993. A survey of the most relevant aspects of the individual and corporate income tax codes, transfer tax code and inheritance and gift tax code, immovable property tax code, tax incentives statute, VAT and other related legislation.
(B. 113.658)

FAUSTINO, Manuel.
IRS – teoria e prática.
Lisbon, Edifisco Ltda. 1993, pp. 414.
IRS – theory and practice. Theory and practice on the individual income tax.
(B. 113.657)

Russia

IMF ECONOMIC REVIEW NO. 9, 1993: Russian Federation.
Washington, IMF International Monetary Fund. 1993, pp. 140.
(B. 113.559)

Sweden

ENVIRONMENT AND TAXATION: the cases of the Netherlands, Sweden and the United States.
Paris, OECD Organisation for Economic Co-operation and Development. 1994, pp. 143.
Case study on the use of environmental taxes in the Netherlands, Sweden and the USA.
(B. 113.597)

Switzerland

GRAF, Thomas.
Steuerbefreiung von Sportvereinigungen.
Zürich, Schulthess Polygraphischer Verlag. 1992.
Zürcher Studien zum öffentlichen Recht, No. 108, pp. 199.
Tax exemption of sports clubs under Swiss federal and cantonal tax laws.
(B. 112.423)

© 1994 International Bureau of Fiscal Documentation

DIE STEUERN VON BUND, KANTONEN und Gemeinden. Ein Kurzabriss über das schweizerische Steuersystem.
Bern, Eidg. Steuerverwaltung. 1993, pp. 71.
Short summary of the Swiss tax system.
(B. 113.402)

Ukraine

INVESTMENT GUIDE FOR UKRAINE.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 147. 120.- Ffrs.
Information guide on the tax system, foreign investment policy, taxation of indivuals and corporations and VAT in Ukraine.
(B. 113.536)

United Kingdom

SETTING SAVINGS FREE. PROPOSALS for the taxation of savings and profits.
London, IFS – The Institute for Fiscal Studies. 1994, pp. 62.
A summary of the final report of the IFS Capital Taxes Group.
(B. 113.507)

INVESTMENT IN THE UNITED Kingdom.
Amsterdam, KPMG Peat Marwick. 1993, pp. 110.
Information guide on the UK opportunities for international investors, exporting to and from the UK, business entities, business taxation, taxation of individuals and labour law.
(B. 113.517)

SIMON'S TAX CASES 1993.
Editor Rengan Krishnan.
London, Butterworths. 1993, pp. 819.
(B. 113.605)

SIMON'S TAX CASES. CUMULATIVE tables and index 1973-1993. Edited by Susan J. Murphy.
London, Butterworths. 1993, pp. 290.
(B. 113.606)

FOREIGN EXCHANGE GAINS AND losses: draft regulations.
London, Inland Revenue. 1994, pp. 36.
Text of draft regulations and comments thereto regarding foreign exchange gains and losses.
(B. 113.600)

INTERNATIONAL

WORLDWIDE CORPORATE TAX GUIDE and directory.
New York, Ernst & Young. 1994, pp. 545.
The book summarizes the corporate tax systems in over 100 countries based on information current to 1 January 1994.
(B. 113.584)

HUIZINGA, Harry.
Withholding taxes and the cost of public debt.
Washington, IMF International Monetary Fund. 1994.
IMF Working Paper WP/94/18, pp. 18.
This paper examines the international incidence of withholding taxes on public interest accruing to non-residents by estimating the extent to which these taxes raise the cost of government borrowing.
(B. 113.599)

JENKINS, Glenn P.; LAMECH, Ranjit.
Market-based incentive instruments for pollution control.
Cambridge, Harvard Institute for International Development. 1992.
Development Discussion Paper No. 438, pp. 60.
This paper reviews the theoretical foundations for idealized pollution-control market-based incentives (MBI). It then focuses 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.
(B. 113.264A)

GINSBERG, Anthony.
International tax planning. Offshore finance centres and the European Community.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 374. 170.- Dfl.
Explanation of the importance and uses of offshore finance centres. The book is divided into three sections. Section One focuses on the general elements comprising the offshore finance system: the various techniques, structures and advantages available, as well as the importance of offshore finance centres in international business. Section Two discusses the representative offshore finance centres (and tax havens) and their attributes. Section Three examines the effect of the European Community in international tax planning and how this might effect the use of offshore financial centres.
(B. 113.545)

WORLDWIDE PERSONAL TAX GUIDE.
New York, Ernst & Young International, 787 Seventh Avenue, New York, NY 10019, USA. 1994, pp. 660.
The book summarizes the personal tax systems, including social security and gift and estate taxes as well as net wealth tax in over 100 countries as of 1 january 1994.
(B. 113.583)

JENKINS, Glenn P.; LAMECH, Ranjit.
Fiscal policies to control pollution: international experience.
Cambridge, Harvard Institute for International Development. 1992. Development Discussion Paper No. 439, pp. 75.
This paper is a comparative analysis of the fiscal instruments used by countries in Asia, Europe and North America, whose philosophy explicitly incorporates an environmental agenda. 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.
(B. 113.263)

GORDON, Richard; SUMMERS, Victoria.
Trusts and taxes in civil law emerging economies: issues, problems and proposed solutions.
Cambridge, Harvard Institute for International Development. 1992.
Development Discussion Paper No. 435, pp. 40.
(B. 113.264)

HEIJDRA, Ben J.; BROER, Peter.
Fiscal and monetary policy and a dynamic model of imperfect competition.
Rotterdam, Erasmus University. 1993.
Research Memorandum 9306, pp. 40.
(B. 113.460)

BOVENBERG, A. Lans; MOOIJ, Ruud A. de.
Environmental policy in a small open economy with distortionary labor taxes. A general equilibrium analysis.
Rotterdam, Erasmus University. 1993.
Research Memorandum 9304, pp. 26.
(B. 113.459)

Developing Countries

PETERSON, Stephen B.
Making it work: Implementing effective financial information systems in bureaucracies in developing countries.
Cambridge, Harvard Institute for International Development. 1993. Development Discussion Paper No. 447 TRS, pp. 26.
The author provides a framework for explaining why information systems succeed in developing bureaucracies in developing countries. It is based on the experience of developing a financial information system in Kenya.
(B. 57.938)

TERKPER, Seth E.
Improving the accountancy context of tax reform in developing countries.
Cambridge, Harvard Institute for International Development. 1992.
Development Discussion Paper No. 440, pp. 43.
The author examines the importance of accountancy to tax policy and administration review and the influence of professional accounting bodies found in virtually every country.
(B. 57.939)

OECD

MODEL TAX CONVENTION:
Attribution of income to permanent establishments.
Paris, OECD Organisation for Economic Co-operation and Development. 1994.
Issues in International Taxation, No. 5, pp. 50.
(B. 113.483)

© 1994 International Bureau of Fiscal Documentation

AGHA, Ali.
Designing VAT systems. How many rates and at what levels?
Cambridge, Harvard Institute for International Development. 1993.
Development Discussion Paper No. 459, pp. 17.
This paper is a cross-country analysis of the determinants of VAT compliance using data from a sample of 17 OECD countries for 1987. The paper concludes that the results of the authors' study support the conventional wisdom that VAT compliance improves with a lower VAT rate, fewer rates, a smaller population, more learning time, and greater spending on administration.
(B. 113.261)

LATIN AMERICA

Mexico

LEY DEL IMPUESTO SOBRE LA RENTA.
Mexico , Goodrich, Riquelmo y Asociados. 1994, pp. 85.
Memorandum on the tax changes effected by 1994 Finance Law and related legislation applicable as of 1 January 1994.
(B. 18.819)

POLITICA Y ESTRUCTURA FISCAL DEL impuesto predial en México.
Guadalajara, Indetec. 1993, pp. 111.
Tax structure and policy of local tax laws in Mexico.
(B. 18.815)

MIDDLE EAST

Israel

CHECKLIST STARTING A BUSINESS IN Israel.
Tel Aviv, Kesselman & Kesselman. 1994, pp. 150.
Handbook on taxation and investment in Israel. Import and export procedures are discussed. An outline of the customs procedures is included together with relevant foreign currency controls and special provisions for importers and exporters (e.g. VAT issues, exemption from purchase tax and customs drawback). The guide is a follow-up of the publication "Guide to investment in Israel" (1992).
(B. 57.996)

NORTH AMERICA

USA

NEELEY, Carla A.
Net operating losses. Concepts and computations.
Washington, Tax Management Inc. 1993.
Tax Management Portfolio, No. 539, pp. 140.
This Portfolio describes and illustrates the applicable tax principles for converting a taxpayer's net operating loss into a net operating loss deduction under Sec. 172.
(B. 113.473)

INTERCOMPANY TRANSFER PRICING
Regulations under US Section 482 temporary and proposed regulations.
Paris, OECD Organisation for Economic Co-operation and Development. 1993, pp. 53.
Report by the Committee on Fiscal Affairs of the OECD providing the US Administration with the collective views of other OECD Member Countries on the new regulations under Sec. 482 of the US Internal Revenue Code.
(B. 113.596)

ENVIRONMENT AND TAXATION: THE cases of the Netherlands, Sweden and the United States.
Paris, OECD Organisation for Economic Co-operation and Development. 1994, pp. 143.
Case study on the use of environmental taxes in the Netherlands, Sweden and the USA.
(B. 113.597)

INTERNAL REVENUE CUMULATIVE bulletin 1993-1, January-June.
Washington, Government Printer. 1993, pp. 957.
Compilation of all official rulings, decisions, executive orders, tax treaties and other items of a permanent nature published in the monthly bulletins during January-June 1993.
(B. 113.622)

Loose-leaf Services

Received between 1 and 30 April 1994

AFRICA

FISCALITE AFRICAINE
release 6
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIA INCOME TAX– LAW AND PRACTICE
- Rulings and guidelines
  release 147
- Legislation
  release 73

Butterworths, North Ryde.

AUSTRALIAN STAMP DUTIES LAW
Tolhurst - Wallace - Zipfinger
release 128
Butterworths, North Ryde.

SUPERANNUATION AND RETIREMENT BENEFITS IN AUSTRALIA
Brown - Edstein
releases 30 and 31
Butterworth Pty., North Ryde.

AUSTRIA

DIE ÖSTERREICHISCHEN ABGABENGESETZE – Textausgabe
release 57
Wirtschaftsverlag Anton Orac, Vienna.

CANADA

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 878-881
Prentice-Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Skattebestemmelser – Systematisk
  release 4

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 342

Kluwer, Deventer.

FRANCE

JURIS CLASSEUR – CHIFFRE D'AFFAIRES – COMMENTAIRES
release 6160
Editions Techniques, Paris.

GERMANY

DEUTSCHE GESETZE
Schönfelder
release 83
Verlag C.H. Beck, Munich.

EINKOMMENSTEUERGESETZ. KOMMENTAR
Kirchhof - Sohn
release 51
Peter Deubner Verlag, Cologne.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBIEL-KAPITALANLAGEN
release 65
Peter Deubner Verlag, Cologne.

HANDBUCH DER EINFÜHRNEBENABGABEN
release 1
Von der Linnepe Verlagsgesellschaft, Hagen.

STEUERERLASSE IN KARTEIFORM
release 308
Verlag Dr. Otto Schmidt, Cologne.

STEUERRECHTSPRECHUNG IN KARTEIFORM
releases 504 and 505
Verlag Dr. Otto Schmidt, Cologne.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

THE INTERNATIONAL TAX TREATIES
release 59
The International Tax Treaty Service – In-Depth Publishing Ltd., Dublin.

NETHERLANDS

BELASTING PRAKTIJKBOEK VOOR DE ONDERNEMER
releases 12 and 13
Kluwer, Deventer.

BELASTINGWETGEVING
Editie J.M.M. Creemers.
releases 100 and 101
Gouda Quint/D. Brouwer, Arnhem.

CURSUS BELASTINGRECHT
Mobach
release 214
Gouda Quint/D. Brouwer, Arnhem.

DUTCH BUSINESS LAW
Schuit – Beek – Zevenboom – Schifman
release 8
Kluwer, Deventer.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Gemeentelijke belastingen e.a.
  release 184

Kluwer, Deventer.

FISCAAL FUNDAMENT
release 3
Kluwer, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Algemene wetgeving inzake douane
  releases 2 and 3
- Tarief van invoerrechten
  release 109
- Gecombineerde nomenclatuur
  release 88

Kluwer, Deventer.

KLUWERS FINANCIEEL ZAKBOEK
release 12
Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 371 and 372
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 147 and 148
Kluwer, Deventer.

KLUWERS TARIEVENBOEK
releases 435 and 436
Kluwer, Deventer.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
release 172
Kluwer, Deventer.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  release 76
- Heffing over uitkeringen en loon
  release 49
- AKBW
  release 48
- AWBZ
  release 110

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
release 296
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  releases 235-237
- Inkomstenbelasting 1964
  release 901
- Invorderingswet
  release 57
- Loonbelasting
  release 574-576
- Omzetbelasting
  releases 249-251
- Successiewet 1956
  release 173
- Vennootschapsbelasting
  releases 322 and 323
- Vermogensbelasting 1969
  releases 159 and 160

Kluwer, Deventer.

PERU

CODIGO TRIBUTARIO
release 47
Editorial Economica y Finanzas, Lima.

IMPUESTO A LAS VENTAS
release 76
Editorial Economica y Finanzas, Lima.

SPAIN

LEYES TRIBUTARIAS
releases 1-4
Ministerio de Economia y Hacienda, Madrid.

UNITED KINGDOM

SIMON'S TAX CASES
releases 6-14
Butterworth & Co., Sevenoaks.

SIMON'S TAXES
release 198
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE
releases 13-16
Butterworth, London.

VALUE ADDED TAX – DE VOIL
release 224
Butterworth & Co., Sevenoaks.

USA

TAX IDEAS – REPORT BULLETIN
releases 2 and 3
Warren Gorham Lamont, Boston.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Australia:
Ann O'Connell:
Capital Gains Tax Amendments 176

Abe. I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Benelux:
Paul Sleurink, Hans Decleir and Veronique Sway:
Holding Companies 271

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Implementing Regulations for the New Income Tax Law 250

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Olivier Delattre and Clotilde Fournier:
Tax Regime of Holding Corporations 281

Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Germany:
Dr Thomas Töben:
Holding Companies 285

Hong Kong:
Ian Harris:
Budget Bonanza 257

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Lynette V. Eastmond:
Public International Law Aspects of Some Transfer Pricing Issues 351

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shoma and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Vito Tanzi and Parthasarathi Shome:
A Primer on Tax Evasion 328

Israel:
Taxation of Corporations 141

Latin America:
Ruben Diaz, Jr.:
Selected Tax Aspects of Investment 306

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

New Zealand:
Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Russia:
Dr Elena Markina:
Results of Initial Implementation of Tax Reform 338

Qatar:
Finbarr Sexton:
Taxation Regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

© 1994 International Bureau of Fiscal Documentation

Singapore:
Lee Fook Hong:
1994 Budget 347

Switzerland:
Dr Nico H. Burki:
Holding Companies 292

Wiliam Bush:
Low Tax Opportunities 183

United Kingdom:
Michael McGowan:
Setting up a UK International Holding Company 296

United States:
David M. Benson and Matthew M. McKenna:
Deductibility of Interest and Other Financing Charges in Computing Income 310

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Kenneth J. Krupsky, Esq.:
New IRS Transfer Pricing Documentation Requirements 321

Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

James J. Tobin and William R. Seto:
Hybrid Entities 315

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41, 200, 260, 269

IV. CONFERENCE DIARY 55, 81, 137, 207, 267, 327

V. BIBLIOGRAPHY
- Books 45, 103, 150, 201, 261, 358
- Loose-leaf services 49, 107, 154, 205, 266, 366
- List of addresses of the major publishing houses appearing in the Bibliography 51

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

SEPTEMBER 1994

Tax Treatment of Derivative Instruments, London, 17-18 September 1994 (English):

The International Faculty of Finance, IIR Ltd., 2nd Floor, Market Towers, 1 Nine Elms Lane, London, SW8 5NQ, England, Tel.: 44-71-0344 3830, Fax: 44-71-344 3860.

Interpretation of Tax Treaties, Amsterdam, 22-23 September 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Transfer Pricing, Brussels, 26-27 September 1994, (English):

Management Centre Europe, Rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

Tax-Effective Management of an International Treasury, London, 27-28 September 1994 (English):

Bookings Department, Attn: Kathryn Soulard or Nicola Stephens, IBC Financial Focus Ltd, 57-61 Mortimer Street, London W1N7TD, Tel.: 44-71-637 4383, Fax: 44-71-323 4298.

Tax Arbitrage Using Derivatives, London, 29-30 September 1994 (English):

Risk Magazine, 104-112 Marylebone Lane, London W1M 5FU, England, Tel.: 44-71-487 5326, Fax: 44-71-486 0879.

OCTOBER 1994

International Taxation Management Techniques, Brussels, 3-5 October 1994, (English):

Management Centre Europe, Rue Caroly 15, B-1040 Brussels, Belgium, Tel.: 32-2-516 1911, Fax: 32-2-513 7108.

World Corporate Tax Systems, Amsterdam, 13-14 October 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Taxation of International Partnerships, Amsterdam, 21 October 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Conference, Toronto, 28 October 1994 (English);

Ernst & Young, Attn: Joseph Gill, Tel.: 1-416-943 3063.

NOVEMBER 1994

International Tax Conference, New York, 2-3 November 1994 (English);

Ernst & Young, Attn: Jan Carnevale, Tel.: 1-212-773 6590.

Double Taxation Relief Planning, Amsterdam, 2-4 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Planning Association meeting, Nassau, 7-8 November 1994 (English):

International Tax Planning Association, Attn: Elizabeth Husband., Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732 762910, Fax: 44-732 763762.

The Taxation of International Services, Amsterdam, 11 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

IBFD'S TRANSFER PRICING LIBRARY

THE TAX TREATMENT OF TRANSFER PRICING

The first ever in-depth, per-country, loose-leaf survey of transfer pricing in major trading countries. Includes legislation, case law, regulations and practice (including the arm's length principle) and liability of specific transactions.

Full documentation (in English). Three binders, updated twice a year.

NLG 1,850

TRANSFER PRICING STRATEGY IN A GLOBAL ECONOMY

by Jill C Pagan and J Scott Wilkie

Unique book offering practical information and thought-provoking analysis. Includes advice on dealing with tax authorities, treaty considerations, legislative approaches, the role of transfer pricing in a range of transactions, a discussion of Advance Pricing Agreements and practical guidelines on developing and implementing a transfer pricing strategy.

NLG 245

THE INTERNATIONAL TRANSFER PRICING JOURNAL

In-depth journal for transfer pricing experts worldwide. Each issue explores an important aspect of transfer pricing, presented in a series of detailed country reports.

The journal also includes articles on current transfer pricing topics and news of the latest developments around the world.

Published three times a year.

NLG 450

INTERNATIONAL TRANSFER PRICING IN THE ETHICAL PHARMACEUTICAL INDUSTRY

by Maurice H Collins

A detailed report on the role of transfer pricing in the movement of products and ingredients in an international operation. Includes a critical assessment of models for establishing transfer prices. Background information on the pharmaceutical industry is included, and the text is supported by relevant statistics.

NLG 650

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658
Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on prices given

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 10 OCTOBER 1994

JAPAN:
1994 TAX REFORMS 487
Vicki L. Beyer

Japan's tax system undergoes annual "adjustments", generally in the form of amendments to existing tax laws. Four bills were enacted this year. One of the four bills creates a new law, the "Special 1994 Income Tax Reduction Temporary Measures Law"; the remaining three bills contain amendments to the inheritance tax law, the Special Taxation Measures Law and the liquor tax law. This article surveys the most significant of the 1994 changes.

AUSTRALIA:
THE TIMES THEY ARE A CHANGING: TAX REFORM IN 1993/94 492
Michael Dirkis

Tax reform has moved at a frantic pace since 1985 with Australia's income tax laws being substantially remodelled. Nevertheless, during late 1993 and 1994 the tax reform juggernaut continued to power on with further major changes and reform announcements. This article focuses on the more important aspects of the proposed changes which may affect persons and/or organizations carrying on business in Australia.

NEW ZEALAND:
UPDATE ON THE TAX IMPLICATIONS OF THE NEW COMPANIES ACT 1993 504
Adrian J. Sawyer

Some noticeable changes have been introduced as part of the Taxation Reform (Companies and Other Markets) Bill 1994 in respect of share buy-backs and amalgamations, and the treasury stock method of accounting for share buy-backs has been given limited application. This article outlines the changes to the tax treatment of company share buy-backs, treasury stock and amalgamations.

INTERNATIONAL:
PAST AND PRESENT WORK IN THE OECD ON TRANSFER PRICING AND SELECTED ISSUES 508
Diane Hay, Frances Horner and Jeffrey Owens

The main theme of this article is the need to provide guidelines for taxpayers and tax authorities to assist them in achieving an appropriate allocation of income and expenses between associated enterprises operating in different countries. Included are background to the current discussions at the OECD, the arm's length principle and its application by means of transaction-based methods, a comparison of the arm's length method to global formulary apportionment and new approaches to improving the operation of the arm's length principle.

INTERNATIONAL:
TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 521
Report of the OECD Committee on Fiscal Affairs

Excerpts from the Discussion Draft of an OECD Report that will be a revision of the 1979 Report on Transfer Pricing.

UNITED STATES:
WORLDWIDE COMBINED REPORTING RULED CONSTITUTIONAL AS *BARCLAYS* LOSES IN THE US SUPREME COURT: WHAT ARE THE OPTIONS FOR A FOREIGN-BASED COMPANY? 525
Leonard W. Rothschild, Jr.

On 20 June 1994 California's controversial use of worldwide combined reporting was upheld by the US Supreme Court in the long-awaited decisions of the *Barclays* and *Colgate-Palmolive* cases. This article addresses the implications of these cases and examines some strategies in dealing with the decisions.

UNITED STATES:
NEW TRANSFER PRICING PENALTY REGULATIONS REQUIRE IMMEDIATE ACTION TO AVOID OVERVALUATION PENALTIES 529
Peter J. Connors and Michael F. Patton

The IRC Section 6662 accuracy-related penalties were enacted to deter aggressive intercompany pricing regarding transfers of tangible and intangible property; however, they also apply to many cross-border transactions involving international banks. This article takes a look at how international banks are affected.

© 1994 International Bureau of Fiscal Documentation

UNITED STATES:
DOES THE BROWN GROUP CASE SPELL THE EFFECTIVE END OF SUBPART F? 534
Peter J. Connors and Robert M. Spevack
The US Tax Court recently held that the distributive share of profits of a controlled foreign corporation from a partnership engaged in a foreign purchase and sale business was not foreign base company sales income of the CFC, even though this income would have been base company sales income if it had been received directly by the CFC. This article discusses the decision and consequences of *Brown Group, Inc. v. Commissioner.*

MEXICO:
INTERNATIONAL TAX TREATY DEVELOPMENTS: THE MEXICAN EXPERIENCE 537
Barry Larking
Certain features of Mexico's tax treaties are unusual, and in some cases appear to be entirely new. This article highlights some of these features and considers their place in the development of tax treaty practice in general.

IFA NEWS 545

BIBLIOGRAPHY
– Books 547
– Loose-leaf services 559

CONFERENCE DIARY 506

CUMULATIVE INDEX 563

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

JAPAN

1994 TAX REFORMS

Vicki L. Beyer

Assistant Professor, Bond University School of Law.

Japan's tax system undergoes annual "adjustments" to facilitate the nation's economic position. These adjustments, most often in the form of amendments to existing tax laws, are usually enacted in the first quarter to have effect from 1 April, the beginning of the government's fiscal year. 1994 is no exception. Pursuant to a February committee report on tax reforms, which recommended reforms that take into account political requirements as well as the economic situation, four tax bills were presented to the Diet on 8 March 1994. These bills were passed into law on 29 March. For the most part, the changes made by these laws are effective from 1 April.

One of the four tax bills created an entirely new tax law, the "Special 1994 Income Tax Reduction Temporary Measures Law". The remaining three bills contained amendments to the Inheritance Tax Law, the Special Taxation Measures Law and the Liquor Tax Law. The amendments, particularly those to the Special Taxation Measures Law, were predominately extensions or expansions of existing economic stimulus programmes. This is particularly interesting in light of the fact that this is the first tax package prepared by the coalition government that came to power in August 1993. Perhaps it demonstrates the tenuous position of the coalition or the continued clout held by the LDP.

This article surveys the most significant of these 1994 changes to Japanese tax law.

I. INCOME TAX REDUCTION

The cornerstone of the 1994 tax reforms is the special fixed rate tax reduction implemented by the "Special 1994 Income Tax Reduction Temporary Measures Law". This tax reduction measure is intended to stimulate the economy by leaving consumers with more money to spend.

The tax reduction is available to all taxpayers with income tax liability for the period between 1 January 1994 and 31 December 1994. It will be effected by means of a deduction from the taxpayer's income tax liability.[1] The tax reduction amount is fixed at 20 percent of the taxpayer's income tax liability, but capped at ¥ 2 million.[2] For purposes of this calculation, "income tax liability" is basically the liability calculated applying the provisions of Income Tax Law Book 2, Chapter 2, part 4; Chapter 3; Chapter 4; and Article 165.[3] These provisions deal specifically with calculation of the tax base, deductions and the ultimate tax liability.

For wage earners and recipients of public pensions, the tax reduction will be implemented in two stages. In the first stage, in June, there will be a refund of 20 percent of the withholding tax withheld on wages or pensions paid for the period between January and June.[4] For high income earners subject to the ¥ 2 million cap, ¥ 1 million will be refunded.

The second stage will take place at the time of the year-end adjustment for 1994, usually December. At that time a second refund will be made. The calculation for this refund is more complicated. First, the total tax due for the year will be calculated. Then, 20 percent of that figure will be identified as the taxpayer's total tax reduction amount. From this amount will be deducted the amount of the refund made in June. The remainder will be the taxpayer's year-end tax reduction refund.

Taxpayers with business income will receive their entire tax reduction at the end of the year by deducting 20 percent from their 1994 income tax amount before filing their final return relating to 1994. Since business income earners use their year's income tax liability in estimating their tax liability for the following year, the special tax reduction amount must be included in that calculation.[5]

The coalition government's original tax reform proposal suggested that the consumption tax rate should rise to offset this reduction in income tax revenue. This proposal was strongly opposed by some members of the coalition, who argued that such a move would be counterproductive to the boost in consumer spending it is hoped will result from the drop in income taxes. The ultimate decision was to make no increase in the consumption tax rate at this time but to discuss it again later in the year. Although a consumption tax rate increase seems inevitable, recent personnel changes within the coalition government make it even more difficult to predict just when the increase will take place.

In fact, the consumption tax rate on ordinary automobiles was decreased as of 1 April. Ordinary automobiles have been subject to a special, higher consumption tax rate since the creation of the tax in 1989. That rate, which was set at 4.5

1. Special 1994 Income Tax Reduction Temporary Measures Law, Art. 3.
2. Art. 4.
3. Art. 2(1)(3). The definition also specifies a number of related provisions in the Special Taxation Measures Law that are to be applied in calculating the income tax liability.
4. Arts. 9 and 11.
5. Art. 5.

© 1994 International Bureau of Fiscal Documentation

percent from 1 April 1992 to 31 March 1994, has been allowed to expire, so that ordinary automobiles are now subject to the same consumption tax rate as all other taxable goods, 3 percent.

II. INHERITANCE TAX REDUCTION

The continued existence of the inheritance tax in Japan is controversial. Its unpopularity has been accentuated by the continued rise in property values. Since these values play an important role in calculating the tax base, their rise has brought into the tax net estates arguably never meant to be there, created bracket creep problems and resulted in an increase in the number of taxpayers who cannot raise the cash to pay the tax and therefore make in-kind payments. The 1994 amendments to the Inheritance Tax Law seek to alleviate these problems. The amendments are effective from 1 April, but apply to inheritances after 1 January 1994.

The inheritance tax is paid by those persons who acquire property by gift or inheritance.[6] It is calculated by first determining the aggregate value of the taxable property received by those persons. From this amount is deducted the basic exemption amount.[7] The basic exemption amount is a base amount plus a specified amount for each statutory successor.[8] The amendments have raised the base amount from ¥ 48 million to ¥ 50 million. The amount per statutory successor has been raised from ¥ 9.5 million to ¥ 10 million. This increase in the basic exemption effectively increases the minimum size of estate subject to the inheritance tax.

For those estates which remain subject to the inheritance tax, by far the most important change is to the tax brackets themselves, including elimination of several rates of tax.[9] The new rates and brackets are:[10]

- not more than ¥ 8 million 10%
- more than ¥ 8 million but not more than ¥ 16 million 15%
- more than ¥ 16 million but not more than ¥ 30 million 20%
- more than ¥ 30 million but not more than ¥ 50 million 25%
- more than ¥ 50 million but not more than ¥ 100 million 30%
- more than ¥ 100 million but not more than ¥ 200 million 40%
- more than ¥ 200 million but not more than ¥ 400 million 50%
- more than ¥ 400 million but not more than ¥ 2 billion 60%
- more than ¥ 2 billion 70%

The inheritance tax is calculated by applying these tax rates to the statutory shares of the estate. Irrespective of these statutory shares, the tax is paid by those persons who actually received the inheritance in proportion to the amount of the estate each actually received.[11] Once the tax liability of each taxpayer has been ascertained in this way, there are a number of special credits or surtaxes that may be applied. The spouse of the decedent is entitled to a special tax credit the minimum amount of which has been raised from ¥ 80 million to ¥ 160 million.[12] However, to counteract attempts at disguising or concealing assets for inheritance tax minimization purposes, the tax on such disguised or concealed assets is not creditable.[13]

As mentioned above, the first step in determining inheritance tax liability is to determine the aggregate value of taxable property. This value is basically the fair market value of the property at the time of death, based on evaluation rulings issued by the National Tax Administration. Another noteworthy amendment is to the manner in which this value is calculated in the case of small (up to 200 square meters) plots of land which have been the site of a business or residence. These small plots have, for some time, been subject to a reduced valuation for inheritance tax purposes.[14] That valuation has been further reduced by the 1994 amendments.

For residential land, in case the successor is a relative who lived on the property with the decedent and has continued to live on the property, only 20 percent of the value of the property will be included in the aggregate value of taxable property. In other cases, 50 percent of the value is included in the aggregate value.

For land on which a business has been operated (except where the business consisted of renting the land), in case the successor is a relative who has continued to operate the business after the death of the decedent, only 20 percent of the value of the property will be included in the aggregate value of taxable property. In other cases, 50 percent of the value is included in the aggregate value. Similarly, 50 percent of the value of business land where the business consists of renting the land is included in the aggregate value.

For land which has been held for national business purposes, in case it is possible to carry on the national business, only 20 percent of the value of the property will be included in the aggregate value of taxable property. In other cases, 50 percent of the value is included in the aggregate value.

6. Inheritance Tax Law, Art. 1.
7. Art. 15.
8. For an explanation of the statutory successor concept and its role in the inheritance tax, see Huston, Miyatake, Way and Beyer, *Japanese International Taxation* (1993) S7.01[2][c].
9. The former rates and brackets were:
- not more than ¥ 7 million 10%
- more than ¥ 7 million but not more than ¥ 14 million 15%
- more than ¥ 14 million but not more than ¥ 25 million 20%
- more than ¥ 25 million but not more than ¥ 40 million 25%
- more than ¥ 40 million but not more than ¥ 65 million 30%
- more than ¥ 65 million but not more than ¥ 100 million 35%
- more than ¥ 100 million but not more than ¥ 150 million 40%
- more than ¥ 150 million but not more than ¥ 200 million 45%
- more than ¥ 200 million but not more than ¥ 270 million 50%
- more than ¥ 270 million but not more than ¥ 350 million 55%
- more than ¥ 350 million but not more than ¥ 450 million 60%
- more than ¥ 450 million but not more than ¥ 1 billion 65%
- more than ¥ 1 billion 70%

10. Inheritance Tax Law, Art. 16.
11. Art. 17.
12. Art. 19-2(1).
13. Art. 19-2(5).
14. Special Taxation Measures Law, Art. 69-3.

© 1994 International Bureau of Fiscal Documentation

The final amendment pertaining to the inheritance tax has been the establishment of special rules for payment in-kind of past due inheritance tax amounts. In certain circumstances, it is possible to receive permission to pay the inheritance tax in instalments over a five year period.[15] Under the new special rule, taxpayers who have received this permission relating to inheritances taking place between 1 January 1989 and 31 December 1991 who are finding that paying the remainder due in cash creates hardship may receive permission to make an in-kind payment.[16] The property with which the in-kind payment is made must be land situated in Japan which was an asset forming part of the basis for calculating the inheritance tax in the first place.[17] The taxpayer may apply for this permission only once; the application must be made between 1 April 1994 and 30 September 1994.[18] This special rule recognizes the difficulties "land-rich" taxpayers have in paying their tax.

Overall the amendments to the inheritance tax will have the effect of raising the minimum taxable inheritance and further protecting inheritance by spouses as well as succession to the family home or family business. The new special rule for in-kind payment will also alleviate the difficulties the increased land values of the late 1980s have created for some taxpayers.

III. REDUCTION OF TAXES ON REAL ESTATE TRANSACTIONS

Real estate speculation, as well as holding undeveloped land in urban areas, became increasingly common through the 1980s. These practices resulted in rising real estate values, which in turn contributed to the onset of Japan's current recession. They also made it increasingly difficult for ordinary families in the strip between Tokyo and Osaka to acquire homes. Over the past few years a number of tax programmes have been introduced to overcome these problems. The 1994 amendments expand and extend these programmes.

Capital gains, although a category of income, are taxed at special rates depending on the length of time the property had been held by the individual prior to disposing of it. Long-term capital gains, that is on disposals of land which has been held for five years or more, are subject to a lower rate of taxation, 30 percent.[19] If the disposal contributes to the construction of good quality housing, the gain is eligible for the even lower tax rate of 15 percent.[20] This latter rule has been amended expanding the type of land sale that will be seen as contributing to the construction of good quality housing to include sales of land in urbanizing areas for use by a person operating a construction business[21] and sales of parcels of land over 1,000 square meters to a person engaging in residential development.[22] Capital gains by a corporation on these same two categories of land sales are now subject to a 10 percent levy in addition to the corporation's ordinary corporation tax liability on the gain.[23] These changes apply to sales after 1 January 1994.

Between 1 January 1994 and 31 March 1995, both individual and corporate taxpayers may take an 80 percent reduction in their capital gains on disposals of land, buildings and structures acquired after 31 December 1981 and on disposals outside established urban areas if the taxpayer intends to replace the land, buildings or structures disposed of in accordance with established land policy.[24] In regard to the latter, the reduction amount was 60 percent for sales after 1 January 1992, but has risen to 80 percent under the amendments. Although the 80 percent reduction in capital gains scheme was already in existence for certain types of transactions, this expanded eligibility and, in particular, the strict time limit on it, indicates that it is definitely intended as an economic stimulus.

Similarly, in keeping with the government's policy of promoting home ownership, the amount of capital gain on the sale of the taxpayer's residence that may be deferred if the taxpayer purchases a new residence within a specified time has been increased from ¥ 100 million to ¥ 200 million.[25]

In general, ¥ 500,000 may be deducted from capital gains before those gains are included in the calculation of taxable income.[26] The Special Taxation Measures Law provides for a larger deduction from certain types of capital gains.[27] The scope of these larger deductions has been expanded by the 1994 amendments. The special deduction of ¥ 15 million from capital gains on land sold for a specific housing area creation project is now also available for capital gains on sales after 1 April to the third sector for creation of housing and on sales between 1 January 1994 and 31 December 1995 of five hectares or more of land earmarked for development of a public housing project.[28] The special deduction of ¥ 20 million from capital gains on land sold for a specific land development project is now also available for capital gains on sales to regional public interest groups for specific projects.[29]

IV. HOME OWNERSHIP PROMOTION

As mentioned above, the government maintains a policy of promoting home ownership. Among the measures employed in pursuit of this policy is allowing a credit to taxpayers who have incurred debt to purchase or extend their homes.[30] The credit is calculated as a percentage of no more than ¥ 20 mil-

15. Inheritance Tax Law, Art. 38.
16. Special Taxation Measures Law, Art. 70-10(1).
17. Art. 70-10(2).
18. Art. 70-10(3).
19. Art. 31.
20. Art. 31-2.
21. Art. 31-2(2)(5).
22. Art. 31-2(2)(7).
23. Art. 62-3(4)(5) and (7).
24. Arts. 37 and 65-7.
25. Art. 36-6.
26. Income Tax Law, Art. 33(4).
27. Special Taxation Measures Law, Chapter 2, Part 4, Sec. 5; Chapter 3, Part 6, Sec. 2.
28. Arts. 34-2 and 65-4.
29. Arts. 34 and 65-3.
30. Art. 41.

© 1994 International Bureau of Fiscal Documentation

lion of the balance of the home loan. This amount has been increased to ¥ 30 million.

Another home ownership promotion policy was allowing certain gifts of cash for purposes of residence acquisition to be eligible for reduced gift taxation. Taxpayers with taxable income of less than ¥ 8 million who received a gift of cash for purposes of residence acquisition of no more than ¥ 5 million would only be subject to gift tax on 1/5 of the gift.[31] Under the 1994 amendments, the taxable income amount has been increased to ¥ 12 million and the size of the gift has been increased to ¥ 10 million.

V. TAXATION OF BUSINESS

A variety of tax measures relating to business activities have been created, expanded or extended by the 1994 amendments. In addition, the Special Corporation Tax established from 1 April 1992,[32] was allowed to expire on 31 March 1994, as originally written in the statute.

Some new measures introduced to rationalize certain business practices include:

- Between 1 April 1994 and 31 March 1996, dividends from limited liability companies (*Yugen gaisha*) that are reinvested in the limited liability company to satisfy the minimum capitalization requirements of ¥ 3 million are exempt from taxation.[33]
- When a stock company (*kabushiki kaisha*) extinguishes interest-bearing shares after 1 April 1994, that portion of the share which is not extinguished because it is a capital amount, although deemed a dividend, will not be subject to income tax withholding.[34]
- A special investment loss reserve system for established small and medium enterprises has been created.[35]
- A special reserve system for gas supply corporations in anticipation of the cost of customer's switching to gas heating has been created.[36] This system replaces the "gas supply pipeline construction reserve".
- A special reserve system has been established for the World Cities Exposition which will be held in Tokyo in 1996.[37]

A number of special measures have been expanded, including:

- Assets eligible for special initial depreciation have been expanded to included qualified structures acquired by a specified corporation under an authorized plan based on the Law Promoting Development of Osaka Harbour.[38] The special initial depreciation rate is 12 percent.
- In order to allow greater eligibility for depreciation of machinery acquired pursuant to an agricultural business plan, the scope of qualifying agricultural businesses in fruit trees, tea plants, established horticulture and livestock has been reduced.[39]
- Amounts allowed to be held in reserve for special maintenance and expansion of urban railways has been increased from 25 to 50 percent.[40] In addition, the period for maintaining these reserve funds has been extended to 31 March 1996.

The applicable periods for a number of special measures have been extended, as follows:

- Specified foreign investors are allowed to carry-forward losses incurred in the first three years of operation. The period for this loss carry-forward has been extended from seven years to ten years.[41]
- Tax exemption for interest on deposits accounted for as special international investment transactions allowance has been extended to 31 March 1996.[42]
- The special rules granting a two month extension for tax payment in the event of spot financing of a forestries business have been extended to cover spot financing activities up to 31 December 1996.[43]
- Special initial depreciation of 30 percent by small and medium-sized enterprises on qualifying electronically-controlled equipment will continue for acquisitions up to 31 March 1996.[44]
- Special initial depreciation of 20 percent (formerly 30 percent) by authorized telecommunications companies on qualifying equipment for high-density telecommunications will continue for acquisitions up to 31 March 1996.[45]
- Special initial depreciation of 12 percent will continue on offices, stores and business facilities built in authorized local promotion areas up to 31 March 1996.[46]
- Domestic finance and insurance corporations maintaining an overseas investment loss reserve may continue to deduct amounts credited to that reserve until 31 March 1996.[47]
- Special taxation measures allowing maintenance of several other minor types of reserve funds have also been extended until 31 March 1996.[48]
- The investment tax credit scheme for acquisition, production or construction of qualified plant and equipment designed to improve energy utilization has been extended until 31 March 1996.[49]

Although a number of special initial depreciation schemes have been extended, as discussed above, showing the importance of the scheme, in a number of other instances, the rates of special initial depreciation have been reduced by one or two percentage points.[50] This is due to an attempt to rational-

31. Art. 70-3. Note, if the gift was larger than ¥ 5 million, the first ¥ 5 million would be eligible for the reduction.
32. Special Corporation Tax Law (Law No. 15, 1992).
33. Special Taxation Measures Law, Art. 9-4.
34. Art. 9-5.
35. Art. 55-4.
36. Art. 56-2.
37. Art. 56-6.
38. Art. 43-4(1)(3).
39. Art. 46-4.
40. Art. 56.
41. Art. 66-13.
42. Arts. 7 and 67-6.
43. Art. 41-6 (formerly Art. 41-8).
44. Art. 42-6.
45. Art. 44-6.
46. Art. 44-8 (formerly Art. 44-9).
47. Art. 55-2.
48. E.g. Arts. 55-5, 55-6, 55-7 and 57.
49. Art. 42-5.
50. E.g. Arts. 43-2, 43-3, 44-2, 44-3, 45, 45-2, 47, 48, 52-4 and 55.

© 1994 International Bureau of Fiscal Documentation

ize the tax system itself. This is also the reason that several special measures have been abolished or allowed to expire, including non-application of income tax withholding on ship lease payments,[51] special initial depreciation on constructing industrial water supply lines,[52] special initial depreciation on sprinkler systems in retail outlets[53] and special initial depreciation on qualifying facilities acquired by a designated cooperative.[54]

The special deduction available to corporations which have derived income from overseas transactions relating to technical services has been reduced to 7 percent (formerly 8 percent) in the case of intellectual property transactions and 14 percent (formerly 16 percent) in the case of technical services transactions.[55] In no case can this deduction exceed 35 percent (formerly 40 percent) of the corporation's total income.

As a further rationalization, where a corporation maintains funds for unspecified purposes during the period 1 April 1994 and 31 March 1996, the corporation shall be liable to a 40 percent supplemental corporation tax in addition to its ordinary corporation tax liability.[56]

Finally, a minor change has been made in the taxation of non-profit organizations. The income from specified profit-making activities of such organizations is taxable.[57] However, a percentage of that income is tax-exempt if it is transferred to a non-profit branch of the organization or to another non-profit organization. That percentage was 30 percent and has been reduced to 27 percent. Schools and social welfare organizations continue to be allowed to transfer the larger of 50 percent or ¥ 2 million.

Aside from the small reductions in depreciation rates and a few specified deductions, these changes to the taxation of business activities are consistent with the government's desire to stimulate the economy.

VI. CHANGES IN LIQUOR TAXES

The tax rate on several forms of alcohol has been raised effective 1 May 1994.[58] The additional tax on sparkling liquors is abolished. The minimum amount of beer which must be produced under a manufacturing licence has been reduced from 2,000 kiloliters to 60 kiloliters.[59]

VII. OTHER MISCELLANEOUS AMENDMENTS

A Landholding Tax was introduced from 1 January 1992 as a tax on the ownership of land.[60] Because the object of the tax was to discourage holding land for speculative purposes, several types of land ownership were exempted from the tax, including residential land and agricultural land.[61] Land used for a business which employs handicapped persons as at least 25 percent of its workforce is also tax exempt.[62] This latter exemption has been expanded so that severely handicapped persons who work shorter hours can be included in calculating the percentage of handicapped employees. Land used for parking lots as part of a special city plan has also become tax exempt under the 1994 amendments.[63]

Other minor changes or additions made to the tax laws include:

- Money from the Japan Olympic Committee is not subject to income taxation.[64]
- Buildings constructed for aged and handicapped persons are eligible for an additional depreciation of 20 percent over five years.[65]
- Sole proprietors are given an extension of time for filing their final Consumption Tax return.[66]

VIII. SUMMARY

The most significant change wrought by the 1994 tax reforms is the 20 percent reduction in the 1994 income tax. Clearly it is hoped that this reduction will stimulate consumption. For this reason, as well as due to political considerations, the consumption tax rate remains unchanged for now.

Other amendments also reflect governmental concern over the current economic slump. Reductions in the inheritance tax rates and taxable values used to calculate the tax base, as well as reductions in taxable capital gains and other measures to stimulate the housing sector are evidence of this. The extension or expansion of a number of other measures that have already been in place for a few years demonstrate that while the economy has not necessarily responded as originally expected, these measures have shown enough success to be continued.

51. Former Art. 41-19.
52. Former Art. 43(1)(2).
53. Former Art. 44-7.
54. Former Art. 51.
55. Art. 58.
56. Art. 62.
57. Corporation Tax Law, Art. 7.
58. Liquor Tax Law, Art. 22.
59. Art. 7.
60. Law No. 69, 1991.
61. Art. 6.
62. Special Taxation Measures Law, Art. 71-7 (formerly Art. 71-6).
63. Art. 71-4.
64. Art. 41-8.
65. Art. 47(2) and (3)(6).
66. Art. 86-5.

© 1994 International Bureau of Fiscal Documentation

AUSTRALIA

THE TIMES THEY ARE A CHANGING: TAX REFORM IN 1993/94

Michael Dirkis

LL M(Comm)(Adel), GDLP(SAIT), BEc (ANU), Lecturer in Law at the University of Canberra, Canberra, Australia. **Mr Dirkis** is admitted as a Barrister and Solicitor, is a Fellow of the Tax Institute of Australia and is actively associated with the National Centre for Corporate Law Research and Policy. He has also written a number of articles in leading journals. His major interests include revenue law, corporation law and corporate crime.

The author wishes to thank Mr Brett Bondfield for his comments and editorial suggestions during the preparation of this article.

I. INTRODUCTION

Tax reform in Australia has moved at a frantic pace since 1985 with Australia's income tax laws being substantially remodelled. This process began in 1986 with the introduction of the capital gains provisions,[1] a foreign tax credit system[2] and a fringe benefits tax.[3] In 1987 a dividend imputation system[4] was introduced and 1991 saw the introduction of the controlled foreign company and transferor trust measures.[5] The formalization of a self-assessment system[6] was undertaken in 1992 as was the introduction of Foreign Investment Fund ("FIF") measures.[7]

Given this comprehensive list of reforms it would have seemed that as most of the major tax reform issues had been addressed, tax reform in Australia would have slowed. However, during late 1993 and early 1994 the tax reform juggernaut continued to power on, with further major tax changes and reform announcements. These announcements, contained in various reports, a consultative paper, rulings and new legislation, have impact in areas as diverse as the taxation of financial arrangements, and the FIF measures. They also affect entities such as Offshore Banking Units and foreign bank branches. The aim of this article is to focus on the more important aspects of the proposed changes having the potential to affect most people and/or organizations carrying on business in Australia.

II. REPORTS

A. Report No. 326 – An Assessment of Tax – A Report on an Inquiry into the Australian Taxation Office

The Commonwealth Parliament's Joint Committee of Public Accounts (the "Committee") in its *Report No. 326* handed down in November 1993 recommended 148 changes to various areas of taxation administration and legislation.[8] Given the size of the Report and the vast number of recommendations only those recommendations which potentially have the greatest impact on the current tax system are discussed.

1. Simplification of current tax legislation

The scale of tax reform since 1985 has resulted in thousands of pages of new legislation. This added complexity has dramatically increased the difficulties facing taxpayers. Over the last three years the professional accounting and law bodies have been outspoken in their criticism of this complexity and called for simplification of the tax laws. The Committee has responded to these calls in their most important recommendation, a demand for a priority redraft of Australia's major tax Act, the Income Tax Assessment Act 1936 (the "Act"). They requested that the redraft be carried out in two years, with full simplification within five years.[9]

In mid-December the Government acted on this recommendation by establishing a Tax Law Improvement Project Team.[10] As the Project Team comprises only government officials, concerns have already been raised by a parliamentarian about its composition and its potential effectiveness.[11] To provide ongoing advice to the project team, it also provided for the establishment of a consultative committee.[12] Despite the Government's willingness to tackle this issue quickly, it is interesting that the very bodies which were at the forefront of the criticism of the Act, have been reluctant to join that committee and contribute to the reform process.[13] The Government finally announced the appointments to the

1. Introduced by Income Tax Assessment Amendment (Capital Gains) Act 1986 (No. 52 of 1986).
2. Introduced by Taxation Laws Amendment (Foreign Tax Credits) Act 1986 (No. 51 of 1986).
3. Fringe Benefits Tax Assessment Act 1986 (No. 39 of 1986).
4. Introduced by Taxation Laws Amendment (Company Distributions) Act 1987 (No. 58 of 1987).
5. Introduced by Taxation Laws Amendment (Foreign Income) Act 1990 (No. 5 of 1991).
6. Taxation Laws Amendment (Self Assessment) Act 1992 (No. 101 of 1992).
7. Part XI introduced by Income Tax Assessment Amendment (Foreign Investment) Act 1992 (No. 190 of 1992).
8. Joint Committee of Public Accounts, *Report No. 326 – An Assessment of Tax – A Report on an Inquiry into the Australian Taxation Office* (Canberra: AGPS, 1993).
9. *Id.*, recommendations 22 and 23; also see paras. 5.22-5.38.
10. Treasurer's Press Release No. 172/1993 of 15 December 1993.
11. "PAC chief slams tax administration", *Australian Financial Review* (14 April 1994), at 10.
12. Treasurer's Press Release No. 17/1994 of 20 February 1994.
13. "Tax simplification plan fails to spark interest", *Australian Financial Review* (21 February 1994), at 7.

© 1994 International Bureau of Fiscal Documentation

15 member committee on 21 April 1994. The project team is to concentrate initially on the core provisions of the income tax law (concepts of income, deductions and rebates), with discussion papers and exposure drafts of legislation released progressively over the next 12 months.[14]

2. Reform of legislative drafting system

The current system of legislative drafting, which involves interaction of three separate agencies (the Tax Policy Division of Treasury, the Australian Taxation Office ("ATO") and the Office of Parliamentary Counsel), has also been subject to criticism. It is claimed that the complexity of tax legislation is a direct result of the problems in coordinating and integrating tax policy in three agencies with very distinct roles.[15] Tax Policy Division's role in this system is to put forward the policy proposals for change. The ATO advises on the technical validity of the proposals and whether they are administrable. Upon acceptance by Government, the ATO is responsible for refining the detailed operation of the proposed legislation, under the direction of Tax Policy Division. The ATO then issues instructions to the Office of Parliamentary Counsel which drafts the legislation and ensures that it reflects the Government's stated policy.

In accepting that there were potential problems in coordinating and integrating tax policy given the separate roles of the agencies involved, the Committee recommended a number of procedural changes to overcome any potential difficulties. Suggestions that the policy sections of the three agencies should be merged into one centralized body were rejected.[16]

3. Reform of the structure and administration of the ATO

The ATO is not technically a separate legal entity. The law only provides for a Commissioner of Taxation, who is responsible for the general administration of the tax laws,[17] and for three Second Commissioners who have all the Commissioner's powers except for the delegation power.[18] The Commissioner is appointed for a period of seven years by the Governor-General.[19] The Commissioner is independent, but is required to present an annual report to the Treasurer, who lays it before Parliament.[20] To support the Commissioner and Second Commissioners the ATO has evolved, consisting of a National Office, 22 branch offices (each presided over by Deputy Commissioners) and 19 regional offices.

The Committee was concerned with this 80-year old structure and saw the need to make a number of recommendations which would translate into efficiencies for the economy. They recommended that the ATO should be established under its own Charter as the Australian Taxation Commission and that the general power of administration be vested in a chief executive, to be known as Chief Commissioner of Tax.[21] They also suggested that the functions of current Deputy Commissioners be couched in terms of branch or regional manager and their titles be changed to reflect these functions.[22]

Since 1989, to ensure "...regular and effective contact with tax practitioners and business groups..." the Commissioner has established the Commissioner's Advisory Panel and the National and Branch Tax Liaison Groups.[23] These advisory panels have no formal role within the ATO or the tax system. The Committee thought that such panels made a valuable contribution in advising on the administration practices of the ATO. The Committee recommended that the role of these advisory panels be formalized and strengthened so that they could continue to play a positive role in the context of the proposed new administrative structure.[24]

4. Reform to the Ruling system

In order to support the self-assessment system, taxpayers need a mechanism for gauging the Commissioner's view of a project. They also need to be certain that if that project is undertaken in accordance with ATO advice, it is free from subsequent challenge by the ATO. To meet these two concerns the Government introduced from 1 July 1992 a system for obtaining the Commissioner's view on the law or a specific project, i.e. a Ruling. These Rulings are binding upon the Commissioner.[25]

There are two types of Rulings, public and private. Public Rulings are rulings on a class of arrangements or a class of persons, and apply generally to all taxpayers.[26] There are two forms of public Rulings, Taxation Rulings ("TRs") and Taxation Determinations ("TDs"). They have post and past application, other than where there exists a prior private Ruling.[27] Private Rulings which are also binding, are given to individual taxpayers about their specific tax affairs.[28] They are only binding on the Commissioner as against that taxpayer.

In respect of binding public Rulings, the Committee recommended that all public Rulings should, when expressing the preferred view of the Commissioner, acknowledge any alternative interpretations of the law. Should that alternative view cast serious doubt on the validity of the Ruling, the Commissioner should refrain from issuing it until receiving clarification.[29] As it was felt that the Rulings should be vetted by senior staff, the Committee recommended that all public Ruling go through a formal approval process. The Committee also felt that the definition of a "public Ruling" was uncertain. In order to clarify what statements by the Commissioner are public Rulings the Committee recommended that when

14. Assistant Treasurer's Press Release No 87/1994 of 12 July 1994.
15. See Aust. *Arnold Report on the Implementation Issues arising from the Foreign Investment Fund Legislation* (1992), at 60.
16. See *supra* note 8, paras. 5.39-5.47.
17. See Taxation Administration Act 1953, Secs. 3A and 4.
18. *Id.*, Secs. 4 and 6D.
19. *Id.*, Sec. 8.
20. *Id.*, Sec. 3B.
21. See *supra* note 8, recommendations 1 and 2; also see paras. 3.37-3.46.
22. *Id.*, recommendations 12 and 13; also see paras. 3.95-3.100.
23. *Towards a World Class Tax Administration: Commissioner of Taxation Annual Report 1991/92* (Canberra: AGPS, 1992), at 4.
24. See *supra* note 8, recommendations 15 and 16; also see paras. 3.101-3.131.
25. See Secs. 170BA to 170BI Income Tax Assessment Act 1936. All sections cited without reference to an Act will be from this Act. Sections from other Acts will be so identified.
26. See *supra* note 17, Part IVAAA.
27. Taxation Ruling TR 92/20.
28. See *supra* note 17, Part IVAA.
29. See *supra* note 8, recommendations 28-30; also see paras. 6.15-6.26.

© 1994 International Bureau of Fiscal Documentation

a public Ruling is issued, a notice identifying and summarizing the Ruling should be placed in the Commonwealth Gazette.[30]

Finally, given the binding nature of Rulings, the Committee believed that Parliament should have a supervisory role. It recommended that all public Rulings should be tabled in Parliament within five days of Gazettal, allowing the Parliament to evaluate and analyse them, and respond to unsatisfactory Rulings.[31] This view of parliamentary scrutiny of Rulings, however, does seem to conflict with the belief that the Commissioner should have complete independence in the administration of the tax laws. In the meantime the Committee recommended that the Commissioner should review all the ATO's Determinations and public and private Rulings to determine their continued validity.[32] In respect of private Rulings the Committee recommended that where a taxpayer indicates in a return that they are not following a private Ruling, no penalties should be applied. It also recommended that penalties should not apply where a Determination is ignored. Hypotheticals should be ruled upon, resources permitting.[33]

The final recommendations were concerned with the creation of a publicly available computer database of all private Rulings and the creation of a public register consolidating all Determinations, and public and private Rulings.[34]

5. A new avenue of review

Where a taxpayer is dissatisfied with his assessment or a Ruling request, a process of review is available. Initially the taxpayer can request a review of the decision by the Commissioner (a taxation objection).[35] Where the Commissioner does not decide the objection within a specified time or the taxpayer is dissatisfied with the Commissioner's decision on the objection, the matter can be referred to either the Administrative Appeals Tribunal ("AAT")[36] or to the Federal Court.[37] Appeals are available on an adverse AAT decision to the Federal Court, but they are restricted to appeals on issues of law. Appeals can be made on an adverse Federal Court decision to the Full Federal Court. An unsuccessful party then may seek to have the matter heard by the High Court, but the matter will only be heard if the High Court grants Special Leave to hear the matter.

This appeal process is very costly. Taxpayers referring matters to the AAT face a filing fee of $ 300 and a $ 500 hearing fee and, regardless of success, are liable for their own legal expenses. A Federal Court matter can cost upwards of $ 15,000 per day, and, if unsuccessful, the taxpayer can also be liable for the ATO's costs.

In response to the costs associated with contesting an assessment, the Committee made a number of recommendations. The first was a recommendation for the creation of a Small Taxation Claims Tribunal to deal with disputes of less than $ 5,000. The taxpayer may seek review of the ATO decision by this Tribunal, but any decision would be non-appealable. The cost of such an appeal would be only $ 50. Alternatively, the ATO would have the option, where taxpayer wishes to use the Tribunal, to refer the matter to the Federal Court, with the ATO having to meet the taxpayer's costs.[38] Unlike current AAT hearings, these hearing would be held in public unless the taxpayer elected to have a private hearing.

The Committee also recognized that the ATO, like many government agencies, is not limited by funds in any litigation. This puts a small taxpayer at a disadvantage in this expensive environment, potentially foregoing a successful outcome because of the costs of litigation. The Committee responded to these concerns by recommending that where the ATO has been unsuccessful at first instance and decides to appeal the adverse decision, the ATO should have to meet all costs, even if the appeal raises an issue of principle.[39]

6. Limitations on the Commissioner's information gathering powers

The Commissioner has very wide investigatory powers. They include the ability to access any place to inspect and copy documents,[40] and the powers to command attendance of a taxpayer to either deliver up documents and/or submit to oral examination.[41] As well, there are wide powers to obtain information offshore.[42] All of these powers can be exercised administratively, without the need for judicial sanction. The only limitations are legal processional privilege or public interest immunity (formerly "crown privilege").[43] Although seizure is not permitted, documents can be seized via the obtaining of a search warrant.[44]

To curb possible abuse of these powers the Committee has recommended that the Commissioner's access powers be amended such that the ATO must show just cause before being allowed to enter private property. It also recommended that the compulsive interview powers be amended to ensure that Tax Officers discuss with taxpayers their obligation to answer questions and their rights of representation and any interviews should be recorded, with a copy of the tape made available to the taxpayer in seven days. The Committee also

30. See *supra* note 8, recommendations 32-33; also see paras. 6.32-6.36.
31. See *supra* note 8, recommendation 35; also see paras. 6.37-6.66.
32. See *supra* note 8, recommendation 42; also see paras. 6.96-6.98.
33. See *supra* note 8, recommendations 37-40; also see paras. 6.71-6.80.
34. See *supra* note 8, recommendations 36 and 43; also see paras. 6.67 and 6.97-6.98.
35. See *supra* note 17, Secs. 14ZU-14ZZ.
36. See *supra* note 17, Secs. 14ZZA-14ZZM.
37. See *supra* note 17, Secs. 14ZZN-14ZZS.
38. See *supra* note 8, recommendations 140-144; also see paras. 14.7-14.30.
39. See *supra* note 8, recommendation 145; also see para. 14.30.
40. Sec. 263 and see "1984 Revisited? – Review of the Commissioner of Taxation's Powers under Section 263 of the Income Tax Assessment Act 1936", 12 *Adelaide Law Review* (1989), at 126.
41. Sec. 264 and see "An Orwellian Spectre – A Review of the Commissioner of Taxation's Powers to Seek Information and Evidence under Section 264 of the Income Tax Assessment Act 1936 and under Section 10 of the Crimes Act 1914 (Cth)", 12 *Adelaide Law Review* (1989), at 63.
42. Sec. 264A and under exchange of information clauses in bilateral tax treaties under the Income Tax (International Agreements) Act 1953, and see "Foreign Income: Out of sight: Not Out of Mind", 1(1) *Taxation in Australia Red Edition* (1992), at 26.
43. *Perron Investments v. Deputy Commissioner of Taxation* (1989) 20 ATR 1299 and *Middendorp Electric v. Law Institute of Victoria & DCT* (1993) 27 ATR 64, respectively.
44. Sec. 10(1) of the Crimes Act 1914 (Cth).

© 1994 International Bureau of Fiscal Documentation

recommended that the current practice of having taxpayers sign statements or transcripts of interviews should cease.[45]

7. Limitations on the Commissioner's powers to impose administrative penalties

Currently, where there is a tax shortfall, authorized ATO officers can administratively impose penalties ranging from 5 to 90 percent of the tax shortfall. Again to curb possible abuses, the Committee has recommended that the power to administratively impose culpability penalties be removed, or if these powers are retained, that penalties should be imposed by a legally qualified Officer. Also, it recommended that the Taxation Administration Act 1953 (Cth) be amended to stop the re-imposition of a penalty where a prosecution is withdrawn.[46]

8. State of play

Of the many important recommendations of the Committee, only the simplification project has been acted upon. It is hoped that this lack of action is indicative of a Government working hard to formulate a considered and reasoned response to these recommendations. Unfortunately, this inaction could also indicate that the Government intends to ignore these recommendations, as past governments have done in respect of reforms recommended in other reports/inquiries, such as Aspery[47] and Martin.[48]

B. National review of standards for the tax profession

The Act permits only a registered tax agent to charge a fee in relation to the preparation of an income tax return, objection or the transaction of any business on behalf of a taxpayer in respect of tax matters. An unregistered person performing such tasks faces a penalty of $ 2,000 unless the person was a legal practitioner preparing an objection or acting in an advisory capacity in respect of a return.[49] These provisions, which were introduced on 1 November 1988, also regulate tax agent registration and conduct.

The strictness of the rules as they relate to registration have been the subject of much criticism and judicial action. As a result of these criticisms and other concerns about professional standards, a Committee was established in July 1992 to undertake a National Review of Standards for the Tax Profession.[50] On 20 December 1993, this Committee released a Discussion Paper which made 82 recommendations for change, including the implementation of a Code of Practice and new disciplinary rules.[51]

The proposed Code of Practice consists of three tiers, an aspirational code, disciplinary rules and best practice notes. The aspirational code will set out high standards for tax agents to aspire towards. The disciplinary rules, on the other hand, will set out the minimum standards, a breach of which will lead to disciplinary action and/or sanctions. The best practice notes are intended to provide recommendations on how to handle specific issues or problems.

These recommendations have met with a hostile reaction from those working in the "taxation industry". At a fundamental level, the Law Council of Australia has seen the review as an expensive, time-consuming exercise that serves no purpose as it argues that there is no such group as tax professionals. It believes that there are already adequate standards for the two professional groups (tax lawyers and tax accountants) involved in the tax area.[52] The role of the ATO in formulating the standards has also been criticized as ATO staff will not be subject to the proposed Code and the disciplinary rules.[53]

The major proposed change concerns a taxpayer's liability for penalties. Currently a taxpayer is vicariously liable for any penalties arising from a tax short-fall arising from errors of his agent. However, the taxpayer may sue a tax agent for any penalty, additional tax and interest charge arising from the agent's negligence.[54] The draft report recommends changes which will create a safe harbour for taxpayers. A taxpayer will be deemed to have taken reasonable care (and thereby avoid culpability penalties) where he has conformed with a tax agent's advice. This is subject to the taxpayer establishing that he has presented the agent with all facts and kept full records. Any primary tax liability will still have to be met by the taxpayer. The onus of proof rests with the taxpayer.[55] Where the agent is found to be at fault, the agent will be subject to disciplinary action.[56] The effect of this safe harbour is to create a bias to registered tax agents over firms which merely render tax advice.

Concern with the proposals have focused on the disciplinary action, which is to be initiated by taxpayer's complaints and the possible civil legal action which may follow.[57] Although, in such actions the onus is on the taxpayer complaining, the tax agents defending any claim will still have to establish they took reasonable care and that client knew or was advised of the risks involved.[58] It leaves a major problem for tax practitioners in terms of how they receive instructions from clients and render warnings.

45. See *supra* note 8, recommendations 103-107; also see paras. 11.78-11.91.
46. See *supra* note 17, Sec. 82E(2).
47. Taxation Review Committee (Aspery Chair) Full Report, (Canberra: AGPS, 1975).
48. House of Representatives Standing Committee on Finance and Public Administration, *Follow the Yellow Brick Road: The Final Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting* (Martin, Chair) (Canberra: AGPS, 1991), at xiv, 30-35, in particular recommendation 3, that trusts be taxed as if they were companies.
49. Part VIIIA of the Act and Part 9 of Income Tax Regulations.
50. McKenry, K. "Proposed Standards for the Tax Profession", Taxation Institute of Australia, 28th Western Australian Convention paper (1993), at 52.
51. National Review of Standards for the Tax Profession Committee Draft Report (1993), recommendations 11-14, 42 and 63-82; also see paras. 11 and 13-14.
52. "Lawyers argue hotly against the review", 28 *Taxation in Australia* (1994), at 432.
53. "Professional Conduct: The Client's Interest Always Takes Priority", 28 *Taxation in Australia* (1994), at 431, 432.
54. Sec. 251M.
55. See *supra* note 51, recommendations 9 and 10; also see paras. 10-11.
56. See *supra* note 51, recommendation 74.
57. "Gloves off in tax standards code brawl", *Australian Financial Review* (15 April 1994), at 2.
58. See *supra* note 51, recommendations 32 and 40; also see paras. 12-13.

© 1994 International Bureau of Fiscal Documentation

C. Taxation of financial arrangements

Following the 1992-93 Budget announcements, the Treasurer issued, on 22 December 1993, a Consultative Document (the "Document") entitled *Taxation of Financial Arrangements*.[59] The Document outlines a proposal to introduce a comprehensive system for the taxation of financial arrangements on an accruals basis. The closing date for submissions on the Document was extended to 31 May 1994.[60] The main features of the proposed system are briefly summarized below.

1. Reasons for the measures

In the introduction to the measures, the Treasurer conceded that the current law for taxing financial transactions is inadequate. It is limited to taxing specific transactions on their legal or contractual form. As the law is not designed to deal with many modern financial instruments, it allows transactions that have a similar economic outcome to be taxed differently.

The proposed accruals system outlined in the Document is an attempt to tax financial arrangements on an economic substance basis, to ensure tax neutrality. This format is expected to create a taxing regime that is flexible enough to regulate new forms of financial instruments. This substance approach should also reduce complexity and uncertainty arising under the current legal system.[61] Although many commentators share the Treasurer's belief that the measures will provide certainty, they do not believe that they will necessarily reduce complexity.[62]

2. Scope of the measures

The broad classes of financial transactions caught under the measures are:

- debt transactions and transactions that are in substance debt;
- the debt component of certain hybrid transactions;
- debt derivatives, together with non-debt derivatives based on the value of a group of commodities or equities;
- transactions comprising the right to receive or the obligation to pay an amount in foreign currency, and any physical holding of foreign currency.[63]

Thus, loans, bonds, bills of exchange, discounted and deferred interest securities, coupon securities (which are issued and redeemed at face value), indexed securities, contingent rights to receive and obligations to pay, annuities, perpetual notes, preference shares, debt substitutes, debt component of hybrids, derivatives, currency futures, currency option contracts, forward exchange agreements, foreign currency loans and cash flow fees are all caught.

Where a hybrid instrument's debt and equity components cannot be identified, the instrument will be classified as either debt or equity under a debt test. Under the debt test a debt arrangement is defined widely as an arrangement involving "the payment of an amount that gives rise to a right to receive, or an obligation to pay, another amount that is reasonably likely to equal or exceed the first-mentioned amount".[64]

As well as applying to domestic financial transactions, the measures are also intended to have cross-border application. Although the Document does not give a detailed explanation of how this is to be achieved, it broadly suggests that the measures will apply to a cross-border financial transaction where a double tax agreement does not exist, or if one does, where it fails to have a source deeming provision for a particular category of gain.

This statement, if given at its narrowest interpretation, means that most cross-border modern financial products will be subject to the measures. This arises as most modern financial products are not specifically named in double tax agreements nor do they easily fit within the usual categories of interest, dividends and royalties. The Document also foreshadows the development of source rules based on a factor approach in the area of global trading and the extension of withholding tax provisions to any transaction (including swaps) which are identified as economically having an interest component.[65]

3. Commencement date

The measures will only apply to new financial arrangements entered into, on or after the commencement date.[66] It is expected the measures will not commence before the end of 1994.[67]

4. Exemptions

Despite the wide scope of the proposed measures, there are a number of financial transactions specifically exempted. Essentially, financial transactions which are not a debt arrangement (i.e. equity arrangements) will be exempt. Thus, equity and commodity derivatives, which are not based on an index made up of a number of equities or commodities (e.g. gold options, equity options, wool futures and gold futures), ordinary shares and other equity instruments denominated in foreign currency will be exempt. So are short-term trade credits, leasing transactions for plant and equipment and non-cash flow fees (e.g. brokerage, legal and accounting expenses, government charges and application fees).[68]

As well as specific arrangements, the holders of specific interests are also excluded. The most important group excluded are the financial transactions of individuals, provided their financial transactions do not total more than $ 500,000 or provided there are no significant tax deferral opportunities arising under the transactions. Also excluded are entities not subject to tax (e.g. charities or religious institutions), interests in controlled foreign companies, interests

59. *Taxation of Financial Arrangements: A Consultative Document* (Canberra: AGPS, 1993).
60. Treasurer's Press Release, No 31/1994 of 18 March 1994.
61. See *supra* note 59, at 3-5.
62. "Derivatives tax could skew product selection", *Australian Financial Review* (7 January 1994), at 22.
63. See *supra* note 59, at 19.
64. See *supra* note 59, at 22.
65. See *supra* note 59, at 139-146.
66. See *supra* note 59, at 152.
67. See *supra* note 59, at 12.
68. See *supra* note 59, at 30-32.

© 1994 International Bureau of Fiscal Documentation

in FIFs, life insurance policies, retirement interest annuities[69] and member interests in superannuation funds, pooled superannuation and approved deposit funds.[70]

5. Calculation methods

Under the proposed measures there are three measurement methods; the daily compounding accruals method, the straight-line accruals method and the market value accounting method. The principle system of measurement will be a daily compounding accruals system. Under this method, the income or loss is calculated in terms of daily compounding interest. As the interest is brought to account at a constant interest rate throughout the duration of the instrument, it is claimed that it best reflects the economic income of the instrument.[71] The compounding method cannot be used for forward contracts, futures contracts and options as the cash flows cannot be identified in these types of instruments.[72]

Taxpayers can elect to use a straight-line accruals method. Under this method the income or loss is calculated in terms of total gains and losses spread evenly over the period of the arrangement. As income is based upon a constant periodic payment, its use is restricted to situations where there is no significant deferral opportunity and where the income result is not materially different from that obtained under the daily compounding accruals method.[73]

The last method is the market value accounting method. Under this method the gain or loss from the instrument is deemed to be the increase in the market value of the instrument during the period, adjusted for any amounts paid or received during the period. This method is easy to use where established exchanges or markets exist for the instrument. Difficulties that arise where no markets exist are overcome by deeming the market value at the end of the period to be the net present value of future cash flows under the arrangement. As it is the most inaccurate of the calculation methods, taxpayers can elect to use this method only if it is used consistently for all similar arrangements and it produces a fair estimate of value. However, taxpayers must use the market value accounting method for forward contracts, futures contracts and options. The other calculation methods are considered impractical, as cash flows cannot be identified under these arrangements.

The potential different tax treatments proposed for forward contracts, futures contracts and options when compared with swaps has been criticized. As the purpose of these derivative contracts is for financial institutions to "... hedge their exposure in foreign exchange and interest rate markets",[74] such a tax differential could result in the selection of the most tax effective hedge rather than the most efficient hedge.

6. State of play

As the measures are prospective, large areas of existing law will continue to operate for transactions entered into prior to the commencement date. The provisions include those dealing with discounted securities, traditional securities and foreign exchange gains and losses. As all the gains and losses will be either assessed or allowed as a deduction, there will be no scope for application of the capital gains provisions. To avoid double taxation, significant amendments will be required to the capital gains provisions to remove these transactions from their scope.[75]

Given the wide scope of the measures and the dramatic changes required to the Act, it is not surprising that the Document has been referred to the Senate Standing Committee on Finance and Public Administration.[76] The issues subject to the Committee's inquiry and report are the adequacy of the existing law, the impact on business of the proposed initiatives and whether the initiatives are compatible with tax simplification. Given this reference and the proposal to issue an Exposure Draft Bill, it is highly unlikely the measures will be in effect to meet the original deadline of end of 1994.

III. RULINGS AND DRAFT RULINGS

A. Transfer pricing

1. Ruling on basic transfer pricing concepts

The Commissioner has stated that transfer pricing is "... possibly the most strategic issue of the 1990s as far as international taxation is concerned."[77] As a result, on 31 August 1993 the Commissioner released a 105-page Draft Taxation Ruling, TR 93/D40 (the "Draft"), which deals with transfer pricing arrangements between separate entities (i.e. external transactions). On 31 May 1994, a rewrite of the Draft was released as Taxation Ruling TR 94/14 (the "Ruling"). Although the rewrite resulted in a 125-page document, it is in content substantially the same as the Draft. As such, many of the areas of concern raised earlier in respect of the Draft remain current.

The significance of the Ruling is that it is the first comprehensive Ruling since the introduction of Division 13 ("Div 13"), which has been in operation since 27 May 1981.[78] Prior to the release of the Draft the only formal indications of the Commissioner's views on the operation of Div 13 were two

69. As defined in Sec. 27H.
70. See *supra* note 59, at 30-32.
71. See *supra* note 59, Ch 2.
72. See *supra* note 59, at 97.
73. See *supra* note 59, Ch 2.
74. See *supra* note 62.
75. See Cooper, Graeme, "Cross Examination: New Regime for Taxing Financial Arrangements", 28 *Taxation in Australia* (1994), at 460.
76. Senate Hansard (22 March 1994), at 1948.
77. "Controversy likely on ATO ruling", *Australian Financial Review* (31 August 1993), at 4.
78. Div 13 was introduced by Income Tax Assessment Amendment Act 1982 (No. 29 of 1982). It replaced the former Sec. 136, which was based on a 1915 UK transfer pricing provision. Despite the fact that the former Sec. 136 was easily avoided and the existence of the 1975 Aspery Report recommendation to redraft it, it took the loss by the Commissioner in *FCT v. Commonwealth Aluminium Corporation Ltd.* 80 ATC 4371; (1980) 11 ATR 42, for the Government to make the necessary changes.

© 1994 International Bureau of Fiscal Documentation

limited Rulings[79] and two Draft Taxation Determinations.[80] Given this lapse of time and continued uncertainty about the scope of Div 13, it was felt that the Draft was long overdue.[81] The concerns about the delay in retrospect were misplaced as the Draft contains few surprises for those who have "... long understood the potentially broad scope of Div 13."[82] In fact the professional bodies[83] in a joint submission stated that "the Commissioner of Taxation should be applauded for embarking on the task of issuing detailed Rulings on a number of aspects relating to the application of Division 13 ... the first in the series, TR 94/14, is a considered and well reasoned statement of the basic concepts underlying the operation of Division 13 ...".[84]

Given the size of the Ruling and given the Ruling's mainly non-controversial views, it is not feasible nor of any great value for this article to describe in detail its scope and effect upon the operation of Div 13. Thus, the following focuses on the areas of the Ruling which have borne the brunt of criticism.

By way of background it will be necessary to briefly outline the operation of Div 13 as it applies to external transactions.[85] Although Div 13 regulates internal arrangements (e.g. dealings between a branch operating through a permanent establishment and its other branches or its head office),[86] these provisions are not considered as they are not dealt with by the Ruling.

(a) Application of Div 13 to transfer pricing arrangements between separate entities

Div 13 relies on the arm's length principle. In order for the Commissioner to determine that the section applies in respect of an external arrangement, the following elements must be present:

- a taxpayer;
- who is supplied property;[87]
- under an international agreement;[88]
- the parties must not be acting at arm's length; and
- the consideration is less than should have been given (or alternatively, no consideration is rendered, excessive consideration is given or the consideration given is indeterminable).[89]

If the Commissioner's discretion to use the section is then exercised, an arm's length price as determined by the Commissioner is deemed to apply in that transaction.[90] Penalties on any adjustment can be imposed.[91]

(b) Major criticisms of the Ruling

Some initial reactions to the Draft were in fact favourable;[92] however, the majority of commentators were critical of selected aspects of the Draft. These criticisms are not aimed at the fundamental approach adopted in the then Draft, rather they concern fringe issues. Many criticisms centred on the piecemeal approach of issuing up to 14 Rulings (rather than one) and the length of time between the Draft and the enactment of the legislation.[93]

What concerned many commentators was the rejection of a number of presumed limitations on the scope of Div 13.[94] Rejected was the view that Div 13 only operated when tax avoidance was present.[95] The Commissioner points to the Second Reading Speech on the Bill introducing Div 13 as supporting this view.[96] The professional bodies in their joint submission submit that by adopting this stance the Commissioner is in effect creating a strict liability code which applies to render "... all taxpayers who did not pay or receive an arm's length price under an international agreement ... to automatic adjustment".[97] They argue that this strict liability code could not have been the intention of Parliament that prescribed the application of the section to be discretionary.

The other presumed limitations rejected in the Ruling were the presumptions that the Division would not apply where a specific business purpose exists, or where the entity is located in a jurisdiction which has comparable or higher foreign tax rates.[98]

Concerns were also raised about the Commissioner's adoption of stringent documentation requirements,[99] i.e. if the documentation brought into existence at the time the dealing was contemplated is not available, the company will have difficulty in convincing the Commissioner that the transaction was arm's length.[100] Deloitte Touche Tohmatsu[101] point

79. TR 92/11 (application of Div 13 to loan arrangements and credit balances) and Taxation Determination TD 92/103 (interaction between Div 13 and accruals income under Part X and Div 6AAA).
80. TD 92/D220 (payment of disputed tax where Div 13 adjustment) and TD 93/D188 (application of Div 13 to loans to non-resident subsidiary to enable it to guarantee loans of another non-resident subsidiary).
81. "Tax office ruling near on transfer pricing", *Australian Financial Review* (30 July 1993), at 4.
82. Deloitte Touche Tohmatsu, *Transfer Pricing Guidelines: Draft Taxation Ruling TR 93/D40* (Sydney: CCH, 1993), at 3.
83. The Taxation Institute of Australia, the Australian Society of Certified Practicing Accountants, the Institute of Chartered Accountants and the Law Council of Australia
84. "Rulings and Determinations", 29 *Taxation in Australia* (1994), at 51
85. For a more detailed analysis, see Deutsch, R.L., "Transfer Pricing (with a special focus on TR 93/D40" (1994) Sixth Annual Australasian Tax Teachers' Conference paper; and Killaly J., "Division 13: Transfer Pricing Rules and Practices", 2 *Taxation in Australia Red Edition* (1993), at 46.
86. Sec. 136AE(4)-(6).
87. Property is defined in Sec. 136AA to including chose in action, any estate, interest, right or power, whether at law or in equity, in or over property, any right to receive income, and any services.
88. Defined in Sec. 136AC.
89. Sec. 136AD(2)-(4).
90. Sec. 136AD(1).
91. Sec. 225(1A).
92. Murphy, T., "Transfer Pricing", 20th International Trade Law Conference paper, Canberra (12 November 1993).
93. "Accountants criticize draft ruling on pricing", *Australian Financial Review* (12 November 1993), at 6.
94. See *supra* notes 77 and 93, and Anderson, P. and Ellis, P., "Draft Taxation Ruling TR 93/D40: ATO gets serious about transfer pricing", *Butterworths Weekly Tax Bulletin* (1993), at para. 824.
95. Taxation Ruling TR 94/14, paras. 119-121,401-409.
96. Killaly J., "Division 13: The Long and Short of Transfer Pricing", 28 *Taxation in Australia* (1994), at 388, 390.
97. See *supra* note 84.
98. See *supra* note 95 paras. 137, 441-444, and paras 122, 410-411, respectively.
99. See *supra* note 94.
100. See *supra* note 95, paras. 103-113 and 401-409.
101. See *supra* note 82, at 29.

© 1994 International Bureau of Fiscal Documentation

out that these rules are based upon the Treasurer's Explanatory Memorandum to the self-assessment legislation.[102] The professional bodies argue that these rules are not, however, supported by legislative provisions. They see these rules as presuming a non-arm's length price wherever there is non-arm's length dealing and evidence is lacking. In their joint submission they argue that the fact that parties are not acting at arm's length does not mean that there was not an arm's length price paid. Each case should be determined on its own particular facts.[103]

In order to overcome the complexities and resultant uncertainties involved in determining the arm's length price in a situation where no exact comparable arm's length transaction exists, the professional bodies have suggested that both a tolerance limit and a de minimis threshold be adopted. Thus, the taxpayer, where no evidence of tax avoidance exists, would be safe from amendment where the price utilized by a taxpayer is with a deviation of 10% from the Commissioner's interpretation of an arm's length price or where the overseas transaction was a small component of gross sales. They believe this would be consistent with the tax administration objectives of certainty and simplicity.[104] However, these submissions were not adopted in the Ruling.

The retrospectivity of the Ruling[105] has also been criticized.[106] The professions in their submission are that, as it deals with the exercise of discretionary power, it should only apply to an exercise of the discretion after issue date.[107] Again this issue was not adopted in the Ruling.

In summary, given the non-negotiable stance expressed on behalf of the Commissioner in respect of some of the above criticisms, it was predictable that the Ruling would issue with only minor amendment, which is what happened.[108]

2. Advanced pricing agreements

On 14 July the Commissioner released a draft of the second of the planned transfer pricing Rulings, Draft Taxation Ruling TR 94/D32. The Draft deals with advanced pricing agreements. An advanced pricing agreement can be either a unilateral agreement with the ATO or a bilateral agreement between the ATO and other foreign tax authorities. Such agreements establish what methodologies, expenditures, etc. will be accepted by the relevant taxing authorities for determining a transfer price in an international transaction, conducted by related parties. The Commissioner's power to give such rulings is found in the private Rulings system and the mutual agreement article in the bilateral tax treaties.

The Draft is an attempt to formalize procedures for obtaining such agreements. The Draft sets out the procedure for applying for such an agreement, the informational requirements, the requirement for annual reporting by the subject taxpayer and the duration of such agreements.

Given that the first advanced pricing agreement was entered into in 1991 with the United States Internal Revenue Service[109] and there are currently five advanced pricing agreements (involving intellectual property transfers) under consideration,[110] this formalization of procedures was long overdue. With a knowledge of the procedures and the time frames involved, taxpayers will be able to better judge whether such agreements will be of use.

3. State of play

As Taxation Ruling TR 94/14 and Draft Taxation Ruling TR 94/D32 are the first two of a series of fourteen planned rulings dealing with various aspects of Div 13,[111] the Commissioner's complete view will not be known for some time. Whether clarity and simplicity will be the result remains debatable.[112]

B. Offshore Banking Units ("OBU")

In order to encourage the use of Australia as an offshore banking centre, Division 9A was introduced[113] to provide a concessionary rate of tax (10 percent) to offshore banking ("OB") income derived after 30 June 1992. In order to qualify for the concessional treatment, the Act requires the Treasurer to classify the bank or foreign exchange dealer as an OBU.[114] For the activities of an OBU to qualify as OB, the intermediation must be in the form of the specific financial dealings (borrowing and lending, hedging, etc.)[115] between non-resident parties[116] and the OBU must carry on business in Australia.[117] The provision of financial services to non-residents in respect of business or transactions outside Australia are also classified as OB activities. Any transactions falling outside of these activities will be taxed at normal tax rates. An interest withholding tax exemption also is available.[118]

The use of common financial terms like borrowing or lending in the definitions of OB activity has resulted in uncertainty. Taxpayers need to be clear on what these terms mean as if an OBU derives more than 10 percent of its income from non-offshore income the tax concessions will not apply. In response to these concerns the Commissioner has issued 23 Tax Determinations during 1993.[119] As well as dealing with the make up of offshore income and what funds constitute offshore funds, these Determinations addressed issues as

102. See *supra* note 6.
103. See *supra* note 84.
104. See *supra* note 84, at 51-52.
105. See *supra* note 95, paras. 20-21.
106. See *supra* note 93.
107. See *supra* note 84.
108. See articles by Killaly, First Assistant Commissioner, *supra* notes 85 and 96.
109. ATO Media Release No. 10/1991
110. See minutes of National Taxation Liaison Group – Transfer Pricing Subcommittee Meeting of 18 February 1994 reported in 2 *Taxation in Australia Red Edition* (1994), at 306.
111. *Id.*, at 307. Topic covered by these proposed Rulings include internal transfer pricing, the interaction of Div 13 with double tax agreements, pricing methodologies, and penalty policy.
112. "Tax treatment of transfer pricing 'too complicated' ", *Australian Financial Review* (10 March 1994), at 11.
113. Taxation Laws Amendment Act (No. 4) 1992 (No. 191 of 1992).
114. Sec. 128AE.
115. Sec. 121D.
116. Sec. 121E.
117. Sec. 121EA.
118. Sec. 128GB.
119. Tax Determinations TDs 93/129, 131-136, 203-217 and 241.

© 1994 International Bureau of Fiscal Documentation

diverse as pre-registration activities and the effect of the assignment of loans.

IV. LEGISLATIVE CHANGES

A. Foreign Income Fund changes

The FIF measures were introduced on 1 January 1993 to tax residents (on an accruals basis) on income arising from interests in offshore passive investments entities.[120] Since the introduction of the measures, they have been subjected to amendment twice, with further amendments introduced into Parliament on 30 June 1994.

The first amendments, undertaken in November 1993, consisted only of minor changes to the Regulations.[121] The list of approved stock exchanges in Schedule 3 of the Act was replaced by an expanded list in the Income Tax Regulations,[122] as was Schedule 5 which contains a list of approved sectorial classification systems.[123]

The second set of amendments arose from the 22 December 1993 announcement by the Treasurer. As most of these changes were concessionary,[124] their effect was back dated to 1 January 1993. Legislation to give effect to these announcements was introduced into Parliament on 24 March 1994[125] and became law on 23 June 1994. The measures introduced a holding company exemption for interests in companies which hold a direct interest in subsidiaries engaged in the businesses of general insurance, real estate or multi-industry operations. The exemption is structured in similar terms to the exemption for interests in holding companies of foreign banks,[126] i.e. the holding company's shares must be widely held and traded on an approved stock exchange.[127]

The life assurance exemption[128] was also extended to include interests in holding companies, thereby making it consistent with the current exemption for banking.[129] This amendment recognizes the fact that many holding companies hold the authorization to carry on the assurance business, not the subsidiary.

Finally, the Treasurer removed from the black list interests in companies predominantly engaged in construction and construction related activities.[130] This change appears to be in response to comments in the Arnold Report.[131] The amendment enables such interests to be eligible interests for the purposes of the active business exemption.[132]

While announcing these measures the Treasurer also explained why the Government had rejected other recommendations in the Arnold Report, in particular, the recommendation for an exemption for interests in entities undertaking financial services activities.[133] The reason given for the rejection of this exemption was based upon the nature of financial services. Given their nature there was a high risk that such an exemption would omit passive investments and thereby undermine the integrity of the measures. The Treasurer stated that the existence of the balanced portfolio exemption, which allows taxpayers to hold up to 5 percent of their interests in entities engaged in black-listed activities,[134] should enable taxpayers to invest in financial service entities to an extent that would meet the investment diversity needs of most taxpayers.

The Treasurer also announced that there would be no change to the requirement under the various exemptions for black-listed activities[135] that the shares in the company be actively traded on an approved stock exchange. The Treasurer believes that without this test applying to these "... high risk black-listed activities the integrity of the measures would be threatened".[136]

The final series of changes were introduced into Parliament on 30 June 1994.[137] As the changes involve amendment of not only the FIF provisions, but also of the controlled foreign company ("CFC"), corporate limited partnership and trust provisions, it is not feasible to consider them in detail in this article. Basically, these changes are aimed at:

- removing double taxation arising from the interaction of the FIF and CFC measures;[138]
- correcting defects in the calculation methods under both the CFC and FIF measures (in respect of attribution credits, undistributed trust profits, and losses);[139] and
- aligning the treatment of corporate limited partnerships with the treatment of companies under the foreign tax credit, foreign loss CFC and FIF measures.[140]

B. Foreign bank branches

On 18 June 1993, in a major statement on the Government's banking policy,[141] the Treasurer announced a series of measures to tax branch income of foreign banks.[142] The measures were in response to the Prime Minister's February 1992 announcement that foreign banks engaged in wholesale oper-

120. For an explanation of the measures, see Dirkis, M., "The Last Chapter? Foreign Investment Fund Measures", 47 *Bulletin for International Fiscal Documentation* (December 1993), at 687-697.
121. Statutory Rules No. 275, Commonwealth Gazette No. S332 of 5 November 1993.
122. Regulation 152N and Schedule 12. The stock exchanges added to the list were the Lima Stock Exchange and the Warsaw Stock Exchange.
123. Regulation 152P and Schedule 13. The sectorial classification systems added to the list were the Extel Financial Workstation and the International Finance Corporation Composite Index.
124. Treasurer's Press Release No. 178/1993 of 22 December 1993.
125. Taxation Laws Amendment Act (No. 2) 1994 (No. 82 of 1994).
126. Sec. 504.
127. Secs. 509A, 511A and 523A.
128. Sec. 507.
129. Sec. 507A.
130. See amendments to Sec. 496(2) and Schedule 4.
131. See *supra* note 15, at 17 and 22.
132. Sec. 485.
133. See *supra* note 15, at 17 and 22.
134. Sec. 525.
135. The exemptions are for foreign banking (Secs. 503 and 504), general insurance (Sec. 509) and real estate (Sec. 511).
136. See *supra* note 124.
137. Taxation Laws Amendment Bill (No. 3) 1994.
138. *Id.*, Subdivisions B, D, E, J and L.
139. *Id.*, Subdivisions A, C, G, H, I and K.
140. *Id.*, Subdivision F.
141. Banking Policy Statement (1993) AGPS.
142. The Statement covered issues like competition policy, the Banking Code of Practice and bank and life company mergers.

© 1994 International Bureau of Fiscal Documentation

ations in Australia would be permitted to operate through branches instead of operating through subsidiaries incorporated in Australia.[143] The measures are in two distinct parts, one dealing with transitional issues, the other with ongoing taxation issues.

1. The transitional taxation measures

The transitional taxation measures, which were enacted on 22 December 1993,[144] are aimed at removing any adverse tax effects flowing from the transfer of banking businesses from subsidiaries to branches. As they are transitional measures they do not amend the substantive provisions of the Act, rather they modify the operation of those provisions to the extent they impact on eligible transfers under the measures. The concessions granted include:

- the removal of any normal Commonwealth and State charges and fees;[145]
- the relaxation of the group loss provisions to allow the transfer of losses to the foreign branch or a new Australian bank;[146]
- the provision for the roll-over of all assets subject to Part IIIA at their original acquisition date and cost base, provided the transferor and transferee meet the 100 percent common ownership test;[147]
- the provision for the roll-over of assets subject to depreciation at their depreciated value, provided the transferor and transferee meet the 100 percent common ownership test;[148]
- the provision for the roll-over of other assets such as trading stock,[149] shares, loan advances and traditional securities[150] and the provision for the roll-over of liabilities,[151] provided the transferor and transferee meet the 100 percent common ownership test;
- the modification of Section 128F to ensure that the withholding tax exemption will continue for assets transferred;[152] and
- the relaxation of the bad debts provisions to ensure that bad debts transferred will be available to the transferee.[153]

To qualify for these transitional taxation measures, the company must have been granted a banking authority on or before 26 February 1992 or be registered after that date as a money market corporation. They can only transfer the business to the Australian branch of a foreign bank or another subsidiary of the foreign bank that was granted a banking authority after 26 February 1992 (a new Australian bank).

Despite these concessions, it is claimed that the legislation does not go far enough.[154] Loxton argues that by not providing a mechanism to transfer contractual liabilities (bills of exchange, swaps, etc.), a substantial ongoing administrative cost is created in the transferring subsidiary. This arises as the law of contract requires that in the absence of novation by depositors, swaps must be held until maturity and that bills of exchange cannot be transferred on market once endorsed or accepted by the transferor.

2. The ongoing taxation measures

Legislation was introduced on 30 June 1994[155] to enact the second component of the measures, the ascertainment and assessment of the Australian income of the branch, the "ongoing taxation measures". This calculation of branch income requires treating the branch as a separate entity for tax purposes and applying a number of special rules to determine income and deductions of the branch. A recent article in the *Bulletin*[156] addressed the deductibility issues of intrabank interest expense and the application of withholding tax to such interest paid and the issue of the inconsistency between the Australian and OECD approaches. Therefore, the following only briefly describes the income and deductibility issues not directly covered in that article. The special rules enacted include provisions that:

- deem the branch's income to be derived from a source in Australia;[157]
- allow a deduction for any foreign tax paid by a foreign bank on income derived through its Australian branch;[158]
- remove the application of the thin capitalization rules to bank branches;[159]
- relax the group loss provisions to allow transfer of losses between the branch and its wholly-owned subsidiaries;[160] and
- impose a notional equity requirement which treats 4 percent of the branch's funds as equity, thus resulting in the branch's total interest deduction by 4 percent.[161]

C. Offshore Banking Units

As well as the 23 Tax Determinations, legislation was also required to further clarify the operation of Division 9A. Legislation was introduced into Parliament on 24 March 1994

143. Hon Keating, P., *One Nation*, Statement by the Prime Minister 1992, AGPS, at 69. The Prime Minister was partially implementing a recommendation contained in the November 1991 report of the House of Representatives Committee on Finance and Public Administration, *A Pocket Full of Change* (Martin, Chair) (Canberra: AGPS, 1991), at 160. This change did not extend to foreign banks engaged in retail banking. They are still required to operate through subsidiaries incorporated in Australia.
144. Financial Corporations (Transfer of Assets and Liabilities) Act 1993 (No. 97 of 1993) ("Finance Corporations Act").
145. *Id.*, Sec. 10.
146. *Id.*, Secs. 24-27.
147. *Id.*, Secs. 18-20.
148. This change is not legislated for directly in the Finance Corporations Act. The exemption operates indirectly through Sec. 18 of the Finance Corporations Act which modifies Sec. 160ZZO of the principle Act. This modification enables Sec. 160ZZO to operate in respect of transfers under the Finance Corporations Act which in turn triggers the application of the existing preservation provision contained in Sec. 58(1) of the principle Act.
149. See Finance Corporations Act, Sec. 21.
150. *Id.*, Secs. 15 and 17.
151. *Id.*, Secs. 16 and 17.
152. *Id.*, Sec. 23.
153. *Id.*, Sec. 22.
154. Loxton, D,. "Foreign bank branch legislation leaves cost hurdle", *Butterworths Weekly Tax Bulletin* (1993), at para. 1081.
155. See *supra* note 137.
156. See Kobetsky, M., "Foreign Bank Branches", 48 *Bulletin for International Fiscal Documentation* (May 1994), at 243.
157. See *supra* note 137, Sec. 160ZZX.
158. See *supra* note 137, Sec. 160ZZY.
159. See *supra* note 137, Sec. 160ZZZD.
160. See *supra* note 137, Secs. 160ZZZG and 160ZZZH.
161. See *supra* note 137, Sec. 160ZZZB.

© 1994 International Bureau of Fiscal Documentation

requiring that guarantees, letters of credit or performance bonds can be only be used in respect of transactions with offshore parties, if those transactions are to qualify as OB activities. The legislation also made a number of technical amendments and extended the range of permitted borrowings and loans to gold loans and borrowings.[162] Also during 1993, legislation has been introduced by some State Governments to encourage the establishment of OBUs in their states by giving them exemption from state taxes (e.g. debits tax, land tax, payroll tax and stamp duty).[163]

However, given the amount of change required to the original concessions granted to OBUs, as evidenced by the abovementioned amendments and Rulings, Australia's approach to OBUs has clearly been inadequate. Cooper argues that "Australia's approach appears to be one of providing a tax concession and assuming that would be sufficient to attract offshore banking activity".[164] He believes that by failing to make the concessions easy to understand and practical to use the Government has hindered rather than assisted Australia in becoming a regional financial centre.

D. Regional headquarters

Early in 1994 the Government indicated that it was considering providing tax concessions to encourage multinationals to establish their regional headquarters in Australia.[165] On 4 May 1994 the Government announced[166] details of a two-tier approach aimed at encouraging relocation. It involves concessions to compensate the companies for relocating and then the ongoing concessional treatment of their foreign income. These changes were introduced into Parliament on 30 June 1994.[167]

The relocation concessions involve the provision of a deduction for the capital set-up costs[168] and the provision of an exemption from sales tax for certain imported second-hand computers and computer-related equipment used in the newly established regional headquarters. Where sales tax is levied on such goods during the period 15 December 1993 until the date the provisions become law, the amendments provide for tax credits or a refund of the tax paid.

The income concession is the exemption from dividend withholding tax of certain foreign-source dividends that pass through a resident company to non-resident shareholders.[169] Specifically, an exempt non-resident shareholder will be exempt from dividend withholding tax on a dividend received from an Australian resident company to the extent that the dividend consists of an amount debited from the resident company's foreign dividend account. Only qualifying foreign-source dividends can be credited to this account by an Australian resident company. Thus, the exemption is not available in respect of dividends received by an Australian share holding company holding less than ten percent of the voting power in the foreign company paying the dividend.

Although this income concession was intended to facilitate the establishment of regional headquarters, it is not restricted to regional headquarters. The exemption applies to all such qualifying dividends that pass through Australian resident companies. The ATO has anticipated the passing of the legislation by issuing on 1 July 1994 an addendum to Taxation Ruling TR 93/40, which prescribes the form of the dividend statement that the resident company must provide shareholders.

V. OVERVIEW: NO END IN SIGHT

Since 1985 Australia's income tax laws have continued to undergo dramatic changes. Despite these dramatic changes, the above discussion indicates that pace of reform is set to continue through 1994 and beyond. Thus, it can be confidently said in respect of Australian tax law, "the times they are a changing".

Postscript

Since the preparation of this article, the Australian Government on 9 August 1994 tabled its response to "Report No. 326 – An Assessment of Tax – A report on an Inquiry into the Australian Taxation Office". In its response to the Committee's recommendations on changes to the ATO's structure, the Government rejected the concept of an Australian Tax Commission. The Government stated that such a structure would impinge upon the independence of the Commissioner by allowing direct Ministerial interference. It stated that the current structure addressed the Committee's concerns about a politically independent but outward looking tax administration.

The Government accepted the Committee's recommendations on changes to the Ruling system that notices identifying and summarizing all public Ruling should be placed in the Commonwealth Gazette and that all public Rulings should be tabled in Parliament within five days after appearing in the Gazette. However, the Rulings would not be subject to disallowance by the Parliament. The Government also rejected the recommendations that penalties should not be imposed where a taxpayer indicates in a return that he is not following a private Ruling or where a taxpayer ignores a Determination.

To deal with the recommendation that Rulings should be vetted by senior staff, the Commissioner announced the formation of a panel to review major Rulings, consisting of three senior ATO staff and two external members.

162. See *supra* note 125.
163. The Offshore Banking Units and Regional Headquarters Act 1993 (Qld).
164. Cooper, Gordon, "Offshore Banking Units: OBUs – Only Barely Useable?", 2 *Taxation in Australia Red Edition* (1994), at 150.
165. "Big tax lure for foreign business", *Australian Financial Review* (15 February 1994), at 1 and 12.
166. The White Paper on Employment *Working Nation* (Canberra: AGPS, 1994).
167. See *supra* note 137.
168. See *supra* note 137, Secs. 82C to 82CE.
169. See *supra* note 137, Secs. 128S to 128TF.

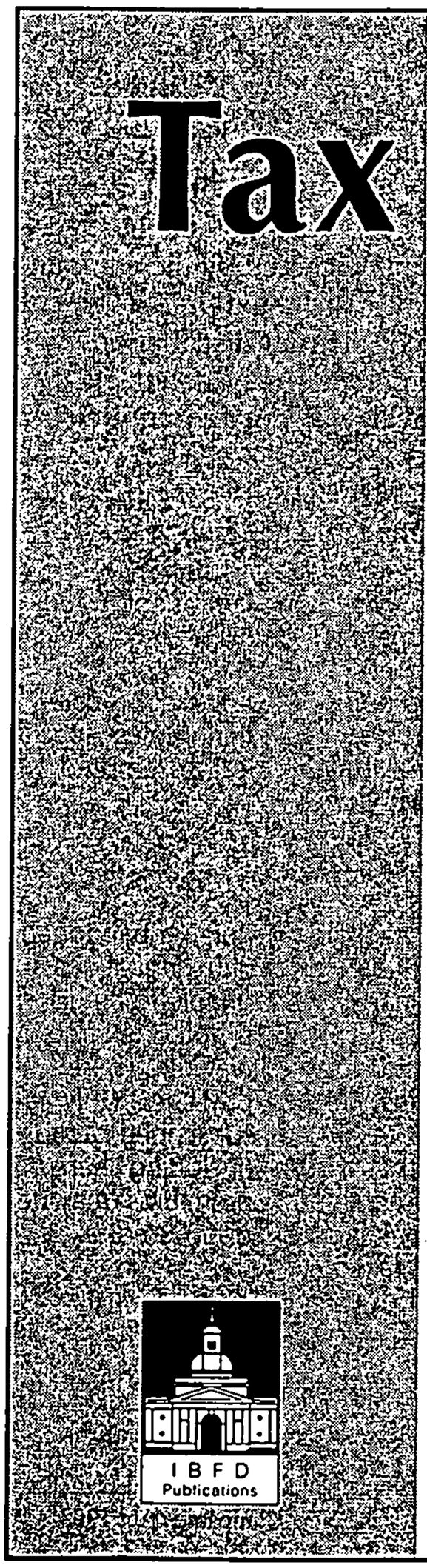
© 1994 International Bureau of Fiscal Documentation

The Government accepted the Committee's recommendations on avenues of review agreeing to set up a Small Taxation Claims Tribunal to deal with disputes of less than A$ 5,000. The Government also supported in principle the funding of test cases and approved the allocation of A$ 4 million for that purpose. It did not accept the recommendation that the ATO should fund all appeals where the ATO has received an adverse decision at first instance.

An alternative avenue of review, the Government announced the creation of a Taxation Ombudsman within the Commonwealth Ombudsman's Office to review independently ATO administrative actions. The Government stated that this new Office will significantly improve the equity in the tax system.

The Government rejected the Committee's recommendation that the Commissioner's access powers be amended so that the ATO is required to show just cause before being allowed to enter private property. The Government indicated that there are sufficient safeguards under existing arrangements. It also did not support the imposition of limitations on the Commissioner's powers to impose penalties.

In addition to the above changes the Government also announced that it would sponsor the drafting of a Charter of Taxpayer Rights, which will inform taxpayers of their rights when dealing with the ATO. This announcement coupled with those above were described by the media as a win for ordinary taxpayers. However, large corporations disagree. They believe that the Government has rejected the crucial recommendations that would have curbed the Commissioner's great powers and could have put balance back into the system.



News Service

Keep track of the latest taxation news from over 150 countries with IBFD's acclaimed weekly newsletter.

Comprehensive coverage of developments of international interest is assured through a network of local correspondents, all experts in their own area. News, trends, proposals and changes in taxation and investment are all reported as they occur.

Tax News Service: there is no better way to keep up with events in international taxation.

NLG 600

Binder, quarterly cumulative indexes and postage by air are included in the subscription. Text includes references for instant updating of IBFD loose-leaf services.

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND

UPDATE ON THE TAX IMPLICATIONS OF THE NEW COMPANIES ACT 1993

Adrian J. Sawyer

M.Com. (Hons.), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand. **Mr Sawyer** is a lecturer in taxation and commercial law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a consultant for the New Zealand Treasury on effective tax rate research and is a member of the New Zealand Society of Accountants and is on the Canterbury/Westland Branch of the Society's Tax Committee. Previously Mr Sawyer was an investigating accountant with the New Zealand Inland Revenue Department.

I. INTRODUCTION

In an earlier article by this author,[1] the tax implications of the new Companies Act 1993 (the "Act") were critically examined, with the overall nature of the proposed tax treatment of the company reforms placing a decidedly restrictive impost on the increased flexibility provided by the Act. Fortunately, New Zealand's legislative process involves the input of tax professionals and representatives of entities directly affected by proposed legislative changes through a consultation process.

The two areas of most concern in the discussion document were share buy-backs and amalgamations. A substantial number of submissions were received on these issues, resulting in some noticeable changes in the revised draft legislation introduced to the New Zealand Parliament as part of the Taxation Reform (Companies and Other Matters) Bill 1994 (the "Bill"). Additionally, the treasury stock method of accounting for share buy-backs has been given limited application. This short note outlines the changes to the proposed tax treatment of company share buy-backs, treasury stock and amalgamations.

II. THE REVISED REGIME: TAXATION REFORM (COMPANIES AND OTHER MATTERS) BILL 1994

The changes introduced by this Bill will be contrasted with the previous situation outlined in the discussion document issued in December 1993.

A. Share repurchases

The situation regarding share repurchases has changed substantially following the receipt of the submissions. Essentially the bright-line tests have been modified, although without any substantial underlying change since the Commissioner is still vested with substantial powers to deem a distribution to be a dividend. The slice rule has gone. Most on-market buy-backs will now be tax-free, but share traders will remain in the situation of being effectively taxed twice when all subscribed capital has been distributed, since tax will be paid on the dividend and on the profits from the repurchase of the shares held on revenue account. With off-market share buy-backs, subscribed capital (amounts received by the company on the issue of shares) is able to be distributed first tax-free to shareholders, but once exhausted, then all distributions will be taxable (to which imputation credits may be attached or RWT is payable). Court approval will not be required for returns of capital of this nature.

The situation is summarized in the table below:

Component Altered	Discussion Document Treatment	Treatment in the Bill
Proceeds received from share buy-backs	Taxable and non-taxable portion in accordance with the bright-line tests and the slice rule.	All taxed as dividend unless specifically exempted.
Slice Rule	Subscribed capital, realized capital gains and share premiums as portion of all shareholders funds are returnable "tax-free"; all other reserves comprising the remaining portion are taxed as dividend.	Rule is abandoned, with capital gains unable to be distributed tax free by way of a share buy-back. Only subscribed capital (including share premiums) may be distributed tax free.

1. See A.J. Sawyer, "Tax Implications of the New Companies Act 1993", 48 *Bulletin for International Fiscal Documentation* (April 1994), at 167.

© 1994 International Bureau of Fiscal Documentation

"On-market" buy-backs	Slice rule and bright-line tests apply as above with the company liable for the tax on the dividend component.	Slice rule and bright-line tests apply as above with the company liable for the tax on the dividend component.
"Off-market" buy-backs	Must satisfy the "bright-line tests". *Pro rata*: 1. If less than 15% of subscribed capital, deemed to be a dividend; 2. If greater than 15%, may still be taxable if the Commissioner considers it is in lieu of a dividend.	New "bright-line tests" provided. *Pro rata*: 1. If less than 10%, deemed to be a dividend; 2. If 15% or over, not taxable as a dividend unless taxpayer can show otherwise (a rebuttable presumption); 3. If 15% or over, not taxable as a dividend *per se* unless Commissioner considers it is in lieu of a dividend.
	Non-pro rata: A shareholder's proportionate interest in the company after the repurchase must not exceed 85% of their pre-purchase interest in the company.	*Non-pro rata*: Distributions require at least 15% of a shareholder's interest in the company to be repurchased, otherwise as above.
Redeemable shares, unit trusts and group investment funds	Special provisions apply.	Special provisions apply, with redeemable shares treated as debt without adverse tax consequences if not in lieu of a dividend.

To clarify the new treatment of share buy-backs, the principles espoused in the Bill are illustrated in the following example:

Off-Market Share Buy-Back: Tax treatment under the Bill
A Company has the following shareholders funds, reflected in the share price of $ 7.50 per share.

Shareholders Funds	
Subscribed Capital (paid in cash)	1,500 (1,500 shares)
Realized Capital Profits	2,000
Retained Earnings	3,000
Excess if share price over net assets	1,000
	$7,500 Market Value of company

The company will *pro rata* buy back 330 shares for $ 7.50 each. This amounts to 22% of the market value of the company, satisfying the bright-line tests (assuming this is not in lieu of a dividend). The cost of the buy-back is $ 2,475. The first $ 1,500 may be deemed to be sourced from subscribed capital and is consequently tax free to the shareholder. The remaining $ 975 is taxable as a dividend to the recipients (imputation credits may be attached or RWT must be deducted – this is an off-market repurchase). All future share buy-backs will be dividends unless further capital is subscribed. Up to 5% of these repurchased shares may be held for 12 months under the treasury stock method without tax being imposed on the share buy-back.

B. Treasury stock

Companies will now be permitted to hold shares that they have repurchased from shareholders without cancelling them and without any tax being imposed on the buy-back, provided that the amount held in this manner does not exceed 5 percent of each class of shares at any one time and that they are sold within 12 months of acquisition. This is a most welcome development since treasury stock accounting for repurchases was strictly prohibited under the regime proposed in the discussion document. This should facilitate the repurchase process and thereby assist in achieving the objectives of the Act.

C. Amalgamations

There have not been any substantial changes regarding amalgamations in the Bill, and this is particularly disappointing for share traders. Share traders (revenue account holders of shares) will have the exchange of shares in the old companies for shares in the new company consequent upon an amalgamation treated as if they had sold their shares, thereby incurring tax on the profit made. No "rollover" relief is provided and according to Coopers and Lybrand,[2] this may frustrate the intention of the Act for institutional investors, a sizeable group of the share trading sector in New Zealand. The Bill clarifies the situation regarding stamp duty. It will not be payable on assets transferred during an amalgamation. Shareholder continuity requirements remain as set out in the discussion document.

2. Coopers and Lybrand, Special Edition: Company Law Tax Changes", *Tax Tips* (3 June 1994).

© 1994 International Bureau of Fiscal Documentation

III. CONCLUSIONS

The Bill provides some welcome relief to the original proposals in the discussion document with respect to share repurchases and treasury stock accounting for share buybacks. It illustrates the role that consultation can play in improving (draft) tax legislation. While the Bill is subject to review and public consultation and submissions through the Finance and Expenditure Select Committee of Parliament, it will probably now be enacted until late August, which is after the Companies Act comes into force. Consequently, the Bill will have retrospective effect to July 1994, but it provides a clearer view of the effective legislative environment for company activities and their taxation implications post 1 July 1994.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

OCTOBER 1994

Reaping the rewards from REPO, London, 6 October 1994 (English):

Bookings Department, IBC Financial Focus Ltd, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-323 4298.

International Transfer Pricing, New York, 11 and 12 October 1994 (English):

Strategic Research Institute, 500 Fifth Avenue, 11th Floor, New York, N.Y. 10110, Tel.: 212-302-1800, Fax: 212-302-9850.

World Corporate Tax Systems, Amsterdam, 13-14 October 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The Taxation of International Partnerships, Amsterdam, 21 October 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Essential international tax techniques after the Finance Act 1994, London, 26 October 1994 (English):

Conference Bookings, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

International Tax Conference, Toronto, 28 October 1994 (English):

Ernst & Young, Attn: Joseph Gill, Tel.: 1-416-943 3063.

NOVEMBER 1994

International Tax Conference, New York, 2-3 November 1994 (English):

Ernst & Young, Attn: Jan Carnevale, Tel.: 1-212-773 6590.

Double Taxation Relief Planning, Amsterdam, 2-4 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Planning Association meeting, Nassau, 7-8 November 1994 (English):

International Tax Planning Association, Attn: Elizabeth Husband., Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-732 762910, Fax: 44-732 763762.

Optimizing taxes internationally as an aspect of cost management, Zürich-Glattbrugg, Switzerland, 9-10 November 1994 (German):

Zentrum für Unternehmungsführung AG, Attn: Dr Fritz Haselbeck, Im Park 4, CH-8800 Thalwil, Switzerland, Tel.: 41-1-720 8888, Fax 41-1-720 0808.

The Taxation of International Services, Amsterdam, 11 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Recent issues in corporation tax law, Hannover, 12 November 1994 (German):

Dr Peter Deubner Verlag GmbH, Seminar-Büro, Scheinerstrasse 7, 81679 München, Tel.: 089-998918-51, Fax: 089-998918-50.

Taxation of financial instruments for managing interest rates and currency risks, London, 14 November 1994 (English):

Attn: Vicki Goffin or Julia Dopheide, Conference Bookings, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

American Tax Institute in Europe 17th Annual Congress, Cannes, 14-16 November 1994 (English):

The American Tax Institute in Europe, Falmer Court, London Road, Uckfield, East Sussex TN22 1HN, Tel.:(0825) 760-901, Fax: (0825)760-903.

11th Asian-Pacific Tax Conference, Structuring Investment and Cross-border Transactions in the Asian-Pacific Region, Singapore, 21 and 22 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Conference, Paris, 23-24 November 1994;

Ernst & Young, Attn: Niels Dejean. Tel.:33-1-46 93 62 32.

US International Taxation, Amsterdam, 24-25 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Valuation of Companies and Mergers and Acquisitions, Zurich, 29 November through 1 December 1994 (German), although interpreters services will be available for the first day of the conference):

Zentrum für Unternehmungsführung AG, Attn: Dr Fritz Haselbeck, Im Park 4, CH-8800 Thalwil, Switzerland, Tel.: 41-1-720 8888, Fax 41-1-720 0888.

DECEMBER 1994

Holding Companies, Amsterdam, 8-9 December 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

The International Bureau of Fiscal Documentation and the IBFD International Tax Academy

are pleased to announce an

International Taxation Essay Competition

The competition is being held to mark the 5th anniversary of the IBFD International Tax Academy ('ITA'). Its aim is to stimulate discussion and development on important areas of international taxation in accordance with the objectives of IBFD and ITA.

The topics may cover either one or, as a combined topic, both of the following:

1. Multilateral tax treaties are preferable to bilateral tax treaties. Please discuss.

2. Which article or articles of the 1992 OECD Model treaty would you delete, what would you replace it or them with, and why?

The competition will be judged by a panel of international tax experts drawn from a number of different countries

The winner will be awarded a cash prize of 5,000 Dutch Guilders and the winning entry will be published in either 'European Taxation' or the 'Bulletin for International Fiscal Documentation' together with any other entry or entries considered to have reached an appropriately high standard. The latter will receive a cash prize of 500 Dutch Guilders. All entrants will receive a complimentary copy of IBFD's International Tax Glossary.

Rules:

1. Entrance is open to all persons with the exception of the following:
   (a) Persons having passed the age of 32 on 1 October 1994
   (b) Persons employed or otherwise connected with the management or organisation of IBFD during the period the competition is open.

2. Essays may be written and submitted by no more than one person.

3. Essays must be typewritten in the English language and be between 5,000 and 8,000 words.

4. 4 copies of each essay must be submitted.

5. Entries should be submitted to arrive at:
   IBFD International Tax Academy
   PO Box 20237
   1000 HE Amsterdam
   The Netherlands
   c/o Ms Roeline Schep
   no later than 30 April 1995.

6. Publication of results: the name of the winner will be announced in 'European Taxation', 'Bulletin for International Fiscal Documentation' and 'ITA Update' as soon as practicable after the closing date.

7. Exclusive publication rights in essays will be ceded on submission to IBFD Publications BV.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

PAST AND PRESENT WORK IN THE OECD ON TRANSFER PRICING AND SELECTED ISSUES

Diane Hay, Frances Horner and Jeffrey Owens

Diane Hay (United Kingdom Inland Revenue & Chair of OECD Task Force on Transfer Pricing), **Frances Horner** (OECD Principal Administrator, Fiscal Affairs Division) and **Jeffrey Owens** (OECD Head of Fiscal Affairs Division). The views in this note are not intended to represent the views of the OECD or the United Kingdom Inland Revenue.

INTRODUCTION

The note is structured in three parts. Part I provides the background to the current discussions at the OECD. Part II sets out the arm's length principle and its application by means of transaction-based methods. It also contrasts the arm's length principle to global formulary apportionment, which is an alternative principle put forward to determine the allocation of income and expenses of MNEs. This part also discusses new approaches to improving the operation of the arm's length principle. Part III examines the possible application of profit methods in a manner consistent with the arm's length principle.

The main theme running through the note is the need to provide guidelines for taxpayers and tax authorities to assist them in achieving an appropriate allocation of income and expenses between associated enterprises operating in different countries. Whilst the note draws extensively on the work being currently undertaken on the revision of the OECD's 1979 guidelines, it would be premature to anticipate the final outcome of this revision, which will not be completed until July 1995 (a discussion draft of Part I of the Guidelines was issued on 8 July 1994).[1] This note therefore should not be taken to represent the views of the OECD or of its member countries. Any viewpoints and opinions expressed in this note should be treated solely as the viewpoints and opinions of the authors. The text should not be quoted without the permission of the authors.

I. THE OECD'S 1979 GUIDELINES AND THE CURRENT REVISION

Transfer pricing issues are not new. Already at the beginning of the 20th century a number of countries had developed transfer pricing rules, sometimes in the form of enabling tax authorities to consolidate the activities of related trades or businesses. This was the case with the US Revenue Act of 1928, Section 806. In some countries the initial focus was on domestic transactions, which is still the case in many non-member countries, where regional incentive schemes make it attractive to shift profits into associated enterprises operating in such regions.

The spread of MNEs since the 1960s – such enterprises now account for 60 percent of world trade and the top 100 MNEs own 20 percent of world assets – has meant that today the main focus of attention is on the pricing practices of these companies. Countries are concerned to ensure that transfer prices do not misallocate the tax base between the countries in which an MNE operates and thereby undermine the tax base and distort competition. Tax authorities are also concerned to minimize any tax avoidance opportunities that arise from the manipulation of transfer prices.

The precise concerns of a country will vary with its economic position. Large capital exporting countries may fear that transfer pricing practices will be used to minimize the repatriation of profits, whilst countries which are large importers of capital may be concerned that transfer pricing will be used to transfer profits outside of their jurisdiction. In the 1960s, the United States, as both a large capital importer and exporter, was experiencing both of these concerns and, under pressure from Congress, issued the 1968 Section 482 Regulations. In the 1960s and 1970s other countries also began to review their legislation and administrative practices in this area. These country developments led to work being undertaken by the OECD's Committee on Fiscal Affairs ("CFA"), which is the main tax policy body of the Organization.

A. Transfer pricing and double taxation conventions

The basis for the separate entity (i.e. arm's length) principle in international tax arrangements is set out in Article 9 of the OECD Model Tax Convention. This article states that when "conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which

1. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Discussion Draft of Part I. The Foreword and Preface to this Report appear in this issue at 521.

© 1994 International Bureau of Fiscal Documentation

differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

This reference to conditions established in the commercial and financial relationships of independent enterprises is the arm's length principle. By seeking to determine the profits that would have accrued to independent enterprises in the same circumstances, the arm's length principle follows the approach of treating the members of an MNE group as separate entities and not as a single unified business.

The OECD 1992 Model Tax Convention is primarily concerned with addressing cases which would give rise to international double taxation, whereas this is the only one of the concerns which is behind most national legislation and the OECD guidelines on transfer pricing.

The 1992 Model follows closely the formulation of Article 9 of the 1963 Model, although in 1977 the current paragraph 2 of Article 9 was added requiring that an applicable corresponding adjustment be made in the other contracting state in cases where the transfer pricing adjustment is made by the other contracting state to relieve double taxation. Apart from this change, the OECD Model has in this area remained unchanged since 1963 and provides the basis for the separate entity approach followed by all OECD member countries in their bilateral treaties and by most non-member countries. The UN Model in Article 9 adopts a similar approach.

There are, of course, many other Articles of the OECD Model Tax Convention which are relevant to transfer pricing issues. In particular, Article 4 defines residence, Articles 5 and 7 determine the taxation of permanent establishments, Articles 10, 11 and 12 determine the taxation of dividends, interest and royalties respectively, and Articles 24, 25 and 26 contain special provisions relating to non-discrimination, the resolution of disputes and exchanges of information.

B. The 1979 OECD Guidelines

In 1979 the OECD published its guidelines on the allocation of income and expenses between associated enterprises under the title "Transfer Pricing and Multinational Enterprises" (hereafter referred to as the "1979 Report"). These guidelines were finalized by the Working Party on Taxation and Multinational Enterprises (Working Party No. 6) of the CFA, which was created in 1973. The Working Party, made up of senior delegates from national tax administrations, finance departments and treasuries, worked for five years on the guidelines, which were unanimously adopted by the OECD Council on 16 May 1979.

The Guidelines were subject to intensive discussions between member countries and also benefited from input by the private sector in the form of comments from the OECD's Business Industry Advisory Council ("BIAC"). The guidelines have been translated in many languages and have been used extensively by tax authorities and taxpayers around the world. In many member countries these guidelines form the basis for national legislation. An overview of the guidelines is provided in Part II below.

C. Related work between 1979 and 1992

At the inception of its work on the 1979 guidelines, Working Party No. 6 decided that the application of the guidelines to specific sectors should be postponed until after the completion of the guidelines. Thus in 1984 the OECD published a follow-up report entitled "Transfer Pricing and Multinational Enterprises: Three Related Issues" (hereafter referred to as the "1984 Report"). This Report dealt with the application of the guidelines to the banking sector, the problem of corresponding adjustments and central management and service costs.

With the completion of the 1984 Report, the pace of work on transfer pricing slowed down. In 1984 and 1985 the Working Party examined the use of unitary taxation by certain states of the United States and submitted a report to the US administration of the problems encountered with a global unitary approach and with the proposals set out in the 1986 Treasury Task Force Report to limit unitary taxation to a water's edge.

Between 1986 and 1991 very little further work was undertaken on transfer pricing, although the Working Party did examine recent developments in a number of countries. Work was also underway on a report on the attribution of income to permanent establishments. In this period, the CFA also organized two meetings of tax inspectors, the first focusing on transfer pricing issues generally and the second on a number of sector studies.

In 1991, the Working Party No. 6 reviewed its work programmes and decided that a series of "peer reviews" of the transfer pricing legislation, practices and operations of selected OECD countries should be undertaken. Working Party No. 6 also is studying potential tax barriers to cross-border mergers and the tax problems arising from the spread of new financial instruments.

In addition to work being carried out by Working Party No. 6, the Committee has undertaken projects in areas which are closely related to transfer pricing, the main projects being:

- Guidelines for competent authorities in the exchange of information were finalized in 1993. These are intended to clarify the scope and interpretation of Article 26 and review a number of practical problems encountered in such exchanges. An OECD standard for exchanges of information was agreed upon in 1992 and a standard for electronic data interchange will shortly be finalized.
- Work is underway on the advantages and disadvantages of extending the EC Convention on Arbitration to all OECD countries.

D. The US Section 482 Regulations

The United States has directed much effort to answering the question of what method an auditor should apply when a corporate uncontrolled price ("CUP"), retail price and cost plus

© 1994 International Bureau of Fiscal Documentation

methods cannot be reliably applied. The results of its analysis lead to the proposed Section 482 regulations being issued in 1992. These proposals set forth how the United States intended to implement the "commensurate with income" standard enacted in the 1986 Tax Reform Act. Many commentators tend to ignore that the need to implement this standard has driven the recent proposals from the US Treasury.

Many countries expressed concern that the 1992 proposed Section 482 Regulations would be applied in a manner inconsistent with the arm's length principle, with particular focus on the role of the comparable profits method. These fears led the CFA to create a special task force to examine the US proposals.

During six months, nine of the member countries worked intensively to draft a report setting out the collective views of the treaty partners of the United States. This report was adopted by the CFA and was published in December 1992 under the title "Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations". The report provided a detailed commentary of the US proposals. Suggestions in that Report appear to have been the basis for some substantial changes in the next version of the Regulations published in January 1993. The new Regulations explicitly reconfirmed the US commitment to the arm's length principle, they put more emphasis on a facts and circumstances approach, limited the sound business judgement rule, introduced the best method rule rather than a strict hierarchy of methods and eliminated the CPM as a mandatory check on other methods.

Nevertheless, some concerns remained with a number of features of the January 1993 Regulations. This led the Committee to issue a second report in July 1993 which proposed further amendments: limiting the CPM to cases of last resort, discouraging IRS auditors from going too quickly to the CPM, emphasizing the serious data availability problems in implementing a CPM, amongst other things. In July 1994 the final version of the US Section 482 Regulations were issued by the Treasury. These regulations are consistent with the spirit – and in some cases use languages which are strikingly similar to – the OECD Draft Guidelines issued for public comment also in July.

Although the work carried out on the US Regulations provided a useful starting point for the revision of the 1979 Report, that work should be seen as a separate exercise from the current project to revise the 1979 Guidelines. The first was directed at a specific set of proposals, whereas the latter is seen as a fundamental review of the underlying principles and application of OECD guidelines. In addition, the composition of the task force carrying out each project has been different.

E. The revision of the 1979 Guidelines

1. Why review the 1979 Report?

One may ask why revise a Report that continues to be used and which is seen as an authoritative international standard? Four reasons can be given for the revision:

- to amalgamate the 1979 and 1984 Reports and to take into account the other work of the Committee referred to above;
- to bring up-to-date the 1979 guidelines to reflect technological developments and the increased globalization of national economies (e.g. the advent of global trading);
- to clarify the ambiguities in the 1979 Report as to whether and to what extent profit methods were acceptable, given that there are divergent interpretations of the 1979 Guidelines in this respect; and
- to respond to the fact that a number of countries had revised their legislation and practices since 1979.

It was these arguments that led the Committee to establish in April 1993 a special task force to undertake this revision.

2. The objective set for the revision

The overriding objective set for this exercise is to develop clearer guidelines for the application of the arm's length principle that would be acceptable to taxpayers and to tax authorities and thereby minimize conflict. The guidelines should provide a clearer indication of which methods are acceptable and which are not and under what circumstances a particular method could be appropriately applied. The revised report will also emphasize why the arm's length principle is superior to a global formulary apportionment method.

3. The way the revision is being carried out

The revision of the 1979 Report is being undertaken by a nine country task force that meets at three-month intervals and reports back regularly to the full Working Party No. 6 and the CFA. In this way all member countries are actively involved in the revision process. The drafting of the report is undertaken by the members of the Task Force and the Secretariat. The business community is being consulted in the revision process; recently a day-long meeting with BIAC was held on this topic.

4. The structure of the revised report

It is premature to set out the final structure of the revised report. However, as presently envisaged the report will be divided into three parts: Principles and Methods; Applications; and Special Topics. Part I will deal with the arm's length principle and examine the ways in which that principle can be applied by means of transaction methods and profit based methods. It will also set out why this principle is preferred to a global formulary approach. Part II will discuss the documentation requirements for the application of each method, will examine the application of these principles to intangible property and services, and will discuss administrative procedures available to minimize conflicts and to resolve conflicts when they occur. The special topics to be discussed in Part III include: permanent establishments, thin capitalization and cost sharing.

© 1994 International Bureau of Fiscal Documentation

5. The timetable

Part I was issued for public comment in July 1994 and will be finalized with Part II in 1995. Part III is not expected to be available before the end of 1996.

II. THE ARM'S LENGTH PRINCIPLE AND ITS APPLICATION

A. The arm's length principle

1. Definition

Somewhat surprisingly, one will not find a definition of "the arm's length principle" in the 1979 Transfer Pricing Report. There is a definition of "arm's length prices" and the Report discusses whether a particular transfer price would "conform" to the arm's length principle, but there is no guidance on what this principle actually means. The revision of the 1979 Report is basing its definition of the arm's length principle on the wording of Article 9(1) of the OECD Model Tax Convention. Article 9(1) reads:

> Where
>
> i) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
> ii) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

In applying the arm's length principle, tax administrators and taxpayers generally share the same view of this concept even if it is not articulated. But in recent years, the question has been raised whether the arm's length principle must focus only on determining prices or whether it can encompass a broader approach that examines the effect of the wider interrelationships between associated enterprises on the conditions imposed between them in their dealings. Under such a broader approach, one could consider whether the profits earned by a member of an MNE group conformed to the arm's length principle without needing to substantiate whether the prices of the individual transactions were "arm's length prices".

The theoretical debate continues. But in its review of the 1979 Report the focus is on a practical resolution to this debate. The aim is to determine whether the conditions imposed between associated enterprises reflect arm's length dealings. Clearly, the most direct way to do this is by examining the price of a transaction, and in the majority of cases this will be the approach used. However, there will be occasions when it will be necessary to employ other methods and look beyond the prices of transactions in order to assess whether the enterprises concerned are dealing with each other at arm's length.

2. Theoretical basis

When independent enterprises deal with each other, the conditions of their commercial and financial relations are generally determined by market forces of supply and demand. However, where associated enterprises deal with each other, the very fact that through the ownership of capital one enterprise may be able to exercise a significant influence over the activities of the other, and both may benefit from the sharing of knowledge and resources, may counteract the influence of market forces on their dealings. The degree to which this can happen will vary from case to case. A lot will depend upon the group's underlying motivation and philosophy, i.e. whether their relationships are defined by a high or low degree of internal competition and the extent to which the MNE group aims at a distribution of profits to its various members based on the real value of their individual contribution, or seeks to concentrate those profits at the centre. The type of business will also influence the degree to which external market forces are relevant. In particular, the degree of vertical integration will affect this. In highly integrated MNE groups, especially those sharing valuable intangible property, the division of functions can often make it difficult to find an external comparable. In addition, enterprises may be subject to government restrictions in the form of exchange or price controls, anti-dumping duties, etc. which can override the laws of supply and demand. Finally, the effect of market forces may be distorted because of tax considerations and in particular any efforts to reduce the overall tax burden of the MNE group.

What the arm's length principle does is to try to eliminate the effect of the above factors by treating each associated enterprise as though it were a separate entity and not as a member of a single unified business. This is the fundamental difference between the arm's length method of allocating profits earned by multinational enterprises and the so-called "unitary" approach which will be considered in subsequent paragraphs.

3. OECD acceptance of the arm's length principle

Since its earliest beginnings, the member countries of the OECD have endorsed the separate entity approach, not just in the field of transfer pricing but also as the fundamental basis for the allocation of taxing rights between nations. Consequently, those member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to ensure a distribution of the tax base which is consistent with the arm's length principle.

One can identify a number of reasons why the OECD has preferred the arm's length principle to other methods. Firstly, it has been accepted that the market forces of supply and demand are the best way to allocate resources and reward effort. Secondly, the arm's length principle provides broadly equal treatment for MNE groups and independent enterprises, thereby avoiding the creation of tax advantages by the concentration of economic power in large MNE groups.

© 1994 International Bureau of Fiscal Documentation

Thirdly, and perhaps most important, at a practical level, the arm's length principle has been successfully applied in the majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price can readily be found.

4. Criticisms of the arm's length principle

The major theoretical criticism of the arm's length principle is that it is inherently flawed because it adopts the separate entity approach. Consequently, the arm's length principle cannot account – at least comprehensively – for the economies of scale or other benefits of integration that accrue to integrated businesses. Another objection is that the arm's length principle cannot cope in situations where associated enterprises engage in transactions that independent enterprises would simply not undertake. Such transactions can be motivated by tax avoidance, but many occur as a consequence of the commercial differences between MNE groups and independent enterprises. In such circumstances, the arm's length principle is difficult to apply because there is no direct evidence of what conditions would have been established between independent enterprises.

A related problem is that because the arm's length principle requires taxpayers and tax administrators to evaluate the transactions and business activities of independent enterprises, this can require access to information which may be extremely difficult to obtain, even if it does exist. Often this information is confidential to the particular taxpayer and cannot be disclosed to others without revealing business secrets.

5. The international consensus

Over the years there has been much discussion of the advantages and disadvantages of using the arm's length principle. Indeed, the problems with its application in increasingly complex situations, which reflect the technological progress of the last two decades and the globalization of the world economy, are to a considerable extent the reason for the revision of the 1979 Report by the Task Force. However, these problems do not present any convincing reason to abandon the arm's length principle because of these problems and to switch to an alternative method of allocating profits.

The arm's length principle is sound in theory because it adopts as a benchmark the normal operation of external market forces. Moreover, applying the arm's length principle has in general been remarkably successful over the years. The strong consensus on this point has laid the foundation for much of the growth and development of international trade and investment over the years. As such, it is extremely unlikely that the member countries of OECD would want to adopt an alternative approach – even if such an alternative might resolve some of the difficulties in applying the arm's length principle. Consequently, the revision of the 1979 Report can be expected to reaffirm the consensus on the arm's length principle, and at the same time to explore the ways in which this principle might be better applied in today's business and trading environment.

B. Contrast with the unitary approach

1. Definition

Before going on to look in more detail at the application of the arm's length principle it is probably appropriate to consider briefly the alternatives. In fact, as mentioned above, the only recognized alternative to the arm's length principle is a unitary approach. Even so, this method has never been applied as between nations, but only in a number of subnational jurisdictions. International disapproval of this method has generally resulted in such authorities restricting the application of the method so as to exclude the results of "foreign" members of the MNE group from its scope.

The unitary approach is in fundamental contradiction to the separate entity approach. It starts from the premise that because of the economies of scale and benefits of integration achieved by an MNE group, the allocation of profits can only be considered on a consolidated basis. Therefore, rather than looking for comparable independent enterprises or transactions, the unitary approach begins by determining the scope of the "unitary business" which may or may not include all of the activities of an MNE group. It then ascertains the global profit of the unitary business and using a predetermined formula, usually based on some proportion of turnover, payroll and assets, allocates the global profit to the various entities. Normally, the same formula is applied regardless of the nature of the business concerned.

2. Criticisms of the unitary approach

The member countries of OECD have not considered the unitary approach to be a realistic alternative to the arm's length principle in the allocation of profits between nations. A major concern is that a predetermined formula is arbitrary and disregards market conditions, the particular circumstances of the individual members of the MNE group, and management's own allocation of resources. It is therefore quite likely to produce an allocation of profits that bears no relationship to the specific facts and circumstances of the case. This method could assign profits to an entity that on an arm's length basis has incurred a loss.

Difficulties also arise in the valuation of assets, especially in the valuation of intangible property. As yet, no solution has been found to address this problem. In addition, difficulties can arise in determining where a sale actually takes place and the solutions adopted may be quite different from those based on the normal allocation of taxing rights. Adoption of a unitary approach is likely to conflict with many of the rules contained in existing bilateral tax treaties.

However, perhaps the most significant concern with the unitary approach would be the difficulty of implementing this in a way in that would protect against double taxation and ensure single taxation of profits. This would require substantial international consensus on the formula to be used and on the composition of the unitary business. It is doubtful whether such consensus could ever be achieved because each country would want to weight the factors in the formula to its best advantage. The transition to a unitary approach would

© 1994 International Bureau of Fiscal Documentation

therefore present a change of enormous political and administrative complexity. And unless the move was total, MNEs would be faced with the equally enormous burden of complying with two different systems for the allocation of profits. This would inevitably run the risk of producing double taxation in every case.

It is not only the member countries of OECD who have rejected the unitary approach – the business community also opposes it. This was evidenced most recently in the comments from the BIAC to the Task Force on Transfer Pricing on the 1979 Report revision. These comments made it clear that the unitary approach may in fact present intolerable compliance costs and information requirements because information has to be gathered about the entire unitary business and presented in each jurisdiction in accordance with the accounting and tax rules of that particular jurisdiction. The view of business is that the documentation and compliance requirements under a unitary approach would be more burdensome than under the separate entity approach. An MNE group would be required, in any event, to maintain separate accounting records for entities that were not part of the unitary business. Moreover, other commercial and accountancy rules would still require the use of arm's length prices, for example customs rules, so that in many instances, an MNE group would have to still retain its records in accordance with the arm's length principle.

C. Application of the arm's length principle

1. General approach

The application of the arm's length principle using the definition provided in Article 9(1) invites us to compare the conditions made or imposed between two associated enterprises in their commercial or financial relations with those which would have been made between independent enterprises. Traditionally, this comparison has centred upon the conditions made or imposed between the two associated enterprises in the transactions between them, and has compared this with the conditions which would have been made or imposed in the transactions between independent enterprises.

Over the years three main methods have evolved which compare the conditions in a controlled transaction to the conditions which would have been made or imposed in transactions between independent enterprises. The comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price which could have been obtained if the parties were independent. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profits margins earned in similarly uncontrolled transactions in order to estimate the gross profit margin which could have been earned had the parties been independent.

There will be few cases where there are no differences between the controlled and uncontrolled transactions or between the associated and independent enterprises undertaking those transactions. Normally there will be differences, but sometimes these differences will not have a material effect on either the price or the gross margin. Even if these do have a material effect, such differences can often be accounted for by reasonably accurate adjustments. In all these situations we would say that we had comparability between the controlled and uncontrolled transactions or the associated or independent persons concerned.

The 1979 Report considers comparability in the context of each of the three methods referred to above, but does not set out any general standard against which the application of the different methods in any particular case could be evaluated. The 1979 Report is lacking in this respect and so it is expected that the revision will include a separate section on comparability. It is only by setting out such a general standard that the reliability of any method to arrive at a result which accords with the arm's length principle can be tested. The reliability of a method will depend upon the degree of comparability that can be achieved using that method with those particular facts and circumstances.

2. Factors determining comparability

The extent to which each of the factors discussed below influences the degree of comparability will depend upon the nature of the controlled transaction and the pricing method adopted. The relevance of these factors in the application of the three transactional-based methods is discussed below.

It almost goes without saying that differences in the specific characteristics of the goods or services transferred often account for the major part of any difference in their value in the open market. Differences in the physical characteristics of products, their quality and reliability and their availability all need to be taken into account as do the nature and extent of any services provided. In the case of intangible property, the form of the transaction (licensing or sale) the type of property involved (patent, trade mark, etc.) and the anticipated benefits from the use of the property will all be relevant.

As well as comparing the characteristics of the goods or services transferred, it will normally be important to compare the activities and responsibilities undertaken by the associated and independent enterprises. This is done by analysing the functions undertaken by each party, the assets that are employed in carrying out the functions performed by each party and the risks assumed by each party. In addition, any comparability standard must take into account the contractual terms of a transaction as these generally define how the responsibilities, risks and benefits are to be divided between the parties. Such a consideration of the contractual terms is usually a part of a functional analysis.

A comparability standard should also take into account the business strategy of the enterprises concerned. This aspect was covered in the 1979 Report (see for example Paragraph 43 which deals with "start up" or "market penetration" prices) but more emphasis may be appropriate for this issue because of the importance it has assumed in transfer pricing. What the Task Force is aiming to do is to give more guidance to tax administrations on the extent to which different business strategies should be taken into account when determin-

© 1994 International Bureau of Fiscal Documentation

ing comparability. As a result, the revised report can be expected to highlight a number of factors to be considered when evaluating a taxpayer's claim that it is following a business strategy that results in reduced profits over the short term in return for higher profits in the long run. One consideration is whether there is a plausible expectation that adherence to the chosen business strategy will indeed produce an acceptable return with a reasonable period of time. In determining what would constitute a reasonable period of time, tax authorities may wish to consider the commercial strategies evident in the country in which the associated enterprise pursuing this strategy is located as an indication of the behaviour which could reasonably have been expected if that party had indeed been independent.

3. Recognition of the actual transactions

The 1979 Report covered this point in just one paragraph and stated that, except in exceptional cases, it was inappropriate to disregard the actual transaction undertaken or to substitute an other transaction for it (see Paragraph 23). Given developments in transfer pricing case law since 1979 – the so-called "make or buy" argument which surfaced in the Bausch and Lomb case for instance – this subject merits a deeper analysis and the revised report can be expected to discuss this topic more fully.

This has proved one of the more difficult parts of the report to draft. As in 1979, restructuring controlled transactions is generally inappropriate, unless there is a lack of economic substance to the transaction and it has been structured deliberately in that way to avoid or minimize tax. An example of this type of transaction would be the case of thin capitalization where an investment in an associated enterprise is structured as an interest bearing loan whereas at arm's length the investment, having regard to the economic circumstances of the enterprise, would have been made by way of an injection of capital rather than through the use of debt.

However, there may be a difference between disapproving generally of the restructuring of the controlled transactions and using different transactions undertaken between independent enterprises to help determine whether the transfer price of a controlled transaction (as structured) would satisfy the arm's length principle. For example, take the case where in all similar transactions between independent enterprises, the allocation of risk (e.g. currency risk) was different from the existing allocation in the case of the associated enterprise. The fact that no independent enterprise had allocated risk in that way could be a reason to scrutinize the economic substance of that transaction if it was felt that this had been done so in such a way to avoid tax. Normally, this would not be the case and it may well be that the uncontrolled transactions with their alternative allocation of risk could provide a comparable uncontrolled price, if sufficiently accurate adjustments could be made to reflect this difference.

4. Other aspects: ranges and multiple year data

Chapter 1 of the 1979 Report deals with a number of other aspects to be taken into consideration in applying the arm's length principle. Most of these are just as valid today as they were in 1979 and can be expected to reappear in the revised report. However, the report will expand the discussion on some of these points (for example losses and the effect of government regulations on the arm's length principle) and likely will introduce two new key factors that can be crucial to a correct application of the arm's length principle. These concern the use of an arm's length range and the use of multiple year data.

On many occasions the application of the most reliable method or methods will inevitably produce a range of figures. This may be simply because more than one transfer price can satisfy the arm's length principle for a particular transaction. Independent enterprises engaged in comparable transactions under comparable circumstances may not always establish the exact same price for the transaction yet each price will necessarily be at arm's length. Another possibility is that even the method may result in a range because the application of the arm's length principle in a particular case can only produce an approximation of the conditions that would have been established between independent enterprises. A range of figures could also result when more than one method is being used and produces a different outcome or indeed its own range of outcomes.

If the price of the controlled transaction falls outside the range, it would normally be appropriate to make an adjustment to a point inside the range. The Task Force has debated at some length where the appropriate point would be, because any point in the range could be said to satisfy the arm's length principle. There are a number of possibilities, including making adjustments to the point in the range which best reflects the facts and circumstances of the controlled transaction.

The 1979 Report considers the problem of sustained losses in Paragraph 28. This recognizes that in an arm's length situation losses may last for a relatively long period in the anticipation of future compensating profits. This multi-year approach could be applied more widely and would give a better and more complete understanding of the facts and circumstances surrounding a controlled transaction. In general, therefore, it can be useful to examine data from both the year concerned and previous years. This information may well help explain what has influenced the determination of the transfer price in question. It will also show whether different economic conditions in an earlier year had a material effect on the price of the controlled transaction. Moreover, differences in business or product life cycles can have a material effect on price that has to be assessed in determining comparability. However, using data from years following the year of the transaction should be undertaken with care in order to avoid the use of hindsight.

D. The transaction-based methods

1. General

The description of and comments on the three transaction-based methods can be expected to follow very closely the remarks made in the 1979 Report. As stated above, in the majority of cases we will be looking at specific transactions

© 1994 International Bureau of Fiscal Documentation

and will be able to apply a transaction-based method, particularly if the standard of comparability is not applied too rigidly. Any adjustment will naturally involve some element of imprecision, but can still be possible to make adjustments and produce reliable results.

In OECD discussions, there appears to be an overwhelming preference in favour of the transaction-based methods. The reason for this is that these methods provide a more direct way of establishing whether the conditions made or imposed between the associated enterprises in their commercial or financial relations differ from those which would have been made between independent ones, because in the majority of cases, those relations will be primarily based on transactions. In many of these cases, the differences between controlled and uncontrolled transactions are identifiable and can be taken into account with reasonably accurate adjustments.

On the other hand, the use of profit-based methods requires a high degree of comparability in relation to the characteristics of the associated and the independent enterprises. For example, adjustments may need to be made to take into account factors such as differences in business strategies, the efficiency of management, the competitive position, etc. Accounting for these differences is often far more difficult than making the kind of adjustments required in using the transaction-based methods. This is why, whilst there are cases where transaction-based methods cannot be applied alone, generally, the use of profit methods is not to be encouraged.

2. The comparable uncontrolled price method

As the 1979 Report makes clear, this method offers the most direct way of determining an arm's length price. This method compares the price in a controlled transaction to the price charged in a comparable uncontrolled transaction between independent enterprises. Any difference between the two prices may lead to the conclusion that the associated enterprises are not operating at arm's length and the price in the uncontrolled transaction may be substituted for the price in the controlled one.

The comparable uncontrolled price method proves to be a highly reliable method if a comparable uncontrolled transaction exists and either there are no differences between the transactions being compared or where such differences exist, reasonably accurate adjustments can be made to eliminate their effect. However, whilst this method may be preferable to all other methods, it can often be difficult to find an uncontrolled transaction that is sufficiently similar such that the differences have no material effect on price. In many respects, this method is far more sensitive to differences in price than other methods, such as the cost plus and the resale price methods. A minor difference in the nature of the goods which are the subject of the controlled and uncontrolled transactions can have a material effect on price, even though the goods may be sufficiently similar that the transactions produce the same overall gross profit margin. Another problem is that it may also be difficult to determine reasonably accurate adjustments to eliminate the effect on price of differences between the controlled and uncontrolled transactions. However, it is particularly important that the need to make accurate adjustments is not interpreted too strictly. In many respects, a flexible approach should be encouraged in this particular area so that the comparable uncontrolled price method can be used if at all possible, even if it needs to be supplemented by other methods.

3. Resale price and cost plus methods

The resale price method begins with the price at which a good that has been bought from associated enterprise is resold to an independent one. The price is then reduced by an appropriate mark-up known as the "resale price margin" which will represent what the reseller needs to cover his costs and to make an appropriate profit on the transaction. By subtracting this mark-up from the final price we can work back towards the arm's length price of the original sale within the MNE group.

The cost plus method estimates an arm's length price by adding an appropriate mark-up to the costs incurred by an associated enterprise which is providing goods or services to another member of the MNE group. The result should be an arm's length price for the transaction. As in the case of the resale price method, determining an appropriate mark-up can be problematic. However, the cost plus method is also less satisfactory because it is often difficult to determine the relevant costs and, furthermore, the extent to which costs are determinative of gross profits is somewhat debatable.

Both the resale price and cost plus methods can be highly reliable ways of applying the arm's length principle. An uncontrolled transaction will be comparable to a controlled one if there are either no differences between the transactions being compared, or between the enterprises undertaking those transactions, that materially affect the gross margin, or where such differences do exist, reasonably accurate adjustments can be made to eliminate their effect. In making comparisons in respect of both these methods, fewer adjustments are usually needed to account for differences in the nature of the goods (or services) than under the comparable uncontrolled price. This is because differences in the nature of the goods are less likely to have a material effect on gross profits margins, which are usually more influenced by the nature of the functions performed and the risks assumed by the parties concerned.

In summary, transaction-based methods are preferable because they provide the best means of establishing whether the arm's length principle as expressed in Article 9 is being observed. The 1979 Report recognized that there would be occasions when such methods would not in themselves be reliable because of the difficulty in finding suitable comparable transactions and in making sufficiently accurate adjustments to account for differences. The 1979 Report suggested that in these circumstances a mixture of these methods or other methods still might have to be used. Beyond that, the 1979 Report gives very little guidance except to say that the object of using a mixture of methods or other methods altogether should be to arrive at a figure which is acceptable for practical purposes. Whilst the OECD endorses the essentially practical nature of transfer pricing, events have moved on since 1979, and consequently we have devoted a consider-

© 1994 International Bureau of Fiscal Documentation

able amount of our time to the consideration of other methods and whether these might produce a figure that is acceptable for practical purposes.

III. OTHER METHODS

This section describes why other methods might be used, the general nature of the other methods and the concerns they can raise. It also describes the two specific "other methods" that have emerged, namely the profit split method and the comparable profits method, and discusses them in the context of concerns over the manner in which they may be applied. It concludes by comparing the views set on profit methods in the July Discussion Draft with the views expressed in the 1979 Report.

A. Moving beyond the transaction-based methods: when and why

1. Why other methods might be necessary

Other methods become relevant when there are no comparable transactions available to apply transaction-based methods reliably. This point is best explained in the context of the definition of the term "comparable", which is set forth above and repeated for purposes of convenience here. A transaction among independent enterprises is comparable to a transaction among associated enterprises provided that (1) there are no differences between the controlled and uncontrolled transactions themselves or between the associated and independent enterprises undertaking the transactions; (2) there are such differences but those differences do not have a material effect on the measure being used (e.g. prices or gross margins) to determine whether the conditions of the controlled transactions reflect arm's length dealings; or (3) there are differences that have such a material effect, but the differences can be accounted for through reasonably accurate adjustments.

As stated above, this standard for comparability is not intended to be applied too rigidly, because perfectly comparable transactions are more the exception than the rule, and adjustments naturally involve some degree of approximation and imprecision. Consequently, even when controlled and uncontrolled transactions are not comparable within the strict meaning of the definition given above, a transaction-based method might still be used, depending upon the degree of comparability, i.e. the degree of reliability of any adjustments that can be made, and the degree of the material effect of any differences.

Even with this flexible approach, there will be cases where the degree of comparability that can be achieved with a transaction-based method will not be considered satisfactory. It may not be possible to achieve a satisfactory degree of comparability because there are many aspects of a transaction that can have a material effect on prices and gross margins. A tax authority or taxpayer may feel that there are too many material differences between the controlled and uncontrolled transactions, and that adjustments cannot be made with sufficient accuracy, to justify relying on a transaction-based method alone, or perhaps at all, in a particular case. These cases are considered cases of last resort.

2. The general nature of other methods and the concerns raised

Other methods have evolved in response to the constraints in applying the transaction-based methods. The goal has been to seek measures or indicators of arm's length dealings that are less adversely affected than the transaction-based methods are to differences between controlled and uncontrolled transactions. This search has led to other methods that focus on net profitability, i.e. profit methods, because net profits ordinarily are not as influenced by characteristics of the particular transactions. Instead, net profits are more directly influenced by the characteristics of the enterprises and the functions being performed, the assets used and the risks assumed in the transactions. This means that profit methods are not as directly connected to the conditions of the controlled transactions as are the transaction-based methods, and so are not preferred. However, because they depend less on transactional similarity, profits methods have been used in difficult and complex cases.

The use of profit methods, even in complex cases of last resort, has proven to be rather controversial. Tax authorities and taxpayers alike have expressed serious concerns about profit methods and in particular about whether they are consistent with the arm's length principle as articulated in Article 9 of the OECD Model Convention. One of the most difficult tasks of the OECD has been to articulate and to understand fully the basis for these concerns. In general, the concerns are that profit methods will be applied in a manner that is too distant from the actual controlled transactions at issue, and without adequate reference to external data from independent enterprises with an acceptable degree of comparability. Both these aspects – a strong connection to the controlled transactions and a reliance on third party data with adequate comparability – are integral to the arm's length principle.

The OECD therefore has been faced with the challenge of reconciling these concerns about satisfying the arm's length principle with the reality that transaction-based methods sometimes cannot be reliably applied alone, or perhaps at all. The OECD also recognizes the importance of reaching an international consensus on this issue. Without an agreement on the use of profit methods, there would be continuous disputes about transfer pricing cases by member countries with each other and with non-member countries as well, and there would be a high likelihood that taxpayers would be subjected to economic double taxation. Thus, resolving the issue of profit methods has become central to the work of the OECD in this area. The approach has been to examine and discuss profit methods in detail, both as a general matter and in terms of the specific aspects presented by each of the two methods that have emerged.

In its general consideration of profit methods, the OECD realized that at a minimum it would be necessary to take precautionary steps to prevent the overly broad use of net profits as an indicator of whether the conditions of controlled trans-

© 1994 International Bureau of Fiscal Documentation

actions reflect arm's length dealings. The most straightforward example is the case where the net profits being examined include income and/or expenses from parts of the business not involving the controlled transactions (e.g. where a tax authority seeks to determine a division of the combined profit of the entire business). A tax authority or taxpayer might be tempted to rely on an over-inclusive figure for net profits because of difficulty in determining the net profits from the controlled transactions separately from the net profits from other parts of the business.

When the net profits being used to apply a profit method extend beyond the controlled transactions, there is a natural question whether the result of the method will be consistent with the arm's length principle. The arm's length principle involves establishing whether the conditions of controlled transactions reflect arm's length dealings. Profit experience must be a relevant indicator of the arm's length nature of those conditions if it is to be used to apply this principle. However, profit experience that goes beyond the controlled transactions will necessarily be influenced by factors unrelated to the conditions of those transactions and so may not be wholly reliable as an indicator of whether those conditions are arm's length.

This example is just one instance of the concern about an overly broad application of profit methods, and it helps illustrate that the root of the problem is in the determination of comparability. Even where the net profits used in an application of a profit method are limited to those derived from the controlled transactions, those net profits could be affected by characteristics unrelated to the controlled transactions. If these characteristics are not replicated in the enterprises used as the source for comparable data, and adjustments are not made to take the differences in characteristics into account, then any deviation between the profit experience of the associated enterprises and the profit experience that independent enterprises might have expected could be attributable to these characteristics rather than to non-arm's length conditions in the controlled transactions.

Thus, profit methods raise a concern that there will be differences between the associated enterprises and the independent enterprises being compared that will have a material effect on net profits, but that these differences will be disregarded or not adjusted for in the net profits analysis. This is a concern that profit methods may be applied without sufficient attention to comparability. The concern seems to stem from the fact that one looks to profit methods precisely when the available data does not provide an acceptable degree of comparability in the transaction-based methods. Thus, the inference might be drawn that profit methods can tolerate a more relaxed standard of comparability. It is true that profit methods do not demand as high a degree of similarity (or as many adjustments to account for differences) in the transactions being compared, because the precise characteristics of the transaction are less likely to have a material effect on net profits than they have on prices or gross margins. The problem is that a tax authority or taxpayer might mistakenly forget (or fail to realize) that there are other differences, non-transactional ones, that could have a material effect on net profits and that these must be taken into account if a profit method is to be applied reliably. It simply is not the case that less attention can be given to comparability in applying a profit method; rather, it is just that different factors may be relevant to the comparability determination.

The factors relevant in determining comparability under a profit method usually will relate to characteristics of the enterprises entering into the transactions, rather than the transactions themselves. Examples include the threat of new entrants, management efficiency, competitive position, differences in the cost of capital, varying cost structures and the degree of business experience. Each of these factors can in turn be influenced by numerous other elements. For example, the level of the threat of new entrants will be determined by such elements as product differentiation, capital requirements, and government subsidies and regulations. It is important that these factors be considered in determining the degree of comparability that exists in applying a profit method in a particular case and therefore in assessing the reliability of the method. The degree of comparability that can be obtained will affect the reliability of profit methods in any particular case.

B. Two specific "other methods"

1. The profit split method

The profit split method identifies the combined profit of associated enterprises from the controlled transactions in which they are engaged, and splits that profit among the participants based on the relative value of the contribution that each of the enterprises expected to make to those controlled transactions. The expected contribution, rather than the actual contribution, is used in this description because taxpayers should not be penalized if their reasonable expectations are not realized. The relative value of the contributions made by the enterprises is to be determined to the extent possible by external market data. The contributions that each enterprise makes are determined based upon a functional analysis.

On the positive side, the profit split method can take into account the actual division of functions and responsibilities between the associated enterprises, and therefore can reflect any unique characteristics of those enterprises of their business. Also the method evaluates both parties to a controlled transaction, thereby helping to ensure that neither party is left with an extreme and improbable result.

On the negative side, there are several concerns. The first is derived from the importance of external market data to the arm's length principle. There is some concern that the profit split method will be applied without adequate reference to external market data. The more tenuous the nature of the external market data used in the profit split analysis, the more subjective will be the resulting allocation of profits. The second relates to data availability, a problem for all methods. In the context of the profit split method, the data availability problem may arise in seeking information from foreign affiliates necessary to carry out a thorough functional analysis, or in determining combined profit from the controlled transac-

© 1994 International Bureau of Fiscal Documentation

tions separately from the profit for other parts of the business. There may also be administrative burdens associated with stating books and records on a common basis and making adjustments to accounting practices and currencies.

The profit split method also needs to consider what the division of profits would have been had actual profits been more in keeping with the profits that could have been reasonably foreseen. Such an approach is important to prevent taxpayers from being penalized by the use of hindsight on the part of a tax authority.

These are two principal approaches for applying the profit split method: the contribution analysis and the residual analysis. Under the contribution analysis, the combined profits, constituting the total combined profit from the controlled transactions, is divided based upon the relative value of the functions performed, assets used, and risks assumed by each of the associated enterprises participating in the controlled transactions. The relative value is determined by assigning a percentage based on a comparison of each party's contribution and external market data. This approach seems to have been used primarily in the context of global trading, but the Task Force is soliciting other examples from the business community. It is unclear at the present time whether there is much general interest in this form of profit split analysis.

Under the residual analysis, the combined profit is divided into two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily the basic return would be determined by reference to market returns achieved in similar types of transaction. In the second stage, any residual profit or loss remaining after the first stage would be allocated among the parties based upon what independent enterprises might have done in similar circumstances. The relative value of the parties' contributions and their bargaining positions would be important to this analysis.

Other approaches are possible, for example a division of profit based upon capital employed, using the division of profits that actually has resulted from comparable transactions among independent enterprises or by examining discounted cash flow from the controlled transactions over the anticipated life of the business.

2. The comparable profits method

The comparable profits method determines the level of profit that would have resulted from controlled transactions if an associated enterprise had earned a profit, as indicated by various profit measures such as the return on assets, equal to the profit realized by a comparable independent enterprise. A functional analysis is important in establishing whether an independent enterprise is comparable to the associated enterprise.

On the positive side, the comparable profits method relies on external measures of profitability that are less adversely affected by transactional differences than are prices or gross margins. Also the method can be simpler to apply than the profit split method because the least complex of the parties can be analysed. This approach simplifies the functional analysis that must be undertaken and also avoids the need for a common statement of books and records for all the participants involved in the controlled transactions.

On the negative side, there are several concerns. First, it is especially critical in the context of the comparable profits method that sufficient attention be paid to characteristics of the enterprises in determining comparability. Any application of the comparable profits method would have to consider a number of factors in making that determination. Another problem relates to data availability, a common problem to all the methods. In the context of the comparable profits method, it may be difficult to locate specific information on profit measures from the controlled transactions separate from other parts of the business, or similarly from the transactions of comparable independent enterprises. It also may be difficult for a corresponding adjustment to be determined when the comparable profits method is being used, particularly where it is not possible to work back to a transfer price and the taxpayer deals with associated enterprises on both the buying and selling sides of the controlled transaction.

Finally, there may be concerns about applying the comparable profits method to only one side of the transaction. A two-sided analysis would act as a strong counter-check of the comparability standard being applied and would ensure that the overall profitability of the MNE group were being taken into account. Further, where the analysis will be one-sided, the associated enterprise to which the method is applied should be the least complex of the enterprises and should not own valuable intangible property or unique assets that distinguish it from potential comparables. This approach will help reduce the possibility of an over-allocation of income to the party to which the method is being applied and will make the use of profit measures from comparable enterprises more reliable.

C. Application of multiple methods

As indicated in some of the passages quoted above, the 1979 Report acknowledged that it may be appropriate in particular cases to use a mix of methods in establishing whether transfer pricing is arm's length. The revised report affirms that view.

The OECD has recognized that in difficult cases there should be a flexible approach that allows the evidence of various methods to be used in conjunction. However, the use of multiple methods should not be a requirement. Rather, each particular case must be assessed on its own merit. As a general rule, a judgment should be made based on the facts and circumstances of each case depending upon the available mix of evidence, and the administrative burdens involved.

More generally, the 1979 Report provides a general concluding statement that leaves open the possibility for the use of methods not described in the Report. Paragraph 75 states: "The methods described do not by any means exhaust the possible techniques, and it does not follow if an approach has not been mentioned it ought not be followed". The revised report is somewhat less generous than this. It does not pro-

© 1994 International Bureau of Fiscal Documentation

vide an open permission for tax authorities to use methods not described in the Report, although it is possible for a tax authority to experiment with other approaches for dividing profit under the profit split method.

D. Comparison with the 1979 Report

1. In general

The 1979 Report has been used for 15 years as an international standard for transfer pricing by OECD member countries and by non-members as well. The revised draft guidelines are intended to address the same topics as the 1979 Report and also to go beyond those topics to provide further guidance to taxpayers and tax authorities in light of developments that have occurred since the earlier report was published. Accordingly, the revised draft guidelines, once finalized, are intended to replace the 1979 Report as the international standard for transfer pricing.

In many respects, the draft guidelines replicate and affirm the guidance of the 1979 Report, with some changes to the precise language to account for organizational and stylistic differences in the two Reports. Perhaps most significantly, the revised draft leaves unchanged the basic tenets of the 1979 Report, and in particular underscore the conclusion that the arm's length principle be the international standard for determining cross-border transfer pricing. There are virtually no substantive changes to guidance provided in the transaction-based methods (CUP, resale price and cost plus methods), although some clarifications have been added. For example, the standard of comparability is clarified for the CUP method, as discussed earlier, so that difficulties in locating comparable uncontrolled transactions do not preclude the use of the method altogether but do make its application less reliable. Further, some clarifying language has been added regarding the costs to be used in establishing the cost plus percentage.

There are also some ways in which the revised draft differs from the views expressed in the 1979 Report, and these differences should be highlighted in order that they receive adequate scrutiny amidst the stylistic changes that have been made. Perhaps the only critical area in which there are differences is in the treatment of profit methods. Those differences, as reflected by the emerging consensus on profit methods suggested above, in general represent an extension and clarification of the 1979 views rather than a change in direction. In particular, the revised draft seeks to provide more detailed guidance and more specific limitations on the use of profit methods than were contained in the 1979 Report.

The 1979 Report expressed a clear preference for the CUP method. Paragraph 46 of that Report states that "[c]learly the comparable uncontrolled price method is basically preferable to other methods since it uses evidence most closely related to an arm's length price..." This preference is mirrored in the revised report by a preference, more strongly stated, for transaction-based methods (although there is no intention to establish an exact priority).

As stated at the outset of this discussion, the 1979 Report also acknowledged that in certain cases "other methods" (i.e. methods that are not transaction-based) may be necessary. To illustrate, there are the following passages in the 1979 Report:

> *Paragraph 13*: "The complexities of real life business situations may put many conceptual and practical difficulties in the way of the application of the methods referred to above. A mixture of these methods, or other methods still, may sometimes therefore have to be used."

> *Paragraph 46*: "There should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case. It has to be recognised that an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek for a reasonable approximation to it."

> *Paragraph 70*: "Cases will often occur where there is no satisfactory evidence of comparable uncontrolled prices and where it may also be difficult to apply either the resale price method or the cost plus method. In such instances, it may be necessary to adopt other reasonable approaches for arriving at an arm's length price. It may also be necessary to have recourse to additional calculations and computations to cross-check a price derived according to one or other of the methods previously described. Some other such methods used in practice are discussed in the following paragraphs, though the list is by no means exhaustive. They all need to be used with care."

Thus, the 1979 Report directly acknowledged a role for "other methods", although cautioning that they "must be used with care". The revised draft agrees with this view but goes beyond it in providing some detail on what would be required to use other methods "with care".

2. The profit split method

The 1979 Report discusses the profit split method, albeit somewhat briefly, in Paragraph 72. That paragraph describes a method that attempts "to allocate some proportion of the combined net income arising from a sales transaction to the various associated enterprises concerned in it on the basis of their proportionate contribution to the final profit". The paragraph indicates this method "is sometimes suggested either as a method of arriving at the arm's length profit or as a method of achieving a similarly equitable allocation of profits between associated enterprises".

However, the 1979 Report does not provide any real analysis of the profit split method or of the considerations for applying it, but instead references an earlier paragraph, Paragraph 14, that addresses global methods. Paragraph 14 is concerned primarily with global formulary apportionment methods, i.e. methods that use "predetermined formulae for allocating profits between affiliates". This lengthy paragraph provides much detail on the shortcomings of a global formulary apportionment method, and rejects it as a permissible approach except "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".

© 1994 International Bureau of Fiscal Documentation

The 1979 Report therefore did not consider or analyse whether the profit split method, applied independently to a particular case based on the specific facts and circumstances, should be distinguished from global formulary apportionment methods, which use predetermined formulae for all cases. In this respect, the 1979 Report leaves incomplete the consideration of the profit split method, which was appropriate given the stage of development of transfer pricing issues at that time. The revised draft attempts to fill the gap left by the 1979 Report by distinguishing between global formulary apportionment and the profit split method. It concurs fully in the rejection of global formulary apportionment methods, and provides much greater elaboration of the basis for this rejection. However, as discussed above, it acknowledges a role for the profit split method in cases of last resort, and provides guidance intended to prevent the method from being used in an inappropriate manner or in inappropriate circumstances.

3. The comparable profits method

The 1979 Report discusses the role of comparable profits in Paragraphs 15 and 71. Paragraph 15 acknowledges that "[t]he starting point for scrutinizing transfer prices would frequently be the appearance of a discrepancy between the profits returned by an associated enterprise and those which might be expected to be made by comparable enterprises in the uncontrolled situation". Paragraph 71 is more specific; it states that "[t]ax 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". It goes on to provide a reason why profit comparisons might be relevant (because "[l]evels of profit in an industry [may] conform to a pattern") and also cautions that these comparisons are not necessarily conclusive and that "a method [of looking at the profit situation] which is appropriate for one company may not be appropriate for another". In the end, the paragraph concludes that profit comparisons "could normally be regarded only as pointers to further investigation".

The revised draft provides a more specific limitation on the use of the comparable profits method, by restricting it to cases of last resort. As discussed above, the role for the comparable profits method is subject to very specific guidance intended to prevent the method from being used in an inappropriate manner or in inappropriate circumstances. As a result, the revised draft provides a new discipline on the use of the comparable profits method that had not been imposed by the 1979 Report, and thus it should reduce the potential for economic double taxation arising from the use of this method.

4. Other approaches

The 1979 Report also acknowledged two other approaches that could serve as "other methods". Paragraph 73 describes a method that compares "the yield or return on the capital invested in the relevant associated enterprises with the yield or return on the capital invested in enterprises carrying on similar activities and requiring the same kind of capital investment". Paragraph 74 describes an approach of "look[ing] at the yield on the capital involved, for example to assume in the case of transactions between a parent and a subsidiary company that the subsidiary's arm's length profit would be related in some way to the return which would be expected from investing the relevant capital in other ways". Both of these "other methods" are criticized in the 1979 Report, although not much detail is provided. These approaches are also addressed very briefly in the revised draft, but there has not been any substantial experience with theses approaches that allow for expansion of the 1979 discussion.

More generally, the 1979 Report provides a general concluding statement that leaves open the possibility for the use of methods not described in the Report. Paragraph 75 states: "The methods described do not by any means exhaust the possible techniques, and it does not follow if an approach has not been mentioned it ought not be followed." The revised draft is somewhat less generous than this. It does not provide an open permission for tax authorities to use methods not described in the Report, although it is possible for a tax authority to experiment with other approaches for dividing profit under the profit split method.

E. Conclusions

The complexity of the issues that arise in the transfer pricing area preclude simple solutions being adopted by countries. The Committee on Fiscal Affairs has recognized this and has accepted that even with the completion of the revised guidelines there will be a need to have regular reviews of the experiences of member and non-member countries in the use of methods to implement the areas arm's length principle, with particular emphasis on the difficulties encountered in the application of profit methods. Thus the Committee intends to monitor carefully these experiences and, if necessary, issue supplementary guidelines.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS

An official version of the text has been published by the OECD, *Draft Discussion on Transfer Pricing*, 1994. The OECD maintains its copyright on this material. It may not be reproduced in whole or in part without the permission of the OECD.

The Report has also appeared in the IBFD publication, *International Transfer Pricing Journal*, Vol. 1, No. 3.

Report of the
OECD Committee on Fiscal Affairs

1994

DISCUSSION DRAFT

Organisation for
Economic Co-operation and Development
Paris

Foreword

This Discussion Draft comprises Part I of a Report that will be a revision of the OECD 1979 Report on Transfer Pricing ("*Transfer Pricing and Multinational Enterprises*"). It was drafted by a Task Force of nine OECD Member countries under a mandate from the OECD Committee on Fiscal Affairs and recommended for release as a discussion draft by the full Committee on Fiscal Affairs on the 28th June 1994. It is published on the responsibility of the Secretary-General of the OECD.

Note to readers

The Committee on Fiscal Affairs decided to revise the 1979 Guidelines for the following four reasons:

1. to amalgamate it with a 1984 OECD Report on Transfer Pricing ("*Transfer Pricing and Multinational Enterprises: Three Related Issues*") and to take into account other work of the Committee in this area;
2. to bring up-to-date the 1979 Guidelines to reflect technological developments and the increased globalization of national economies;
3. to clarify ambiguities in the 1979 Guidelines regarding whether or to what extent profit methods are acceptable, given that these methods have been applied in practice and there have been divergent interpretations of tax conventions and the 1979 Guidelines in this respect; and
4. to respond to the fact that a number of countries have revised their legislation and practices since 1979.

Part I of the Report (Principles and Methods) is being released for public comment while work is proceeding on Part II (Applications) of the Report. This Discussion Draft reflects the current position of the work on this topic at the OECD as of the time of release but it should not be interpreted as reflecting the final views of any Member country, as a final evaluation of Part I requires consideration of its interaction with Part II. Final approval, therefore, will be given only when Part I can be considered together with Part II and in light of the public comments received on Part I.

The Report was divided into Parts to facilitate the efficient progress of the work and because it was felt important to get additional comments from the business community on the early key chapters of the Report before completing work on the later chapters, though extensive comments have already been received on earlier drafts of Part I from the Business and Industry Advisory Committee which acts as a liaison between the business community and the OECD.

The Discussion Draft of Part I contains a preface and three chapters. Chapter I reconfirms the commitment of the OECD Member countries to the arm's length principle as a means for establishing pricing in a manner consistent with Article 9 of the *OECD Model Tax Convention on Income and on Capital*. It also sets forth guidance for applying the arm's length principle, including a detailed discussion of comparability and functional analysis and incorporating the concept of a range of acceptable transfer pricing.

Chapter II describes the transaction-based methods that are used in establishing arm's length transfer pricing. The description of these methods in the 1979 Guidelines has been brought up-to-date in the light of experience in their use since then. The discussion makes clear that the determination of comparability should be made flexibly rather than rigidly in applying the traditional comparable uncontrolled price method. The Discussion Draft also makes clear that transaction-based methods are the most direct and reliable way to apply the arm's length principle where there is adequate data available.

Chapter III describes and discusses profit methods. The discussion indicates that the determination of whether a profit method can be applied in a manner consistent with the arm's length principle depends on the specific case taking into account the strengths and weaknesses of the method. The Chapter states that there are substantial concerns regarding

© 1994 International Bureau of Fiscal Documentation

the use of the comparable profits method, in particular that it may be applied without adequately taking into account the relevant differences between the associated enterprises and the independent enterprises being compared. The Chapter also describes weaknesses in the profit split method, in particular that the more tenuous nature of the external market data used, the more subjective will be the resulting allocation of profits. The chapter concludes that as a general matter the use of profit methods is discouraged and that profit methods should be applied only in cases of last resort. Guidance is given for determining whether application of a profit method is appropriate in such a case. The Chapter makes clear that tax examiners should not apply a profit method automatically simply because there is a difficulty in obtaining data, but rather they must determine whether the methods can be reliably applied in a case of last resort based upon the guidance in the Report.

Chapter III also includes a discussion of global formulary apportionment (often referred to as "unitary taxation"), which has sometimes been suggested as an alternative to the arm's length principle. The Chapter sets forth a clear rejection of global formulary apportionment and discusses the reasons why this approach is not a realistic alternative to the arm's length principle.

Part II of the Report will address documentation, intangible property, services, and administrative rules, including mutual agreement procedures, simultaneous tax examinations, safe harbours, advance transfer pricing agreements, and arbitration. These topics, and especially the topic of documentation, are critical to assess how the principles and methods described in Part I will be applied and their consequences for taxpayers and tax administrations. It is expected that Parts I and II will be finalized in mid-1995. A Part III of this Report is anticipated at a later date (1996) addressing Special Topics.

. . .

The Report, when finalized, will be subject to periodic updates to take into account the experiences of Member countries. The Committee on Fiscal Affairs intends to have regular reviews of the experiences of countries with the methods used to apply the arm's length principle, with particular emphasis on difficulties encountered in the application of profit methods and the ways in which these problems have been resolved between countries.

Public comments on this Discussion Draft should be submitted in writing to the OECD Secretariat, Mr Jeffrey Owens, Head, Fiscal Affairs by 31 October 1994. The Task Force will meet to consider the public comments and to continue its work on 19-21 September and 5-6 December.

Preface

1. The role of multinational enterprises (MNEs) in world trade has increased dramatically over the last 20 years. This in part reflects the increased integration of national economies and technological progress, particularly in the area of communications. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.

2. These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated.

3. In the case of MNEs, the need to comply with laws and administrative requirements that may differ from country to country creates additional problems. The differing requirements may lead to a greater burden on an MNE, and result in higher costs of compliance, than for a similar enterprise operating solely within a single tax jurisdiction.

4. In the case of tax administrations, specific problems arise at both policy and practical levels. At the policy level, countries need to reconcile their legitimate right to tax the profits of a taxpayer based upon income and expenses that can reasonably be considered to arise within their territory with the need to avoid the taxation of the same item of income by more than one tax jurisdiction. Such double or multiple taxation can create an impediment to cross-border transactions in goods and services and the movement of capital. At a practical level, a country's determination of such income and expense allocation may be impeded by difficulties in obtaining pertinent data located outside its own jurisdiction.

5. At a primary level, the taxing rights that each country asserts depend on whether the country uses a system of taxation that is residence-based, source-based, or both. In a residence-based tax system, a country will include in its tax base all or part of the income, including income from sources outside that country, of any person (including juridical persons such as corporations) who is considered resident in that jurisdiction. In a source-based tax system, a country will include in its tax base income arising within its tax jurisdiction, irrespective of the residence of the taxpayer. As applied to MNEs, these two bases, often used in conjunction, generally treat each enterprise within the MNE group as a separate entity. Member countries of the OECD have chosen this separate entity approach as the most reasonable means for achieving equitable results and minimizing the risk of unrelieved double taxation. Thus, each individual group member is subject to tax on the income arising to it (on a residence or source basis).

6. In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their dealings with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that distort or alter the levels of profits that would have been realized had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD Member countries have adopted the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

© 1994 International Bureau of Fiscal Documentation

7. These international taxation principles have been chosen by the Member countries of the OECD as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimizing conflict between tax administrations and promoting international trade and investment. In a global economy, coordination among countries is better placed to achieve these goals than tax competition. The OECD, with its mission to contribute to the expansion of world trade on a multilateral, non-discriminatory basis and to achieve the highest sustainable economic growth in Member countries, has continuously worked to build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems.

8. The foregoing principles concerning the taxation of MNEs are incorporated in the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between OECD Member and non-Member countries. These principles also are incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations (U.N. Model).

9. The main mechanisms for resolving issues that arise in the application of international tax principles to MNEs are contained in these bilateral treaties. The Articles that chiefly affect the taxation of MNEs are: Article 4, which defines residence; Articles 5 and 7, which determine the taxation of permanent establishments; Article 9, which relates to the taxation of the profits of associated enterprises and applies the arm's length principle; Articles 10, 11, and 12, which determine the taxation of dividends, interest, and royalties, respectively; and Articles 24, 25, and 26, which contain special provisions relating to non-discrimination, the resolution of disputes, and exchange of information.

10. The Committee of Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the application of these Articles to MNEs and to others. The Committee has encouraged the acceptance of common interpretations of these Articles, thereby reducing the risk of inappropriate taxation and providing satisfactory means of resolving problems arising from the interaction of the laws and practices of different countries.

11. In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that has arisen is the establishment for tax purposes of appropriate transfer prices. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. For purposes of this Report, an "associated enterprise" is an enterprise that satisfies the conditions set forth in Article 9, subparagraphs 1(a) and 1(b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises (i.e., if both enterprises are under common control). The issues discussed in this Report also arise in the treatment of permanent establishments and will be dealt with separately in a supplement (Part III of the Report). Some relevant discussion may also be found in the OECD Report "Model Tax Convention: Attribution of Income to Permanent Establishments" published in 1994.

12. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing issues originally arose in dealings between associated enterprises operating within the same tax jurisdiction. The domestic issues are not considered in this Report, which focuses on the international aspects of transfer pricing. These international aspects are more difficult to deal with because they involve more than one tax jurisdiction and therefore any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is appropriate. However, if the other jurisdiction does not agree to make a corresponding adjustment the MNE group will be taxed twice on this part of its profits. In order to minimize the risk of such double taxation, an international consensus is required on how to establish for tax purposes transfer prices on cross border transactions.

13. This Report is a revision and compilation of previous reports by the OECD Committee on Fiscal Affairs addressing transfer pricing and other related tax issues with respect to multinational enterprises. The principal report is Transfer Pricing and Multinational Enterprises (1979) (the "1979 Report") which elaborated on the arm's length principle as set out in Article 9. Other reports address transfer pricing issues in the context of specific topics. These reports are Transfer Pricing and Multinational Enterprises – Three Taxation Issues (1984) (the "1984 Report"), and Thin Capitalization (the "1987 Report").

14. The Report also draws upon the discussion undertaken by the OECD on the proposed 482 Regulations in the United States (see "Tax Aspects of Transfer Pricing within Multinational Enterprises: The US Proposed Regulations"). However, the context in which that Report was written was very different from that in which the present Report is undertaken, its scope was far more limited and it specially addressed the US proposed regulations.

15. OECD Members countries continue to endorse the arm's length principle as embodied in the OECD Model Tax Convention (and in the bilateral conventions that legally bind treaty partners in this respect) and in the 1979 Report. This Report sets forth revised guidelines on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The guidelines are intended to help tax administrations (of both OECD Member countries and non-Member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs, thereby avoiding costly litigation. The Report analyses the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length principle and discusses the practical application of those methods. It

© 1994 International Bureau of Fiscal Documentation

also includes a discussion of global formulary apportionment.

16. This Report focuses on the main issues of principle that arise in the transfer pricing area. The Committee on Fiscal Affairs intends to prepare supplements to this Report addressing related issues such as the application of the arm's length principle to transactions involving a permanent establishment, thin capitalization and the use of cost-sharing arrangements. The Committee intends to have regular reviews of the experiences of Member and selected non-Member countries in the use of the methods used to apply the arm's length principle, with particular emphasis on difficulties encountered in the application of profit methods and the ways in which these problems have been resolved between countries. The Committee will also expect a regular reporting back on the frequency with which profit methods are used. On the basis of these reviews and reporting the Committee may find that it needs to issue supplementary guidelines on the use of these methods.

Transfer Pricing Strategy in a Global Economy

by Jill C Pagan and J Scott Wilkie

For all tax practitioners, corporate financial departments, fiscal authorities and academics & researchers, 'Transfer Pricing Strategy in a Global Economy' represents a landmark in transfer pricing. In one volume you will find practical analysis and guidance on the operation of transfer pricing today, and also challenging thought on theoretical issues affecting its future development.

Includes:

- Clear definition of transfer pricing and full historical background
- Contrast of legislative approaches and differences between major countries
- Role of transfer pricing in a range of transactions
- Full constructive assessment of the vital Sundstrand case
- Discussion of Advance Pricing Agreements
- Advice on dealing with fiscal authorities
- Treaty considerations
- Practical guidelines of developing and implementing a transfer pricing strategy

Price: NLG 245

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item.

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands

Tel.: +31 (0) 20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

WORLDWIDE COMBINED REPORTING RULED CONSTITUTIONAL AS BARCLAYS LOSES IN THE US SUPREME COURT

WHAT ARE THE OPTIONS FOR A FOREIGN-BASED COMPANY?

Leonard W. Rothschild, Jr.

Bancroft & McAlister, San Francisco

On 20 June 1994, California's controversial use of worldwide combined reporting was upheld by the US Supreme Court in the cases of *Barclays Bank plc v. Franchise Tax Board*, No. 92-1384 ("*Barclays*"), and *Colgate-Palmolive v. Franchise Tax Board*, No. 92-1839 ("*Colgate*").

Colgate is a US-based parent company doing business in California with foreign subsidiaries. The *Colgate* decision affirmed the US Supreme Court's 1983 decision in *Container Corporation of America v. Franchise Tax Board*, 463 US 159 ("*Container*"), which permitted California's worldwide unitary tax to be applied to a US parent company with foreign subsidiaries.

The *Container* and *Colgate* decisions did not address worldwide combined reporting in the context of a foreign-based parent company with a subsidiary doing business in California. However, in *Barclays* the US Supreme Court ruled that, where a foreign-based parent company is doing business in California through a subsidiary, California's worldwide combined reporting method did not violate either the Commerce Clause or Due Process Clause.

Now that it is clear that California's use of worldwide combined reporting is constitutional as applied to a foreign-based parent company, it is important for foreign-based companies with subsidiaries operating in California to analyse their options in filing California franchise tax returns. Assuming that they are "unitary," a foreign-based company doing business in California through a US-based subsidiary has two options in complying with California's income tax laws: (i) the foreign-based company and its unitary subsidiaries can voluntarily file a worldwide combined report, or (ii) the subsidiary doing business in California can make a "water's edge" election. This article examines both of these alternatives, as well as strategies in dealing with the *Barclays* decision.

I. FILE A WORLDWIDE COMBINED REPORT

Although most foreign-parent companies try to avoid worldwide combined reporting, in many cases worldwide combined reporting is more beneficial than filing on a separate entity basis in California. Therefore, it is important for the foreign-based company with a US subsidiary doing business in California to compute its estimated California franchise tax under two scenarios: (i) using worldwide combined reporting (including the entire unitary group), and (ii) on a separate entity basis (only the entity doing business in California).

If the foreign-based parent has a number of subsidiaries and affiliates, calculations should be made under a variety of assumptions. For example, one assumption may be that the entire group of corporations constitutes one unitary business. Another computation might only include those corporations within the same line of business. Since the determination of which entities constitute a unitary business is often very subjective, a careful analysis of the entire corporate group should be made to help identify the optimum unitary group (or groups) in terms of minimizing California taxation. Once a corporation files under the unitary method, the California Franchise Tax Board usually insists on continued filings by the same unitary group (or groups) unless operations have changed. Therefore, it is important to make projections of future tax liabilities and not merely to look at the current year in developing a unitary tax strategy. As discussed later, a "water's edge" election can be made in any subsequent year if worldwide unitary taxation proves too costly.

A. What is a unitary group?

A worldwide combined report can be filed only if, based on all of the facts, the foreign parent company and its US-based subsidiary doing business in California form part of a unitary group. A unitary group ordinarily exists when there is: (i) direct or indirect ownership of more than 50 percent of voting stock, (ii) some "unity of operations", and (iii) some "unity of use".

The ownership test is relatively easy to determine since it is objective. However, the other two tests are subjective and require an intensive analysis of all of the relevant facts.

"Unity of operations" generally refers to staff functions, as evidenced by centralized advertising, accounting and man-

© 1994 International Bureau of Fiscal Documentation

agement. These staff functions may include centralized overhead (accounting, legal, insurance, labour relations, employee benefits, etc.), centralized financing and common officers and directors. "Unity of use" generally refers to line functions of executive forces and operational systems. These line functions include intercompany sales or product flow (even if at arm's length prices), centralized purchasing and centralized management.

If it is desirable to file in California on a worldwide unitary basis, it is important for the foreign-based parent company to be certain that all three of the "unities" tests are met (more than 50 percent ownership, "unity of operations" and "unity of use"). There are a number of cases in which the Franchise Tax Board has successfully argued that businesses were not unitary, especially where it was advantageous for the taxpayer to have a unitary business.

B. How does combined reporting work?

California employs a three-factor apportionment formula to allocate income to California. The same formula is used regardless of whether California is taxing a single corporation doing business in California or a combined group of corporations.

If worldwide combined reporting is used, the three-factor formula is computed separately by each company in the unitary group and each factor is aggregated in making the computation. For example, where there is a foreign parent selling inventory into California and a US subsidiary operating in California, the three-factor formula would be computed as follows:

Foreign Parent Company:

Sales	=	California Sales / Worldwide Sales	$ 4,000,000 / $ 200,000,000	= 2.0%
Property	=	California Property / Worldwide Property	$ none / $ 10,000,000	= 0%
Payroll	=	California Payroll / Worldwide Payroll	$ none / $ 4,700,000	= 0%

Average $\frac{(2\% \times 2^*) + 0\% + 0\%}{4}$ = 1.0%

Total Worldwide Taxable Income of Parent $ 10,000,000

* Beginning in 1994 the sales factor is double weighted, and the total of the three factors is divided by four.

California Subsidiary:

Sales	=	California Sales / Worldwide Sales	$ 2,200,000 / $ 20,000,000	= 11.0%
Property	=	California Property / Worldwide Property	$ 120,000 / $ 4,000,000	= 3.0%
Payroll	=	California Payroll / Worldwide Payroll	$ 100,000 / $ 2,000,000	= 5.0%

Average $\frac{(11\% \times 2) + 3\% + 5\%}{4}$ = 7.5%

Total Worldwide Taxable Income of Subsidiary $ 1,000,000

Combined Group:

Sales	=	California Sales / Worldwide Sales	$ 6,200,000 / $ 220,000,000	= 2.8%
Property	=	California Property / Worldwide Property	$ 120,000 / $ 14,000,000	= .9%
Payroll	=	California Payroll / Worldwide Payroll	$ 100,000 / $ 6,700,000	= 1.5%

Average $\frac{(2.8\% \times 2) + .9\% + 1.5\%}{4}$ = 2.0%

Total Worldwide Taxable Income of Combined Group $11,000,000

Income Apportioned to California
2.0% x $ 11,000,000 $ 220,000

In this example, the combined group has 2 percent of its business in California and worldwide taxable income of $ 11,000,000. Therefore, $ 220,000 of taxable income is apportioned to California, and a California tax of $ 20,460 (9.3% California tax rate x $ 220,000) results.

If, however, the California subsidiary was not part of a unitary group with its foreign parent company or if the subsidiary made a "water's edge" election, the California subsidiary would file a separate return. In the example, $ 75,000 of taxable income would be apportioned to California ($ 1,000,000 x 7.5%), and a California tax of $ 6,975 (9.3% x $ 80,000) would result.

Obviously, the relative profitability and apportionment factors of the foreign and US companies will determine whether it is advantageous to file a worldwide combined report, or to file on a separate basis.

Comparing the above examples (combined reporting and separate reporting), it is beneficial for the California subsidiary to file separately. If the foreign-based parent and the California subsidiary form a unitary business, the only manner by which the California subsidiary can file separately from its parent is for the California subsidiary to make a "water's edge" election.

II. MAKING A "WATER'S EDGE" ELECTION

In 1993 several important changes were made with respect to the "water's edge" election, and many foreign-based companies are now considering making this election. It may be advantageous to make this election if: (i) less tax is paid by making the "water's edge" election, or (ii) the burden of accumulating the information to file a combined report is too great.

© 1994 International Bureau of Fiscal Documentation

A complete discussion of the "water's edge" election is beyond the scope of this article, but some of the more important aspects are described below.

A. Who can make a "water's edge" election?

The subsidiary doing business in California can make the "water's edge" election by filing the election form (Form 100-WE) with its timely filed income tax return for the first year of the election. For example, a corporation on a calendar year has an automatic extension of time to file its 1993 California franchise tax return until 15 October 1994, provided the tax is paid by 15 March 1994. Therefore, the decision on making the "water's edge" election does not need to be made until several months after the subsidiary's year end.

The "water's edge" contract with California is for an initial term of 84 months and is automatically renewed each year for an additional one year period unless the taxpayer gives written notice of non-renewal. It is advisable at the time the "water's edge" election is made immediately to give written notice of non-renewal. In that way, the election is limited to 84 months, and at the end of that period a new election, if desired, can be made. Since the "water's edge" election is for at least seven years, it is important, before making the election, to project its effect in future years.

B. What is the effect of making the election?

If the "water's edge" election is made, California income is computed based on the income and apportionment factors of only the following entities: (i) any corporation whose US apportionment factors are 20 percent or more, (ii) a corporation eligible to file a US consolidated income tax return (generally US corporations with 80 percent or more common ownership), (iii) a US corporation that is not eligible to file a consolidated return, if more than 50 percent of its stock is controlled by common ownership, (iv) an export incentive company (i.e. a Domestic International Sales Corporation, a Foreign Sales Corporation or an Export Trading Company), and (v) any other entity to the extent that its income is derived from or attributable to US sources.

In most foreign parent situations, the includible companies in the "water's edge" group are 50 percent-or-more owned companies incorporated in the United States and 50 percent-or-more owned foreign corporations doing more than 20 percent of its worldwide business in the United States.

In determining income for purposes of the "water's edge" election, special rules apply to dividends received by companies within the group.

C. Information returns and maintenance requirements

An information return must be filed by every California taxpayer that allocates and apportions income (irrespective of whether a "water's edge" election is made), if it and its 50 percent or more related corporations have total assets in excess of $ 200,000,000. However, no information return needs to be filed if the taxpayer's property, payroll and sales within the United States are each less than $ 500,000 in a year.

The information return identifies the corporate parent and all 20 percent-or-more affiliates owned directly or indirectly by the parent. The information return must be filed within six months after the due date (including extensions) of the tax return of the California taxpayer. The information return is filed for the first year in which a "water's edge" election is made, and then in every third year thereafter unless there is a substantial change in the taxpayer's business activities.

The taxpayer is required to maintain and to provide on request to the Franchise Tax Board information necessary to: (i) determine the amount of income attributable to California, (ii) classify income as business or non-business income, (iii) determine unitary apportionment factors for use within the "water's edge", and (iv) make audits of attribution of income to the United States and foreign countries under certain federal provisions.

There are substantial penalties for failing to file the information returns or to comply with the information maintenance requirements.

D. Why is the "water's edge" election more viable today?

The legislation effective in 1994 substantially liberalized the election, as follows: (i) the election fee was repealed, (ii) the domestic disclosure spreadsheet was replaced with the information return (described above), and (iii) the Franchise Tax Board cannot now disregard a "water's edge" election. In addition, the election period was extended from five to seven years.

III. STRATEGIES IN DEALING WITH THE *BARCLAYS* DECISION

A. What should be done in future years?

Each foreign-based parent company engaged in a unitary business with a US subsidiary doing business in California should determine whether it is advantageous to make a "water's edge" election. The legislative changes made in 1993 combined with the *Barclays* decision will encourage a number of companies to make the "water's edge" election for the first time in 1994. Some taxpayers may wish to make a "water's edge" election for 1993, even though they will incur the election fee for one year.

B. What should be done for years under audit?

Those taxpayers under audit by the Franchise Tax Board, whose cases have been held in abeyance pending a decision

© 1994 International Bureau of Fiscal Documentation

in *Barclays*, will now have a more difficult time trying to negotiate a settlement with the Franchise Tax Board.

However, since *Barclays* does nothing to change the definition of a "unitary business" or to provide any further guidance on what is a unitary business, the factual issue of whether a group of companies constitutes a unitary business still remains. Even in cases where it is clear that a unitary group exists, the author has been successful in "working with the numbers" to reduce substantially the amount of California franchise tax. For example, it may be possible to make certain elections that reduce the level of income in the years under examination (depreciation elections, LIFO inventory method election, etc.).

Even if it is clear that a foreign parent and its US subsidiary are engaged in a unitary business, in appropriate circumstances it may be possible to argue "distortion" (i.e. that California is seeking to tax a disproportionate amount of the group's income). The *Barclays* decision does *not* make it constitutional for a state to tax income earned outside its borders. If there is a significant "distortion", it is possible that a court will find the unitary method impermissibly allocates too much income to California.

IV. CONCLUSION

Foreign-based parent companies doing business in California through a US subsidiary can no longer argue that worldwide combined reporting is unconstitutional as a matter of law (the unitary tax still could be unconstitutional based on the particular facts in a case, for example, if a substantial "distortion" exists). Instead, a premium will be placed on doing the necessary analysis and planning to minimize exposure to the California franchise tax.

As a first step, all corporate groups affected by the decision in *Barclays* should examine the advisability of making a "water's edge" election. The changes made to the "water's edge" election beginning in 1994 will encourage many more taxpayers to make this election.

Second, a factual analysis should be made to determine if groups of corporations are really "unitary" under the three "unities" tests. Perhaps by restructuring certain operations one or more of the affiliated companies could be eliminated from (or added to) the unitary group.

Finally, the opportunity of making tax elections that will minimize or defer income for California franchise tax purposes should not be overlooked.

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

NEW TRANSFER PRICING PENALTY REGULATIONS REQUIRE IMMEDIATE ACTION TO AVOID OVERVALUATION PENALTIES

Peter J. Connors and Michael F. Patton

Mr Connors is Director of International Capital Markets Tax Services at Ernst & Young, New York. **Mr Patton** is Chairman of Ernst & Young's Transfer Pricing Task Force in Washington, D.C.

Section 6662 imposes an accuracy-related penalty of either 20 or 40 percent of the amount of an underpayment attributable to price adjustments under IRC Section 482 that are characterized as substantial or gross valuation misstatements. On 27 January 1994 and 8 July 1994, the IRS and Treasury published Temporary and Proposed Regulations under IRC Sections 6662(e), 6662(h) and 6664(c) ("the Regulations") to implement the amendments to the IRC enacted as part of the Revenue Reconciliation Act of 1993 ("RRA '93"). These sections potentially impose penalties of 20 and 40 percent on transfer pricing adjustments greater than $ 5 million. While these penalties were enacted to deter aggressive intercompany pricing regarding transfers of tangible property (e.g. finished goods, components, etc.) or intangible property (e.g. product technology, trade marks, trade names, etc.), they also apply to many cross-border transactions of international banks, such as trading in financial products.

I. BACKGROUND

Prior to amendment by RRA '93, Section 6662 provided that substantial valuation misstatement with respect to the transfer of property or services existed if the price charged between the controlled parties is 200 percent or more (or 50 percent or less) of the price determined under Section 482 (transactional penalty), or if the net Section 482 transfer price adjustment for the taxable year exceeds $ 10 million (net adjustment penalty). A gross valuation misstatement would arise where the price determined under Section 482 for a transaction between controlled parties or the net Section 482 transfer price adjustment exceed double the threshold requirements for a substantial valuation misstatement.

As a result of the passage of RRA '93, a substantial valuation misstatement under Section 6662 now includes a net Section 482 transfer price adjustment that exceeds the lesser of $ 5 million or 10 percent of a taxpayer's gross receipts,[1] and a gross valuation misstatement includes the case where the net Section 482 transfer price adjustment exceeds either $ 20 million or 20 percent of the gross receipts.[2]

The amendments to the statute under RRA '93 also set forth with greater specificity the circumstances under which an increase in income pursuant to a redetermination of price under Section 482 will be excluded in the determination of whether there has been a substantial or gross valuation misstatement. An increase in taxable income resulting from a price adjustment under Section 482 is not included in determining whether the net Section 482 transfer price adjustment constitutes a substantial valuation misstatement, if

(1) the transfer price was determined under a pricing method specified in the Section 482 regulations and the taxpayer's use of the method was reasonable;
(2) the taxpayer has documentation, which was in existence as of the time of filing the return, setting forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable; and
(3) the taxpayer provides the IRS with such documentation within 30 days of a request therefore.[3]

In addition, the taxpayer may exclude a Section 482 adjustment to taxable income where it can establish that

(1) none of the specified pricing methods of Section 482 were likely to yield a price that clearly reflected income and the pricing method actually used by the taxpayer was likely to result in a price that clearly reflected income;
(2) the taxpayer documented the selection of the pricing method before filing the return for the year at issue; and
(3) the taxpayer provides such documentation to the IRS within 30 days upon a request.[4]

RRA '93 also amended Section 6662(e) to provide that for purposes of determining the amount of a net Section 482 transfer price adjustment, no Section 482 price adjustment will be excluded for reasonable cause, unless excluded by one of the exceptions described above.[5] The changes to the statute by RRA '93 are intended to encourage taxpayers to implement the principles of Section 482 in pricing transactions with related parties and to deter taxpayers from using-

1. IRC Sec. 6662(e)(1)(B)(ii).
2. IRC Sec. 6662(h)(2)(A)(iii).
3. IRC Sec. 6662(e)(3)(B)(i).
4. IRC Sec. 6662(e)(3)(B)(ii).
5. IRC Sec. 6662(e)(3)(D). Also excepted are net increases attributable to any transaction solely between foreign corporations, unless, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

© 1994 International Bureau of Fiscal Documentation

solely *post hoc* arguments to justify a tax return position upon audit.

II. TEMPORARY REGULATIONS

The IRS published Temporary and Proposed Regulations under §§ 1.6662-5T-7T on 27 January 1994, to implement the imposition of the accuracy-related penalties for a substantial or gross valuation misstatement in the context of adjustments of price under Section 482.[6] These Regulations were amended on 8 July 1994, largely to conform with final Section 482 Regulations also issued at the same time. The final Section 482 Regulations are notable in that while no changes were made to the rules for determining the applicable transfer price for services, in other areas, namely, tangibles and intangibles, the standards for comparability have been loosened.

Under the Regulations, whether an underpayment is attributable to a substantial or gross valuation misstatement is based on the original return or amended return filed by the taxpayer prior to being contacted by the IRS regarding the original tax return.[7] In the case of a consolidated group, the Regulations provide that the threshold requirements for a substantial and gross valuation misstatement are applied on the basis of the consolidated income tax return for the group.[8] This has the effect of making the monetary thresholds ($ 5 million and $ 20 million) easier, and the percentage thresholds (10 and 20 percent) harder, to cross.

Under the Regulations, the "net Section 482 transfer price adjustment" for any taxable year is defined to include the sum of all increases in taxable income attributable to using the correct price for the transactions as determined under Section 482 for the taxable year less any decrease in taxable income attributable to collateral adjustments under Reg. § 1.482-1T(e).[9] Gross receipts, for purposes of determining whether there has been a substantial valuation misstatement as a result of a net Section 482 transfer price adjustment, includes any allocation required by Section 482.[10] The inclusion of the amount of any allocation in the denominator makes it slightly more difficult to meet the tests. For example, if a taxpayer reports $ 100 in gross receipts on its return and the IRS proposes adjustments of $ 20, the adjustments are 20 percent of reported gross receipts, but only 17 percent of adjusted gross receipts (20/(100 + 20) = 17%).

With respect to the determination of the net Section 482 transfer price adjustment, the reasonable cause exception of Section 6664(c) applies only to the extent that the requirements of the safe harbour provisions found in Section 6662(e) described below are satisfied.[11] The Regulations also provide that if an increase in taxable income attributable to a Section 482 price adjustment for a taxable year is covered by either of the safe harbour provisions, any collateral adjustments to taxable income under Section 482 must be ratably applied to all of the increases in income attributable to Section 482 price adjustments for the taxable year in determining the net Section 482 transfer price adjustment.[12]

A. Safe harbours

Two safe harbours are provided in Section 6662(e) with respect to Section 482 price adjustments and the Regulations expand on the requirements of the safe harbours. The first safe harbour applies to the situation where the taxpayer has used a method specified in the Section 482 regulations to determine the transfer price and the taxpayer's method of determining the transfer price was reasonable.[13] Under this safe harbour, a taxpayer's selection and application is reasonable if the taxpayer reasonably concludes that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule. However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method.[14] The Regulations state that the determination as to whether the taxpayer's conclusion was reasonable is based on the facts and circumstances and lists four factors to consider:

- the experience and knowledge of the members of the controlled group;
- the extent to which accurate data was available and the data was analysed in a reasonable manner;
- the extent to which the taxpayer followed the procedural requirements under Section 482 with respect to the application of the method;
- the extent to which the taxpayer reasonably relied on an analysis or study conducted by a professional qualified to conduct such an analysis;[15]
- if the taxpayer attempted to determine an arm's length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables.

The application of a specified method is considered the most accurate measure of an arm's length result if the application of the method provides "a more accurate measure of an arm's length result than any alternative specified method and any alternative application of the method chosen".

The second safe harbour applies where the taxpayer, instead of using a method specified in Section 482, employs a method in determining the transfer price not described in the Regulations under Section 482, either because the specified methods for the particular type of transaction were not likely to result in a price that would clearly reflect income, or because the Regulations under Section 482 do not address the determination of the transfer price for the transaction in ques-

6. T.D. 8519, 59 Fed. Reg. 4791 (2 February 1994).
7. Reg. § 1.6662-6T(a)(2).
8. *Id.*
9. Reg. § 1.6662-6T(c)(1).
10. Reg. § 1.6662-6T(c)(5).
11. Reg. § 1.6662-6T(c)(6).
12. Reg. § 1.6662-6T(c)(4).
13. IRC Sec. 6662(e)(B)(i).
14. Reg. § 1.6662-6T(d)(2)(ii).
15. *Id.*

© 1994 International Bureau of Fiscal Documentation

tion.[16] Where a specified method is available, the taxpayer must show, according to the Regulations, that it reasonably concluded that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that it selected and applied an unspecified method in a way that would likely provide a reliable measure of an arm's length result. A taxpayer can reasonably conclude that no specified method was likely to provide a reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the specified methods in a manner consistent with the principles of the best method rule.[17] The Regulations provide that if no method is specified in Section 482 for the taxpayer's transaction, as is true in the case of services, the taxpayer must show that it selected and applied the unspecified method in a reasonable manner.[18]

B. Documentation requirement

The statute provides that neither of the safe harbours will be applicable unless the taxpayer also satisfies a documentation requirement.[19] The Regulations provide that a taxpayer will satisfy the documentation requirement if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that the chosen method provided the most accurate measure of an arm's length result under the principles of the best method rule, the documentation was in existence at the time the relevant return was filed and the taxpayer provides the documentation to the IRS within 30 days of a request for it.[20] The required documents are divided into two categories – principal documents and background documents.[21]

According to the Regulations, the principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer in determining the transfer price reflected in its return.[22] This documentation must include:

- an overview of the taxpayer's business, including economic and legal factors that affect pricing of its products or services;
- a description of the taxpayer's organizational structure, including all related parties whose activities are relevant to transfer pricing;
- any document explicitly required by the Regulations under Section 482;
- a description of the method selected and an explanation of why that method was selected;
- a description of the alternative methods that were considered and an explanation of why they were not selected;
- a description of the transfer pricing transactions in issue (including terms of sale) and any internal data used to analyse them;
- a description of the comparables used, how comparability was evaluated and what adjustments were made;
- an explanation of the economic analysis and projections relied on in developing the method;
- a general index of principal and background documents, and a description of the taxpayer's record-keeping system used to catalogue and access the documents.[23]

Under the Regulations, background documents support the assumptions, conclusions and positions contained in principal documents.[24] Background documents may include materials listed in Reg. § 1.6038A-3(c), which includes original entry books and transaction records, profit and loss statements, pricing documents, foreign country and third party filings, and ownership and capital structure records. However, other documents not listed in the Regulations may be necessary to establish that the taxpayer's method of determining the transfer price was selected and applied in a manner that provided the most accurate measure of an arm's length result. Background documents need not be provided to the IRS in response to a request for principal documents. If requested, however, by the IRS, the taxpayer must provide that documentation with 30 days of the request. The IRS may extend the period for providing the background documents beyond 30 days.[25]

C. Tax return documentation

A new feature of the July 1994 penalty Regulations is tax return disclosure (rather than election). If the taxpayer applies a profit split method, the taxpayer must attach a statement to a timely filed US income tax return disclosing the kind of profit split method employed, the combined operating profit from the relevant business activity and the split of that profit among the controlled participants in that activity. If the consideration for the controlled transfer of an intangible is in the form of a lump sum, a statement is required for each taxable year throughout the life of the intangible. This must describe the calculation of the arm's length consideration.[26]

If the taxpayer applies an unspecified method, the taxpayer must attach a statement to a timely filed US income tax return (with extensions) disclosing the use of such method for the taxable year in which the method is applied.[27]

D. Relationship to Section 6664

Under the Regulations, for purposes of applying the reasonable cause and good faith exception of Section 6664(c) to net Section 482 adjustments, the safe harbour rules apply. A tax-

16. House Report, at 284. A method is a specified method if it is described in the Regulations under Sec. 482. With respect to transfers of tangible property, these methods currently include the comparable uncontrolled price method, resale price method, cost-plus method and comparable profits method. With respect to transfers of intangible property, the methods currently include the comparable uncontrolled transactions method and comparable profits method. A bona fide cost sharing arrangement is considered a specified method. Two limited profit split methods are also provided in the final Section 482 Regulations.
17. Reg. § 1.6662-6T(d)(3)(ii)(B).
18. Reg. § 1.6662-6T(d)(3)(ii)(C).
19. IRC Sec. 6662(e)(3)(B)(i)(II) and (ii)(II).
20. Reg. § 1.6662-6T(d)(2)(iii)(A).
21. *Id.*
22. Reg. § 1.6662-6T(d)(2)(iii)(B).
23. *Id.*
24. Reg. § 1.6662-6T(d)(2)(iii)(C).
25. *Id.*
26. Reg. § 1.6662-6T(d)(3)(iii)(C).
27. Reg. § 1.6664-4(d).

© 1994 International Bureau of Fiscal Documentation

payer cannot satisfy the reasonable cause and good faith exception under Section 6664(c) if it cannot meet the rules of Reg. § 1.6662-6T(d).[28]

E. Other provisions

In addition to the above, there are several miscellaneous rules.

Consistent with the statute, the Regulations also provide that any increase in taxable income with respect to an adjustment of a transfer price for a transaction between related foreign corporations is excluded for purposes of calculating a net Section 482 adjustment, unless the reallocation affects either corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.[29]

The rules for coordinating between the transactional penalty (i.e. the percentage test) and the net transfer pricing adjustment penalty are important. The Regulations provide that a Section 482 allocation attributable to a substantial or gross valuation misstatement under the transactional penalty is included in determining whether the net Section 482 adjustment for the taxable year exceeds the lesser of $ 5 million dollars or 10 percent of gross receipts.[30] If the net Section 482 adjustment exceeds $ 5 million dollars or 10 percent of gross receipts, any portion of the amount that is attributable to a gross valuation misstatement is subject to the transactional penalty at the 40 percent rate but not also to the net adjustment penalty at a 20 percent rate.[31] The remaining amount is subject to the net adjustment penalty at the 20 percent rate, even if such amount is less than the lesser of $ 5 million dollars or 10 percent of gross receipts. On the other hand, if the net Section 482 adjustment exceeds $ 20 million dollars or 20 percent of gross receipts, the entire amount of the adjustment is subject to the net adjustment penalty at a 40 percent rate.[32] No portion of the adjustment is subject to the transactional penalty at a 20 percent rate

Finally, under the Regulations, the transactional penalty and the net adjustment penalty are applicable to any underpayment of tax that is attributable to a substantial or gross valuation misstatement attributable to another taxable year.[33] However, a carry-back or carry-forward attributable to a substantial or gross valuation misstatement from another taxable year is not used in determining whether there is a substantial or gross valuation misstatement for the taxable year at issue.[34]

F. Effective date

The effective date for the portion of the Regulations is the first tax year beginning after 31 December 1993. The Preamble to the Regulations notes that, for taxable years ending after 5 November 1990, but beginning prior to 1 January 1994, the Treasury Department considers the proposed regulations issued on 21 January 1993 to be a reasonable interpretation of Sections 6662(e) and (h), except that no requirement of contemporaneous documentation may be imposed for transactions prior to 21 April 1993. Rev. Proc. 94-33 clarifies that the mandatory contemporaneous documentation rules only apply to transactions in tax years commencing after 21 April 1993 (thus, calendar year taxpayers will be exempt from the requirement until 1994).[35] However, fulfilment of the documentation requirement in years prior to its mandatory application is a relevant factor in the application of the penalty.

III. PLANNING

The Regulations are, in most respects, faithful reflections of Congressional intent in its enactment of Section 6662(e). Congress has expressed its continuing concern with IRS examiners' ability to obtain vital information for transfer pricing audits and has expanded IRS's power to obtain documents several times in the last few years. Sections 982, 6038A, 6038C and 6503(k), among others, all address the perceived difficulties IRS agents have faced when requesting information related to international transactions. Some of these measures have been Draconian; for example, granting the District Director the power to deny the taxpayer the cost of goods sold deduction under Sections 6038A and C.

In effect, Congress has transferred the burden of conducting a transfer pricing audit to taxpayers, has required that intercompany transfers be supported with complete documentation and has backed up these Regulations with heavy penalties.

What the Regulations lack, however, is sufficient guidance to allow taxpayers to be sure they have complied. "Reasonable belief", "reasonably conclude", "reasonable application" and other uses of the word reasonable or variants abound, but in many cases there are no examples, definitions or explanations to guide taxpayers.

In addition, unlike many other penalties, this one has no real safe harbours. If an adjustment meets a threshold requirement, any significant failure to comply with the Regulations under Section 482 leaves the District Director no discretion. Notwithstanding a good faith attempt on the part of the taxpayer to adhere to the rules, the District Director must impose the penalty if required documentation is not prepared and timely turned over to the examining agent. There is no middle ground for taxpayers who act in good faith, but err in some technical way.

28. Reg. § 1.6664-4(d).
29. Reg. § 1.6662-6T(d)(4).
30. Reg. § 1.6662-6T(f)(1).
31. *Id.*
32. *Id.*
33. Reg. § 1.6662-6T(e).
34. *Id.*
35. Rev. Proc. 94-33, IRB 1994-18 (2 May 1994). Regardless of the taxable year, Rev. Proc. 94-33 states that the existence of contemporaneous documentation is a relevant factor in determining whether the taxpayer had reasonable cause and good faith, particularly for transactions after 21 April 1993.

© 1994 International Bureau of Fiscal Documentation

Taxpayers that conduct international transactions with related parties are vulnerable to the penalties under Section 6662(e). If the IRS audits a return, and the adjustments meet or exceed one of the thresholds, the District Director must impose the penalty if the taxpayer does not meet any of the safe harbour provisions. Congressional staff have stated publicly that Congress expects this result. Any taxpayer with significant international related party transactions must make an effort to meet the safe harbour provisions.

A transfer pricing policy statement should be prepared to support the taxpayer's choice of method and its pricing. Key elements that should be included in the policy are:

(1) a statement of basic principles applicable to the taxpayer's situation;
(2) identification of the methods used to set the transfer prices and the method that will be used to evaluate the actual results;
(3) provisions for adjustments to the prices should the need arise; and,
(4) provisions for periodic updates and revisions of the methods used to set transfer prices.

Justification of transfer prices used is the most important element of transfer pricing documentation. A study must be carried out in a manner that conforms to the Regulations. It should include a functional analysis of all parties affected by the intercompany transfers. The functional analysis must look at the parties' functions, risks, tangible and intangible assets. Then, the study must analyse other transactions or companies that could be comparable. The judgement of which transaction or company is comparable and which is not must be based on a number of factors enumerated in the Section 482 Regulations. The availability of comparables of different types will determine what transfer pricing method or methods the client used to set its price. This choice is the most critical decision that must be made. The study should apply the method chosen to financial information for previously filed returns to check the reasonableness of the application of the method. Finally, at the end of the tax year, the taxpayer must assess the actual results to determine whether they meet the arm's length standard, and calculate an adjustment if they do not.

The taxpayer must also keep records of contracts that state the complete agreement between the parties. Relevant contracts include sales/distribution agreements, licences of intangible property, leases, service agreements or loans.

Any specific circumstances that affect transfer pricing must be documented, as well. Among other things, explanations of non routine risks, market share strategy, compensating adjustments, methods to avoid periodic adjustments for intangibles, support for use of an "other" method and any claimed set-offs should be included.

The Regulations are of particular concern to international banks as the substantive Section 482 rules do not provide clear guidelines or methods for common types of cross-border transactions engaged in by banks. For example, no specific guidance is available with regard to trading in financial products. Moreover, the IRS does not generally recognize interbranch transactions which are commonly used by banks operating internationally. In addition, the specified transfer pricing methods for intangible property will rarely apply to international banking activities nor will the limited profit split methods adopted in the Regulations be available; thus in most cases, there will not be a method that is clearly the "best" method. As a consequence, many banks as well as many other taxpayers are considering obtaining Advance Pricing Agreements as the only viable alternative to avoid potentially costly disputes with the IRS and to avoid penalties under Section 6662(e).

In-depth journal for transfer pricing experts worldwide. Each issue explores an important aspect of transfer pricing, presented in in-depth country reports, plus other articles and news of the latest developments around the world

In the current issue of IBFD's

International Transfer Pricing Journal

Interaction Between Sale of Goods and the Use of Trade Marks under Cross-border Group Transactions within Manufacturing and Distributing Countries

Complex taxation issues are thrown up by the interaction of sale of goods and use of intangibles in cross-border group transactions. Until now these issues have been little documented, but this issue of the International Transfer Pricing Journal takes a step towards remedying this.

Detailed country reports present an in-depth consideration of the challenges and an exploration of various approaches for both distributing entity and manufacturer in: Belgium, Canada, Germany, Italy, Japan, Luxembourg, Portugal and Spain.

Annual subscription price to the International Transfer Pricing Journal 1994: NLG 450

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

DOES THE BROWN GROUP CASE SPELL THE EFFECTIVE END OF SUBPART F?

Peter J. Connors and Robert M. Spevack

Ernst & Young, International Tax Services, New York

Since 1963 Subpart F has been the principal mechanism utilized by the United States to make US shareholders of controlled foreign corporations ("CFCs") subject to current taxation on unremitted earnings derived from certain types of operations conducted outside of the United States. One of the designated types of operations that generates Subpart F income which is currently taxable to US shareholders is Foreign Base Company Sales Income.[1]

In the recent case of *Brown Group, Inc. v. Commissioner*,[2] the US Tax Court held that the distributive share of profits of a CFC from a partnership engaged in a foreign purchase and sale business was not foreign base company sales income of the CFC, even though this income would have been base company sales income if it had been received directly by the CFC.

Foreign base company sales income includes income derived by a CFC from the purchase of property manufactured outside of the CFC's country of incorporation by a person other than the CFC and sold to a person related to the CFC for use outside of the CFC's country of incorporation. One of the key points in this definition is whether the purchaser is related to the selling CFC, which is defined in IRC Section 954(d)(3). Under the current version of this provision as amended in 1986 and 1988, a CFC and a partnership are considered to be related persons if the CFC owns more than 50 percent of the partnership. However, a CFC and a partnership were not related persons under Section 954(d)(3) as in effect for 1985 and 1986. In a Revenue Ruling issued in 1989,[3] the IRS attempted to rectify this oversight in the pre-1986 Act definition by taking the position that a CFC's distributive share of any partnership's income is foreign base company sales income if the income would have been classified as base company sales income if received directly by the CFC. (It is unclear whether the 1986 amendment resolves the question of whether a partnership is a related person, where the transaction is between a partnership in which a CFC has a more than 50 percent interest and the US parent of the CFC. In this structure there literally is no transaction between the partnership and the CFC, and it is not clear that the partnership and the US parent are related persons even taking account of attribution rules. The legislative history of the amendment does, however, indicate Congress intended to have this structure result in foreign base company sales income.)

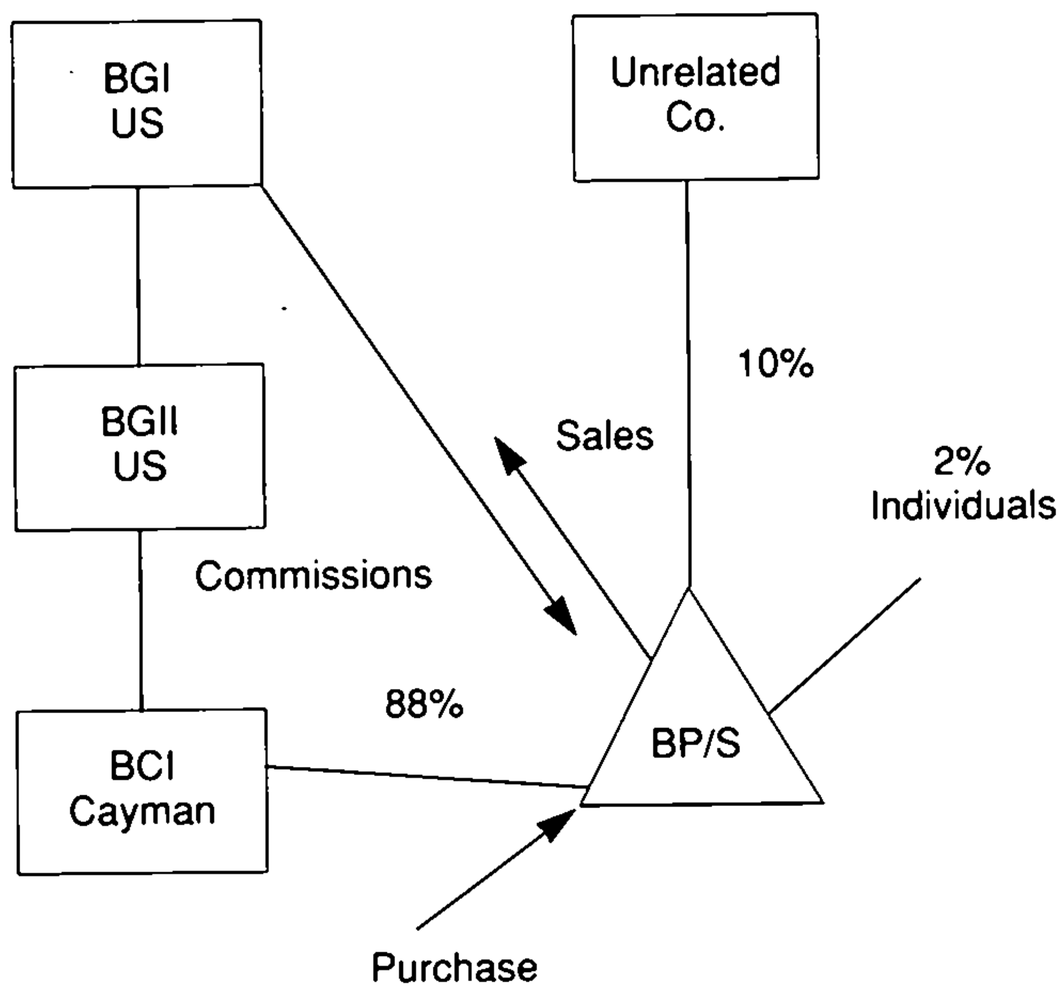
Brown Group is a US corporation that was engaged in manufacturing and distributing footwear. Before 1985, as part of its operations Brown purchased footwear manufactured by independent parties in Brazil, for resale in the United States and elsewhere. The purchases were handled by two individuals who are described in the court's decision as independent from Brown Group and were compensated by commissions from Brown Group for their services on its behalf. It appears that Brown Group was not subject to any foreign tax on its income from the distribution business, but it was subject to current US tax on such income.

In 1985 Brown Group formed a wholly-owned Cayman Islands subsidiary, Brown Cayman, Ltd., which became an 88 percent partner in Brinco P/S, with the other two partners being the individuals who had been purchasing shoes for Brown Group in Brazil. The US parent paid Brinco a 10 percent commission based on the purchase price of footwear for acting as its purchasing agent in Brazil, thereby replacing the two individuals. The two individuals continued to receive remuneration for their services through their distributive shares of partnership income. In 1985 and 1986 the partnership had profits from purchasing footwear in Brazil and reselling the footwear to its indirect 88 percent parent corporation. The profits would have been foreign base company sales income if Brown Cayman purchased the footwear and resold it to the US parent directly (see diagram).

Since Brinco and the US parent, Brown Group, were not related persons under the pre-1986 Act rules, Brown Group took the position that the partnership did not have any foreign base company sales income. Therefore, Brown Cayman's distributive share of partnership income was not foreign base company sales income. On the other hand, the IRS took the position that under Rev. Rul. 89-72, characterization of the partnership's income for Subpart F purposes should be made at the partner rather than the partnership level. The court noted that under IRC Section 702(b) the character of any item of income included in a partner's distributive share is determined as if such item were realized directly from the source from which realized by the partnership – in short, the characterization of income is made at the partner level. The opinion

1. IRC Sec. 954(d).
2. 102 TC No. 24 (12 April 1994).
3. Rev. Rul. 89-72, 1989-1 CB 257.

© 1994 International Bureau of Fiscal Documentation



then lists a number of items specified in the regulations under this provision which are taken into account at the partner rather than the partnership level. The court also recognized there is a catch-all provision in the regulations under which each partner is required to take into account at the partner level, any partnership item which, if separately taken into account by any partner would result in different tax liability for the partner than if the partner did not take the item into account separately.[4]

The court concluded that Subpart F is silent as to whether foreign base company sales income should be determined at the partner or partnership level. Similarly, no court has addressed the issue of whether Section 702(b) applies to require Subpart F characterization at the partner level. Faced with an absence of controlling authority the court chose to follow a line of cases it believed supported a conclusion that, at least in transactions involving property sales, tax characterizations are to be made at the partnership level. Since only a corporation can have Subpart F income, it followed that Brinco as a partnership could not have such income. Therefore, Brown Cayman's 88 percent distributive share of its income could not be foreign base company sales income, because this determination was made at the partnership rather than the partner level.

It is true, that except in the case of foreign base company shipping income, there is no guidance in the IRC or regulations as to whether Subpart F income determinations are to be made at the partnership or partner level.[5] The court declined to accept Rev. Rul. 89-72 as controlling authority for characterizing the income at the partner level. Similarly, the court rejected the government's assertion that Section 954(f)(2) demonstrated Congressional intention to have Subpart F apply at the partner rather than the partnership level. The court made the opposite inference – that is, including a reference to partnerships only in the case of foreign base company income meant Congress intended other types of foreign base company income to be determined at the partnership rather than the partner level.

However, lack of discernible Congressional intention as to the relationship between partnership tax provisions and foreign base company income may provide an easy basis for avoiding foreign base company sales income by simply conducting buying and selling operations between related parties through partnerships rather than directly through foreign corporations. The IRS has withdrawn from its prior position that an entity can not be classified as a partnership for US tax purposes where the partners are subsidiaries of the same parent corporation.[6]

As noted earlier, if the 1986 and 1988 amendments to Section 954(d)(3) are applied strictly according to their literal language the *Brown Group* case is still viable under current law. If the amendments are applied according to the legislative history of the 1986 Act it is possible that Brinco and the US parent would be considered related persons and Brinco would be considered to generate base company sales income in the hands of its parent, Brown Cayman. An obvious weakness in the case could be the amount of income from purchase and sale of footwear that was considered earned by Brinco. There is no evidence in the case that Brinco or Brown Cayman performed any services or had any significant investment in the business. This could make it difficult to justify any profit to Brinco beyond the amount paid to compensate the individual purchasing agents, directly or through their interests in Brinco.

Even if the 1986 amendment precludes utilizing Brown type partnership structures to avoid foreign base company sales income, is it possible partnerships can be utilized to avoid other types of foreign base company income based on the principle that a *partnership* cannot have Subpart F income because it is not a *corporation* and the determination of whether there is base company income is made at the partnership rather than the partner level. For example, if a US corporation creates a wholly-owned subsidiary in a tax haven and capitalizes the subsidiary with money to make tax-free passive investments all of the income will be classified as Subpart F foreign personal holding company income under Section 954(c), which will be taxed currently to the US parent under Subpart F. A logical extension of the *Brown Group* case would suggest that the foreign personal company holding company problem can be eliminated by having the US parent form two tax haven subsidiaries which would become partners in an investment partnership with their pooled funds. Under the case the *partnership* would not have any Subpart F income. Therefore the distributive shares of the subsidiaries would not be Subpart F income which would be currently taxable to the US parent.

4. Reg. §1.702-1(b)(8).
5. In the case of base company shipping income, IRC Sec. 954(f)(2) specifically provides that the character of such income received by a partnership passes through to its partners.
6. See Rev. Rul. 93-4, 1993-1 CB 225, holding that a German GmbH can be classified as a partnership rather than a corporation for US tax purposes where it does not possess more corporate than non-corporate characteristics under the IRS classification regulations, without regard to the fact that all of the partners are subsidiaries of the same common parent.

© 1994 International Bureau of Fiscal Documentation

A possible difficulty with this approach is application of the Excess Passive Assets ("EPA") regime of Section 956A even if there is no actual distribution of earning to the partners of the partnership. Under this provision current and accumulated earnings and profits of a CFC which have not previously been subject to US tax in the hands of the CFC's shareholders are currently taxable to the extent the CFC's passive assets (assets which generate Subpart F foreign personal holding company income) exceed 25 percent of the CFC's total assets. Under Section 956A(c)(2) passive assets generally have the same meaning as for purposes of determining whether a foreign corporation is a passive foreign investment company ("PFIC") under Section 1296(a)(2). Passive assets are assets which produce passive income for a corporation, or which are held for the production of passive income.

If the partnership interests in the hands of the CFC's are treated as passive assets because they generate passive income, up to 75 percent of each CFC's distributive share of the partnership profits will be currently taxable to the US parent as of the close of Year 1. While not absolutely clear, it appears that a partnership interest in a partnership which invests solely in passive assets would itself be considered a passive asset, since this is the character of income that would be generated by the partnership. The most likely opportunity to avoid application of the EPA regime probably is to have the partnership make investments in related foreign corporations which have only income from active operating businesses. Under Section 1296(b)(2)(C) interest, dividends, rents and royalties received by a PFIC from a related person are not considered passive income to the extent the payments are allocable to non-passive income of the related person. Therefore, under the normal PFIC rules, assets which generate such income should not be considered passive assets.

Despite limitations on the usefulness of the *Brown Group* case imposed by the EPA regime, there was swift anonymous reaction to the decision by IRS personnel. Several anonymous items in the *BNA Daily Tax Report* warned taxpayers not to rely on the case because it was going to be appealed, and penalties would be imposed on taxpayers who had ideas of using similar structures in reliance on the case. The IRS subsequently announced it is going to request reconsideration of the decision by the Tax Court. As of this writing there has been no word on whether the Tax Court will grant a rehearing on the case.

While the IRS controls which cases it will litigate in the Tax Count and whether it will request reconsideration of a decision by the court, only the Solicitor General of the Department of Justice can authorize an appeal of an adverse decision. As of this writing it is unknown whether the Solicitor General would authorize an appeal in the event the request for rehearing is denied or the prior decision is sustained.

An issue in using *Brown Group* as a planning technique is the extent to which penalties could be imposed. As far as penalties are concerned, the most likely one to be encountered is the accuracy related penalty for substantial understatement of income tax.[7] This penalty does not apply to the extent there is "substantial authority" for the taxpayer's position or adequate disclosure of the position with the taxpayer's return.[8] Ordinarily, a decision by the Tax Court should be considered "substantial authority" for this purpose,[9] although the IRS has authority to designate particular positions as not constituting "substantial authority". It appears that if a taxpayer were filing a return today based on official outstanding pronouncements, the *Brown Group* case would constitute "substantial authority" to avoid the accuracy related penalty for substantial underpayment of tax.

Another possible attack on using the case could be proposed regulations that were issued on 17 May 1994. These proposed regulations would authorize the IRS to disregard the form of a transaction if a partnership is formed or availed of in connection with a transaction or series of transaction with a principal purpose of substantially reducing the present value of their partners' federal tax liability in a manner that is inconsistent with the intent of the partnership provisions.[10] The exact scope of these proposed regulations which are stated to be effective for transactions occurring on or after 12 May 1994 is unclear. Examples in the proposed regulations make it clear that whether a partnership form is "abusive" will be based on the unbridled judgement of the IRS. A comprehensive evaluation of these proposed regulations and the basis for the authority on which the proposed regulations are being issued is beyond the scope of this article. However, if the regulations are adopted as proposed, it can be anticipated that structures of the type approved in the *Brown Group* case will be an early target.

7. IRC Sec. 6662(a), (b)(2) and (d).
8. IRC Sec. 6662(d)(2)(B).
9. Reg. §1.6662-4(d)(3)(iii).
10. Proposed Reg. §1.701-2, 59 Fed. Reg. 25581 (May 17, 1994)

© 1994 International Bureau of Fiscal Documentation

MEXICO

INTERNATIONAL TAX TREATY DEVELOPMENTS: THE MEXICAN EXPERIENCE

Barry Larking

Technical Coordinator, IBFD International Tax Academy

I. INTRODUCTION

The influence of its tax treaty partners on Mexico's treaty policy is easy to recognize, and also understandable given the short period Mexico has had to develop its own policies.[1] There are, however, some features of Mexico's current treaties which are rarely encountered elsewhere and which in some cases, appear to be entirely new.[2] The object of this article is to highlight some of these features[3] and to consider their place in the development of tax treaty practice in general. Although it may not always be clear whether a particular feature originates from Mexico or its respective treaty partner, its relative novelty is considered sufficient justification for inclusion in this article.

II. TREATY BENEFITS FOR EXEMPT ORGANIZATIONS

The Netherlands and US treaties with Mexico grant treaty benefits to certain tax-exempt organizations.[4] None of the countries concerned include such provisions in their own model treaties nor are they found in any of the OECD or UN Models. Such provisions are, however, becoming more popular, especially in US treaty practice. There is long-standing debate about the need for special mention of these organizations.[5]

Some consider that without special mention, exempt organizations are excluded from treaty benefits because they fail to satisfy the basic (standard) requirement for treaty residence, namely being subject to tax, while others would be prepared to concede residence status to those organizations which are only exempt as regards specific (e.g. investment) income but not as regards other (e.g. trading) income.[6] Another view is that even fully exempt organizations qualify as residents if they would have been subject to tax (i.e. they satisfy the normal "nexus" conditions for taxability in their country of organization, etc.) were it not for being specifically exempted.[7]

The Netherlands appears as a technical matter to take the first-mentioned view (that exempt organizations do not qualify) while in practice it grants treaty benefits to exempt organizations (on the assumption of reciprocal treatment) since, in its view, it is not the purpose of treaties to exclude such organizations.[8] It is surprising that the Netherlands–Mexico treaty (concluded on 27 September 1993) only includes pension funds in this context, whereas the Dutch practice referred to above also covers other public benefit organizations. It might be concluded that treaty benefits will simply be denied to these other exempt organizations. Another possibility is that the principle of reciprocal treaty benefits for such organizations was accepted but that agreement could not be reached on how to define them and that these situations will therefore be decided on a case-by-case basis.[9]

A comparison between the Netherlands and the US–Mexico treaty provisions illustrates the difficulties of framing a provision of this kind. The US provision uses general wording to describe qualifying organizations,[10] and the decision whether a particular organization satisfies this description would therefore seem to be left to the country being asked to grant the treaty benefits. The fact that this wording draws heavily on US domestic law might, however, indicate in favour of a US-based interpretation.[11] The Netherlands provision on the other hand is "self-executing" in the sense that an organization qualifies simply by being designated or recognized

1. Mexico's first comprehensive bilateral treaty (with Canada) was concluded as recently as 8 April 1991. Mexico's treaty policy is reflected in its Model treaty dated May 1993 as well as in the treaties it has concluded.
2. This article deals with the following Mexican treaties, all of which had been concluded but were not necessarily in force at the time of writing (May 1994): Belgium, Canada, Ecuador, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland and the United States.
3. Some "unusual" features receive relatively less attention where their novelty owes more to the peculiarities of a particular tax system, such as the Mexican assets tax or the US foreign tax credit "baskets", or to some other local peculiarity, such as Mexico's until recent non-membership of the OECD and the presumably related appearance in treaty texts of matters otherwise confined to the official Commentaries to the OECD Model.
4. See Protocol Art. 1 to the Netherlands treaty and Art. 22 to the US treaty.
5. See e.g. "International Tax Problems of Charities and other Private Institutions with Similar Tax Treatment", IFA Seminar paper (London, 10 September 1985); and "The Tax Treatment of Charitable Organizations", 34 *European Taxation* (January 1994), at 9.
6. *Ibid.*
7. See e.g. Klaus Vogel, *Double Taxation Conventions* (Deventer: Kluwer, 1990) (hereinafter "Vogel"), at 68.
8. See Statement of the Under-minister of Finance dated 9 July 1993, MvF IFZ93/713.
9. The Dutch introductory words "het is wel verstaan" ("it is understood that") suggest that the latter is more likely the case.
10. "...operated exclusively for religious, scientific, literary, educational...purposes"; see US–Mexico treaty Art. 22.
11. IRC Sec. 501(c)(3).

© 1994 International Bureau of Fiscal Documentation

under the national law governing the organization concerned, i.e. independently of the country being asked to grant treaty benefits. While the self-executing approach clearly has the advantage of providing taxpayer certainty, the reluctance of treaty negotiators to accept provisions such as these which tie a country's treaty benefits to criteria over which it has no control is understandable; the "generic" approach of the US treaty on the other hand suffers from less certainty for the taxpayer but is more comfortable for the country granting the treaty benefits. It is unfortunate that the self-executing approach also results in some uncertainty in the case of the Netherlands provision through its interaction with the domestic rules described above.

Given the fundamental dispute over whether these provisions are exceptions to a rule (that exempt organizations do not qualify as treaty residents) or simply clarifications of a rule (that, subject to satisfying the "basic" criteria for residence, a specific statutory exemption does not take away residence status for treaty purposes) a commonly agreed international view (e.g. in the Commentaries to the OECD Model) would be welcome. In the meantime, the drafting difficulties and uncertainties will remain.

III. AMBULATORY INTERPRETATION CONFIRMED

Article 3(2) of the OECD Model contains the "sweeper" or "renvoi" clause under which the meaning of undefined terms is to be found in the domestic tax laws of the treaty partners (unless the context otherwise requires).[12] Despite the numerous uncertainties surrounding the operation of this provision it is normally carried over letter for letter into bilateral treaties. The Mexico–Canada treaty is an exception. By the simple addition of just six words one of the major difficulties with this provision has been removed, namely the question whether the national laws (from which the meaning is to be derived) are those in place at the time the treaty was entered into or when it is being applied.[13]

It is fitting that a specific endorsement of this principle (the "ambulatory" or "dynamic" principle)[14] of treaty interpretation should appear in a Canadian treaty given the confusion over this issue which arose from the Canadian case of *Melford*.[15] This case supported the "static" principle (basically the opposite of the ambulatory principle) on reasoning subsequently shown to be of doubtful validity such that it was eventually reversed by statute.[16] Although the clarification in the Canada–Mexico treaty may be welcomed, it has to an extent been pre-empted by the new Commentaries to the 1992 OECD Model (hereinafter "Commentary") which now explicitly supports the ambulatory approach.[17] For non-OECD member countries or those who prefer not to rely only on the Commentary for the interpretation of their treaties, it may be something to note for future treaties. However, Mexico apparently did not consider it necessary (or could not get agreement) to include a similar provision in its other treaties.

IV. PERMANENT ESTABLISHMENT PROBLEMS

A. General influences

To a great extent the Mexican treaties follow the OECD Model permanent establishment ("PE") provisions. The influence of the UN Model is also felt, notably in the construction clause (six month rather than 12 month minimum period) and a special provision for insurance activities. The 1963 OECD Draft has also been used to include in the list of excepted activities advertising, supply of information and research (while at the same time resurrecting the ambiguity in the phrase "similar activities which have a preparatory or auxiliary character").[18]

B. Confusing construction PEs

Another UN influenced provision which occurs regularly in Mexican treaties is the inclusion of supervisory activities in the construction clause; such activities, where related to a building site or similar project, also constitute a PE if "such site...or activities last more than six months".[19] Although this is also a standard UN Model provision, it contains an ambiguity as regards supervisory activities carried out by a separate enterprise: either the supervisory activities themselves should last more than six months or any period will suffice if, together with the related building site, the six month test is passed. The French treaty clarifies that the former is the intended meaning.[20] Although supervision is not expressly covered by the OECD Model construction clause, the Commentary[21] indicates that it is intended to be covered although it raises the same ambiguity as mentioned above, i.e. it states that supervision will not result in a PE unless the related site is also a PE (i.e. unless the site exists for the requisite length of time), but leaves open the question whether the supervision should also continue for the same length of time. In the interest of removing ambiguities from treaty texts, the French approach has to be recommended (or a suitable amendment made to the Commentary).

12. For a comprehensive review of this provision, see Avery Jones, J. et al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model (I)", *British Tax Review* (1984), at 14, 54.
13. Art. 3(2) of the Mexico–Canada treaty reads: "As regards the application of the Convention by a Contracting State *at any time*, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has *at that time* under the law of that State for the purposes of the taxes to which the Convention applies" (emphasis added)
14. See *supra* note 12, at 25.
15. *The Queen v. Melford Developments Inc.*, DTC 6281 (Can 1982).
16. The Income Tax Conventions Act.
17. See Art. 3 Commentary para. 11; see also Avery Jones, J., "The 1992 OECD Model Treaty: Article 3(2) of the OECD Model Convention and the Commentary to it: Treaty Interpretation", 33 *European Taxation* (August 1993), at 252.
18. See Vogel *supra* note 7, at 233-234. The treaties with France, Italy and Switzerland recognize the problem and borrow from the later OECD Models by replacing the word "similar" with "other".
19. Mexican Model Art. 5(3).
20. Protocol Art. 2(a).
21. Art. 5(3) Commentary para. 17.

© 1994 International Bureau of Fiscal Documentation

C. No definition for third country residents

Less commendable is the way the Canada–Mexico treaty only recognizes a PE for treaty purposes where the business being carried on is that of a resident of one of the two contracting states. A German company, for example, having a retail shop in Mexico would not have a PE for purposes of the Mexico–Canada treaty. Of course, in most cases this would hardly be a problem given the primary function of the concept being to allocate taxing jurisdiction as between residents of the two contracting states. However, sometimes treaties do regulate taxation in the context of a PE of a resident of a third state. An example of this in the Canadian treaty is the provision defining the source of interest[22] which refers to the payor of the interest as a person, "whether [he] is a resident of a Contracting State or not, [who] has in a Contracting State a permanent establishment ....". Having limited "permanent establishments" to those carried on by residents, one is left with the dilemma of ignoring that limitation or applying a separate definition for the purposes of this clause. Such dilemmas should, it is suggested, be avoided.

D. Loan preparations

A peculiarly Mexican provision is the addition to the list of excepted activities[23] of the "maintenance of a fixed place of business solely for preparation in relation to the placement of loans".[24] This provision probably has to be seen against the political and commercial background of foreign banking business in Mexico which at the time of negotiating the treaties in question was limited to representative offices. Since these would commonly be regarded as perfect illustrations of the basic principle behind the excepted activities list, the provision is arguably superfluous.[25] One Mexican treaty will not exclude such activities from PE status where the funds are derived from within the state where the (lending) activities take place.[26] Although the latter is phrased as an explanation of the provision rather than a modification thereof, it is not clear that this view would be of general application.

E. New independent agent condition

Mexican treaty policy has added a further layer to the complex area of agency PEs by adding a condition to the standard OECD "independent agent" exclusion.[27] This standard formulation excludes from PE status independent agents provided they are acting in the "ordinary course of their business". The Mexican Model provides an additional condition that "in their [i.e the agent's] commercial or financial relations with the enterprise, conditions are not made or imposed that differ from those generally agreed to by independent agents".[28] The initial question is what if anything does this proviso add to the standard (OECD) formulation? Put another way, can an agent retain its independent status and continue to act in the ordinary course of its business (as those terms are understood in the OECD Model) whilst at the same time acting under conditions which differ from those of other independent agents?[29]

At first sight it would appear axiomatic that an independent agent can be expected to act under the same conditions as independent agents in general, and that if this were not the case, he would lose his status as independent. This must be a correct proposition insofar as the conditions in question are necessary elements of independence as understood in the OECD Model. The Commentary indicates that freedom of action or the absence of control are necessary elements of independence;[30] in a similar vein, the UN Model provides that "sole principal" agents will not be independent.[31] An agent which, for example, acted without the appropriate degree of freedom would therefore fail the independence test with or without the Mexican proviso; to this extent the latter appears to add nothing substantive.

The above proposition does not hold good for conditions which are not necessary elements of independence (as understood in the OECD Model). It might, for example, be a general characteristic for independent agents to contract on the basis of standard, pre-printed terms and conditions. An agent who did not follow this behaviour would not, however, appear to lose his independent status as a result, at least under the OECD meaning of the term. To this extent the Mexican formulation would restrict the scope of the OECD independent agent provision, unless it can be said that agents who did not possess these general characterisitcs would anyway be acting outside the ordinary course of their business – and therefore fail the second part of the standard OECD formulation. An interesting question prompted by the Mexican formulation is whether the financial conditions under which independent agents generally operate are necessary elements of independence. Financial conditions clearly play a role under the OECD concept of independence, i.e. the economic independence referred to in the Commentary.[32] But does it follow that an otherwise "independent" agent who receives remuneration above or below the norm for such agents is no longer economically independent? If it does not so follow (and subject to the same point already made as to the effect of

22. Canada–Mexico treaty Art. 11(6).
23. OECD Model Art. 5(4).
24. Mexico Model Art. 5(4). Although this unusual provision appears in the Mexico Model and has succcessfully been incorporated in all of Mexico's treaties, Mexico cannot claim to be the originator, a similar provision being found, for example, in the Dutch treaties with Bulgaria (not yet in force) and the former USSR.
25. For an apparently different view, reference is made to the Dutch treaties mentioned in the previous note, which exclude such loan-related activities (albeit together with other activities) from PE status whether or not they are of a preparatory or auxiliary nature. Notwithstanding the clarity of the treaty texts, the Dutch technical explanation to the treaty with the USSR suggests that some such limitation ("menial tasks") is implied.
26. See Mexico–Italy treaty Art. 5.
27. OECD Model Art. 5(6).
28. Mexican Model Art. 5(7).
29. The official Dutch answer to this seems to be "no". See Dutch technical explanation to the Mexico–Netherlands treaty (Toelichtende Nota, Staten Generaal, 1993-4, 23 583 Nos. 235 and 1, at 5) which indicates that this formulation appears for reasons of "clarity".
30. Art. 5 Commentary para. 38.
31. UN Model Art. 5(7). Provision has been taken up in a small number of Mexico's treaties rather than the standard Mexican formulation described above.
32. Art. 5 Commentary para. 37.

© 1994 International Bureau of Fiscal Documentation

the "ordinary course of business" proviso) the Mexican formulation would seem to have added something to the OECD standard. Although it might be considered that the level of remuneration was an issue for Article 9 OECD Model (i.e. transfer pricing) the historical development of the OECD Model (in particular, the early League of Nations drafts) suggests that normal remuneration was an inherent characteristic of independent agents.[33]

If the ordinary course of "their business" is taken for these purposes in a wide sense as that of independent agents in general, then conditions which differ from those generally agreed to by independent agents will not be in the ordinary course of business. If, on the other hand, "their business" is taken as their own particular business or even the business area (e.g. trade or industry) in which they work, a comparison with what is normal for independent agents in general will not be appropriate. It has been suggested that the OECD formulation reflects the latter, narrow, view of an agent's business[34] by reference to the difference between the OECD formulation, "ordinary course of their business" and that of its UK predecessor, "ordinary course of [their] business *as such*" or US counterpart, "ordinary course of [their] business *in that capacity*" (emphasis added in both cases) as well as to the Commentary's mention of "their *own* business operations".[35] However, the position is far from clear. In support of the wider interpretation, attention is drawn to the same part of the Commentary just mentioned, which refers to "his own trade or business (*namely that of a commission agent*)" (emphasis added)[36] and to relevant case law[37] which appears to support both views.

The above uncertainty is, perhaps, the clue to the origin of the Mexican provision. Under the standard OECD formulation an agent acting under conditions other than those generally adopted by independent agents would not constitute an agency PE unless, as described above, either the conditions in question were fatal to independence as such, or the broad interpretation of "ordinary course of business" were adopted. Under the Mexican formulation, such an agent would constitute an agency PE even if the conditions were not fatal to independence as such, without recourse to the unclear "ordinary course of business" test. Although this might suggest that the "ordinary course" provision is otiose, its retention in all Mexico's treaties could be explained in terms of the narrow interpretation discussed above thus ensuring both meanings are covered.[38] However, if this was Mexico's intention, it is strange that it is not mirrored in the recent amendments to Mexican domestic law[39] which provide that an agent acting under "arm's length" conditions will not be treated as having a domestic PE, with no reference to an additional ordinary course of business requirement.

F. Deferred PE income

In delimiting the PE state's right to tax business profits, treaties normally refer to an enterprise which "carries on business" in the PE state. Where profits generated by the PE are only realized for tax purposes after its termination a strict reading of the treaty text might appear to deny the PE state's right to tax these profits.[40] The Mexican Model recognizes this and amends the standard wording to read, "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries *or has carried* on business in the other Contracting State through a permanent establishment situated therein".[41] Although this formulation, or a variation thereof, is found in all of Mexico's treaties, Mexico is not the originator as can be seen from standard Canadian treaty practice and a limited number of other (especially US) treaties. In most cases it is applied to both Article 7(1) and (2) but in some treaties only to the former; rather strangely, the Swiss treaty only applies it to Article 7(2), while even more strangely the official explanatory report to the treaty states that Article 7 of the Mexico treaty is the same as the OECD Model![42] Taxation of deferred payments must of course also be provided for under domestic law in order for such treaty provisions to have effect.[43]

A similar timing issue arises in the PE parts of the dividend, interest and royalty articles, as well as in the capital gains article. Mexican treaty practice is inconsistent in this respect as an appropriate amendment to the former articles only appears in a number of its treaties and, as regards the capital gains article, only once, in the treaty with the United States.[44] There appear to be timing issues relating to the capital gains article which may not be covered by the simple formulation used to amend the business profits article. For example, assets removed from a PE prior to being sold may still be taxable under some domestic rules, regardless of whether the PE is still in existence at the time of the sale.[45] It has been suggested that such gains could not be taxed where the capital gains article (Article 13(3)) of the US–Mexico treaty

33. See further and generally, Avery Jones, J. and Ward, D., "Agents as Permanent Establishments under the OECD Model Tax Convention, 33 *European Taxation* (May 1993), at 154, 164 (hereinafter "Avery Jones").
34. *Id.* at 173.
35. Art. 5 Commentary para. 38.
36. *Id.*
37. See Avery Jones *supra* note 33.
38. The Treasury Technical Explanation to the US–Mexico treaty certainly indicates that the two provisions have different contents (see Warren Gorham Lamont, *Tax Treaties*, Vol. II, at 62,130; hereinafter, "Tax Treaties").
39. Income Tax Law Art. 2, as amended on 29 December 1993.
40. A number of commentators have suggested that a causal link is sufficient; see, e.g. Vogel (*supra* note 7), at 325 and Vogel, Shannon, Doernberg and Van Raad, *United States Income Tax Treaties* (Deventer: Kluwer), at 323. In support of this view, see also the Dutch case, HR 4 February 1987, *BNB* 1987/131.
41. Mexico Model Art. 7(1) (emphasis added).
42. Memorandum Regarding Double Taxation Treaty with Mexico of 27 October 1993, at 4.
43. See e.g. US IRC Sec. 864(c)(6) and UK Income and Corporation Taxes Act 1988 Sec. 103. The same result has also been established in a domestic law context through case law. See e.g. the Dutch Supreme Court case, HR 27 March 1991, No. 26 409, and the German decision of the Munich Tax Court, 28 October 1975 (Entscheidungen der Finanzgerichte 1976, at 187).
44. US–Mexico treaty Art. 13(3). The treaties with France, Germany and Italy contain a puzzling reference to "gains" where this timing issue is dealt with but in the context of the business profits article (Art. 7).
45. See e.g. US IRC Sec. 864(c)(7) and UK TCGA 1992 Sec. 10(1); in the latter case, the cessation of the PE would trigger a gain on the formerly held asset.

© 1994 International Bureau of Fiscal Documentation

applied.[46] A similar view was expressed in an official commentary to the equivalent provision in the US–Finland treaty.[47] A different view, however, was expressed in official commentaries to the US–Mexico treaty to the effect that the treaty would not prevent application of the domestic taxing rules described above.[48] This apparent difference in opinion in the United States between the scope of the US treaties with Finland and Mexico is difficult to reconcile. One possible explanation may be the slightly different wording between the two provisions: the US–Finland provision follows the US Model formulation and refers to gains which are "attributable" to a PE whereas the Mexican treaty provision follows the OECD Model formulation and refers to "gains [on assets] forming part of the business property of a PE". Although this difference is not generally considered material,[49] the new US–Spain treaty suggests that the United States or Spain thinks otherwise. The basic capital gains provision in that treaty is essentially the same as that in the Mexican treaty; the Protocol to the Spanish treaty clarifies the position in respect of the computation of gains on assets which are "attributable" to a PE but which have been removed from the PE state (and therefore by implication also removed from the PE) before sale.[50] In other words, it is implicit in the treaty with Spain that a gain can be *attributable* to a PE even if the asset is ("has been"?) removed at the time the gain is realized; the same should be the case for the US–Mexico treaty which also uses the "attributable" formulation. The OECD formulation, on the other hand, even where amended along the lines of the US–Finland treaty, by requiring the assets to "form part of the business property of the permanent establishment" does not so clearly cover this situation. In view of the general uncertainty on this issue, some clarification is needed as to whether this kind of provision is needed at all and, if so, its precise scope.[51]

V. AVOIDANCE ISSUES

While the limitation on benefits provisions in the new US–Netherlands treaty may represent the state of the art anti-treaty shopping mechanism, the various Mexican treaties offer an array of less spectacular, but (with the notable exception of the limitation on benefits article itself) arguably more workable, alternatives. A selection of these together with various other anti-avoidance provisions is set out below.

A. Super-limited force of attraction

Mexico's evident wish to preserve its right to tax business profits under the force of attraction principle has been respected by all of its treaty partners according to the "limited" force of attraction principle also found in the UN Model.[52] In most cases, however, this extension of source country taxing rights has been cut down by way of a "bona fide" provision which takes almost as many forms as there are treaties. They range from the German version under which the burden is on the tax administration to demonstrate the actual involvement of the PE in the "direct" sales, to the Spanish version which requires the enterprise to show that the direct sales were made for "valid economic reasons" and not with the sole objective of obtaining treaty benefits. The formulations are not without their difficulties not least because of the vagueness and subjectivity of some of the concepts involved. Attempts to overcome these difficulties, such as those in the Netherlands provision, are themselves not without their defects; in the latter provision, for example, tax avoidance is (rebuttably) presumed if "more than half the sales process takes place through the permanent establishment".[53] This wording is capable of relating to several different factors, such as turnover, unit sales, administration costs or a combination thereof. The official explanatory note to the treaty[54] offers little in the way of solving this difficulty, and does no more than explain that the expression "sales process" covers activities such as negotiations, conclusion of contracts and deliveries but gives no indication of the factors or weights to be applied to these various activities. An easier to apply but somewhat crude formulation is found in the Italian treaty which allows attribution of direct sales of like products where they are advertised or stored, etc. through the PE.[55]

B. Qualified ownership

Not surprisingly, the US–Mexico treaty contains a limitation on benefits clause.[56] This represents an expanded version of the US model provision but is still considerably shorter than its counterpart in the US–Netherlands treaty. Although the Mexican version may seem a triumph for sense and simplicity, this is largely at the cost of rejecting independent treaty

46. See G.L. Phillips and J.R. Washlick, "The new income tax convention between the United States of America and the United Mexican States", 57 *Tax Notes* (11 December 1992), at 1452. Art. 13(3) reads as follows, "Gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a Contracting State has or had in the other Contracting State....may be taxed in that other State".
47. See Senate Foreign Relations Committee Report on the US–Finland treaty, *Tax Treaties*, Vol. I, *supra* note 38, at 37,024-Z2. The relevant part of the treaty (Art. 13(3)) reads, "Gains from the alienation of movable (personal) property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has or had in the other Contracting State...may be taxed in that other State".
48. See Technical Explanation and Joint Committee on Taxation Explanation to the US–Mexico treaty, *Tax Treaties*, *supra* note 38, at 62,141 and 62,209 respectively. See also Lederman, A. and Hirsh, B., "US–Mexico Tax Treaty Complements NAFTA", *The Journal of Taxation* (August 1993), at 104.
49. See e.g. Vogel *supra* note 7, at 738.
50. Protocol Art. 10(b) of the US–Spain treaty reads, "Gains [on property] which are attributable to a permanent establishment which an enterprise [of one state] has or had [in the other state] [on an asset] which [property] is removed from [the other state] may be taxed [in the other state]".
51. For a less ambiguous formulation, see US–Germany treaty Protocol Art. 5.
52. UN Model Art. 7(1) provides: "If the enterprise carries on business [through a permanent establishment], the profits of the enterprise may be taxed in the [permanent establishment] state but only so much as is attributable to (a) that permanent establishment; (b) sales in [the permanent establishment] state of goods or merchandise of the same or similar kind as those sold through that permanent establishment.."
53. Protocol Art. IV (author's translation).
54. See *supra* note 29, at 6.
55. Italy–Mexico treaty Protocol Art. 2.
56. For a full discussion of this provision, see, Morrison, P., "US–Mexico Income Tax Treaty Breaks New Ground – Implications for the New US Model and for Latin America", *Tax Notes International* (October 1992), at 825, 829.

© 1994 International Bureau of Fiscal Documentation

definitions in favour of US-based terminology (and therefore US interpretations). Again, not surprisingly, in the same way that the US–Netherlands treaty recognizes the Netherlands' EC membership, so the US–Mexico treaty makes due deference to NAFTA in applying this provision. The Canadian treaty also adopts a kind of qualified ownership requirement.[57] This kind of provision might better be termed a "disqualifed ownership" provision since any non-local ownership or control (i.e. at any level, either direct or indirect) disapplies the treaty (subject to any further conditions), whereas under US Model type provisions, non-local ownership is irrelevant so long as ultimately the local (qualified) ownership requirement is met. Where this ownership requirement is not satisfied the treaty is disapplied but only if the company is not subject to "normal" tax, i.e. the income in question is subject to "substantially lower" taxation in the state of residence than it would have been in the case of 100 percent local ownership. This provision, which appears to be Canadian inspired,[58] is presumably aimed at the possibility of Mexico introducing some kind of "offshore company" legislation in the future. An interesting variation on this "disqualified ownership" approach to treaty benefits is found in the dividend article to the France–Mexico treaty.[59] Rather than deny all treaty benefits to third state owned companies, this provision restricts rather than denies treaty benefits for direct dividends by permitting a 5 percent withhholding tax instead of the normal zero percent: in effect a sort of "licence to treaty shop".[60] This approach may well be a practical alternative to providing an "escape clause" for bona fide cases.[61]

C. Beneficial ownership, bona fides and back-to-back approaches

A number of Mexican treaties deal with the conduit issue, i.e. the routing of (generally passive) income through a treaty country in order to benefit from its more favourable (treaty) withholding rates, in a more direct manner. Rather an odd variation on a rather common provision is the royalty and interest beneficial ownership requirement of the Mexico–Netherlands treaty.[62] Under modern OECD-based treaties, absence of beneficial ownership means unlimited source state taxation of interest and royalties; under the Mexico–Netherlands provisions, it also means that the residence state is not allowed to tax the recipient of the income. It seems unlikely that this was intended. A more likely explanation is that the "zero option" withholding tax formulation (e.g. as in the OECD royalty article) was inadequately adapted for the situation where withholding tax was to be applied.[63]

Another "anti-conduit" mechanism found in a number of Mexican treaties requires the relevant interest in respect of which the income in question is paid (e.g. the loan) to be held for bona fide reasons or, more specifically, not for taking advantage of the treaty provision.[64] To cover the case where the original interest was created for bona fide purposes but has been acquired by the current holder for treaty shopping purposes, this type of clause usually requires the interest not to have been created *or assigned* for purposes of making use of the treaty provision in question.[65] The Belgian interest and royalty provisions[66] are unusual in this respect since they only apply where the interest in question was *created* for obtaining treaty benefits.[67] In a similar vein, the special interest withholding tax rate on credit sales in the US–Mexico treaty is limited to interest paid to the *original* seller.[68]

Also aimed at the conduit problem is the provision in the US–Mexico treaty which disallows the reduced treaty withholding rates on interest in the case of "back-to-back" loans.[69] This provision (which appears to be unique to the treaty between Mexico and the United States) is strange in that it uses a US term of art[70] apparently to protect a Mexican interest, namely potential abuse of its low interest withholding tax rates.[71] Presumably, Mexico would wish to interpret this expression in accordance with the US administrative practice referred to above[72] and, although it seems safe to assume that treaty interpretation rules would support this[73]

57. Canada–Mexico treaty, Art. 27(3).
58. An identical provision appears limited to a small number of other Canadian treaties.
59. Art. 10(2)(a).
60. In practice, because of the current exemption of dividends from Mexican withholding tax this provision will impact on dividends paid by French companies only.
61. See e.g. US Model Art. 16(2).
62. Arts. 11(1) and 12(1), respectively.
63. The OECD Model Art. 12(1) reads: "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State [i.e. shall not be taxable in the State of source] if such resident is the beneficial owner of the royalties".
Art. 11(1) of the Mexico–Netherlands tax treaty reads: "Interest arising in a Contracting State and paid to a resident of the other State may be taxed in that other State [i.e. the residence State has *a* right to tax] if the resident is the beneficial owner of the interest" [author's translation and emphasis]. OECD Model Art. 11(1) reads the same as the corresponding provision in the Mexico-Netherlands treaty, but without the beneficial ownership requirement.
64. Mexico appears to have taken over this provision from UK treaty practice where it is used regularly.
65. The standard varies from treaty to treaty, some, for example, applying where treaty shopping is the *main* purpose and others only where this is the *sole* purpose.
66. See Protocol Art. 3 to the Belgium–Mexico treaty.
67. The same omission appears in the English (but not the Spanish) text of the Swedish treaty's interest article (Art. 11(9). The unofficial Swedish text supports the English version.
68. US–Mexico treaty Protocol Art. 10.
69. US–Mexico treaty Art. 11(2).
70. See the Joint Committee on Taxation Explanation to the US–Mexico treaty, *Tax Treaties supra* note 37, at 62,221 which refers to a list of IRS rulings by way of illustration.
71. Although this provision is also of potential benefit to the United States, Mexico's relative concern at the time of negotiating the treaty must have been greater since this treaty contains their lowest treaty withholding tax rate (4.9%, to apply after five years) whereas the United States commonly has a zero percent treaty rate. The relevance of this provision has been greatly reduced by the subsequent unilateral reductions in Mexico's withholding rates but not entirely eliminated since the domestic provisions are in some respects narrower than the treaty provisions.
72. The Spanish text also uses the English expression "back-to-back". For relevant US administrative practice, see the IRS rulings referred to *supra*, note 70.
73. Being an undefined expression, the "renvoi" clause in Art. 3(2) would import the national definition of the country applying the treaty, subject to the context otherwise requiring. While there may be differing views as to which of the two countries is "applying" the treaty for these purposes, (see Avery Jones *supra* note 17) in the absence of a national (Mexican) definition of the expression, the "context" would in any event seem to require taking the definition contained in the other country's (i.e. the United States) law (see Art. 3 Commentary para. 12).

© 1994 International Bureau of Fiscal Documentation

given the uncertainty surrounding the issue, a specific confirmation or other treaty definition would have been welcome.

D. Thin capitalization explicitly covered

Five of Mexico's treaties make explicit reference to thin capitalization.[74] Aside from these explicit references, all save one of its treaties[75] address the issue indirectly by way of the interest article "special relationship" provisions. Under standard OECD-based treaties the interest article is disapplied where "the amount of the interest, *having regard to the debt-claim for which it is paid*, exceeds [an arm's length] amount".[76] Under the Mexican variant (and indeed under many modern treaties) the interest article can be disapplied where "the amount of the interest exceeds, *for whatever reason*, [an arm's length amount]".[77] This variant is designed to permit adjustments in the case not only where the rate is excessive but also where the amount of debt is excessive, i.e. in an arm's length situation would have been equity capital.[78] Although the primary effect of the "special relationship" provisions would appear to be to disapply the treaty rates of interest withholding tax, it is generally accepted that they would also permit disallowance of an interest deduction.[79] The reasons for adopting a specific reference to thin capitalization rules may vary from country to country. In France, the concern is more with possible infringement of treaty non-discrimination provisions.[80] Countries may also be concerned that their thin capitalization rules (especially where they apply a fixed debt-equity ratio) may infringe the treaty "arm's length" standard.[81] As for Mexico, although it does not have thin capitalization legislation as such it does have rules for recharacterizing interest as dividends which these treaty references are presumably intended to cover.

A little more surprising is that the above "special relationship" amendment made in respect of the interest article also appears in the royalty article of most of Mexico's treaties.[82] It has been indicated that this amendment is intended to have a similar effect to that in the interest article[83] although not, presumably, in the context of domestic thin capitalization rules.[84] The amendment would seem to make it possible to have regard to all aspects of the licence arrangements in determining whether the royalty is excessive and to take into account factors other than the particular "use, right or information for which [the royalties] are paid[85] such as, for example, licensees' "maintenance" obligations (e.g. to protect, register, etc.). The amendment is, however, unlikely to make disallowances of royalty deductions significantly easier for tax administrations, since all of Mexico's treaties contain an "associated enterprises" article[86] which should have a similar effect (although the scope of the associated enterprises provision can in practice be somewhat narrower than that of the special relationship provisions). Since treaty withholding tax rates on royalties are in general no lower than those on dividends, there would be little to gain the tax administration in invoking the royalty special relationship provisions from a withholding tax perspective, unless this could be done without conceding that the payments had to be treated as dividends under the treaty.

E. Assorted anti-avoidance measures

Mexico's treaties contain a variety of additional provisions, some more common than others, all designed in one way or another to combat treaty abuse. Domestic controlled foreign company legislation is given explicit legitimacy in a number of treaties,[87] although this does not seem generally to be regarded as necessary.[88] Similar protection is given in the Mexico–Spain treaty[89] to the respective "tax haven" laws of the treaty partners. Further anti-abuse provisions include "subject to tax" provisions[90] as well as holding periods.[91]

VI. ENTERTAINING DOUBTS

A number of oddities appear in the "Artistes and Sportsmen" provisions of the Mexican treaties (or "Artistes and Athletes" for those treaties based on the 1977 OECD Model) which in particular illustrate the importance of clear and accurate drafting. In the first part of the standard OECD text,[92] the two generic terms used are "entertainers" and "sportsmen(1992)/athletes(1977)", the former being elaborated by way of a number of examples ("such as a theatre, motion picture, radio or television artiste, or a musician"). Two of the Mexican treaties omit the words "such as" in the previous quote so that, for example, "musicians" are no longer examples of "entertainers".[93] The result is that when the terms

74. See Mexico–France treaty Protocol Art. 5, Mexico–Germany treaty Protocol Art. 2, Mexico–Italy treaty Protocol Art. 7, Mexico–Spain treaty Protocol Art. 5 and Mexico–United States treaty Protocol Art. 9.
75. The exception being the treaty with Switzerland.
76. OECD Model Art. 11(6) (emphasis added).
77. Mexico Model Art. 11(7) (emphasis added). Although the equivalent provision in the French and Canadian treaties differs somewhat from the Mexican Model the broad effect is the same (although in the case of the Canadian version it is not clear that disapplication would be limited only to the "excessive" part of the interest payment).
78. See OECD, *Issues in International Taxation No. 2, Thin Capitalisation* (Paris: OECD, 1987), at para. 61.
79. *Id.* para. 61.
80. See Delattre and Streiff, "France Adopts New Thin Capitalization Rules", 2 *Journal of International Taxation* (1991), at 171.
81. It is notewothy that of the treaties which deal specifically with domestic thin capitalization rules, only the French treaty makes these subject to the arm's length standard.
82. The exceptions being Canada and Switzerland, as well as the Mexican Model itself. Despite not featuring in the latter, this is presumably a Mexican innovation since it appears to be unique to Mexico's treaties.
83. See e.g. Dutch technical explanation to the Mexico–Netherlands treaty (*supra* note 29, at 10).
84. See e.g. the mention of thin capitalization in the Mexico–Italy treaty, which refers to interest but not royalties.
85. This being the standard OECD terminology (OECD Model Art. 12(4)).
86. OECD Model Art. 9(1).
87. See e.g. Protocol Art. 13 to the Mexico–France treaty.
88. See OECD, *Issues in International Taxation No. 1, Double Taxation and the use of Base Companies* (Paris: OECD, 1987), at paras. 43-48.
89. Protocol Art. 13.
90. For a general formulation, see Protocol Art. 12 to Germany–Mexico treaty, and for a specific formulation (limited to royalties only), see Art. 12(3) of the France–Mexico treaty.
91. See Spain–Mexico treaty Art. 23(1) which requires a two year holding period before credit for underlying tax will be granted.
92. OECD Model Art. 17(1).
93. See Mexico's treaties with Ecuador and Spain Art. 17.

© 1994 International Bureau of Fiscal Documentation

"entertainer" and "sportsman/athlete" are repeated in the second part of the article[94] the relevant provision (permitting source state taxation where the income accrues to a third person) does not (at least on its face) apply to the "examples" cited above (e.g. musicians).[95] A similar issue, peculiar to the Mexican treaties arises where the Mexican Model formulation is used[96] to extend the scope of the article to cover "endorsement" income (i.e. income relating to the individual's "reputation").[97] This is achieved by stating that income referred to in the first paragraph of Article 17 shall include endorsement type income. Since this definition is not carried over to the second paragraph of Article 17 (permitting source state taxation where "income" accrues to a third person) the latter provision would (again on its face)[98] not extend to endorsement type income. The final comment on this provision is the apparent difficulty the respective treaty drafters had in formulating the provision regarding endorsement type income, particularly as regards the degree of nexus between the entertainer and his income-generating activities on the one hand and the source state on the other. In the German treaty, for example, endorsement income should simply be "derived from" the source state to be taxable.[99] Precisely what this means is unclear but it does not seem to require a physical presence of the entertainer in the source state. Other treaties reinforce this conlusion by making it clear that, in addition to the requirement that the income be derived from (or "arise in") the source state, a physical presence is also required.[100] Interpretation difficulties may be expected as regards these sourcing concepts. For example, where the term "arise" is used, it is not clear whether the rules which define the source of interest for treaty purposes (e.g. OECD Model Article 11(5)) will apply. In conclusion, this provision as a whole appears in need of an overhaul to provide consistency and clarity.

94. OECD Model Art. 17(2).
95. The only solution for the tax administration would be to argue that the context required the same definition to apply for both parts of Art. 17.
96. See e.g. Italy–Mexico treaty Art. 17(1).
97. This issue is peculiar to the Mexican treaties because Mexico appears to be the only country to cover this kind of income explicitly in its treaties.
98. See *supra* note 95.
99. See e.g. Mexico–Germany treaty Art. 17.
100. See e.g. Mexico–Switzerland treaty Protocol Art. 8.

IBFD'S NAFTA LIBRARY: COMPLETE INFORMATION ON TAXATION AND INVESTMENT POLICIES IN CANADA AND MEXICO...

TAXATION & INVESTMENT IN CANADA

The laws and systems of federal and provincial governments.

Individual, corporate, business and property tax systems
Determination of tax base, application of rates and tax credits
Description of Canada's treaty network and measures for the relief of double taxation
International transfer pricing and anti-avoidance rules
Taxation of branches of foreign companies and other types of vehicles for international investment in Canada
Overview of federal Goods and Services Tax (GST)
Taxation of financial institutions, insurance companies and specialized industries
Income tax incentives
Important details of provincial taxes
Full information on investment for companies and individuals

Includes information on both the Canada-United States Free Trade Agreement and the North American Free Trade Agreement.

New subscription 1994: NLG 400
Includes 1994 & 1995 updates
One binder, updated twice a year

TAXATION & INVESTMENT IN MEXICO

A complete picture of business and taxation in Mexico.

Taxation of resident entities' income
Taxation of resident individuals
Taxation of non-resident entities and individuals
Taxation of specific businesses or activities
Taxation of specific types of income, with particular reference to investment income
Taxation of capital and capital transfers
Taxation of transactions
Other business taxes and charges
Tax incentives and reliefs
International tax aspects
Tax administration

A general introduction to Mexico provides background information and a separate section gives a brief analysis of NAFTA.

Includes all tax treaties concluded by Mexico (in English), with a treaty chart showing the final withholding tax on outbound investment income.

New subscription 1994: NLG 400
Includes 1994 & 1995 updates
One binder, updated twice a year

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on prices given
IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

IFA NEWS

PRESS RELEASE: 48TH IFA CONGRESS EXAMINES DEMERGERS AND INTEREST DEDUCTIBILITY

Nancy J. Payne, International Bureau of Fiscal Documentation, Amsterdam.

The 48th annual congress of the International Fiscal Association was held in Toronto, Canada, from 28 August to 2 September 1994. The participants included approximately 1100 tax specialists from 49 countries representing professional firms, the academic community, government and industry. Founded in 1938, IFA is the only non-governmental, non-sectoral international organization dealing with fiscal matters and its annual congress provides a unique forum for the discussion of international fiscal questions.

This year's congress focused on two important topics in international taxation: the deductibility of interest and other financing charges in computing income; and the national and international tax consequences of demergers. Discussion of the first topic resulted in agreement being reached on a résumé of the international tax issues involved in various types of debt-financed, cross-border transactions. Discussion of the second topic resulted in the approval by the General Assembly of the congress of a resolution urging the introduction of tax provisions, and the improvement of existing provisions, to ensure tax neutrality in the treatment of taxpayers involved in demergers. Details of both the résumé on deductibility of interest and the resolution on demergers are discussed further below.

For both topics, participants benefited from viewpoints expressed by panels of international experts, who explained the tax treatment and issues arising in various countries throughout the world. In addition, rules in the European Union applicable under the Mergers Directive, effective 1 January 1992, were outlined by Dirk Schelpe of the EU Commission. The panel members used a series of case studies to illustrate each type of transaction being considered, and the tax treatment and issues arising in selected countries. Participation from the floor was also encouraged, and many observations were made, resulting in several amendments to the draft resolution and résumé. It is expected that IFA's reputation as a leading body of tax professionals will ensure that the results of the proceedings will stimulate further discussion and influence developments in the areas of demergers and the deductibility of interest and other financing expenses.

A representative of OECD's Committee on Fiscal Affairs attending the congress, Frances Horner, indicated that OECD is currently studying the problems of mergers, demergers and reorganizations. OECD's goal is to investigate existing domestic law in member countries, with a view to greater harmonization of treatment, admittedly an ambitious task. Ms Horner commended IFA on its role in making the rules in different jurisdictions more accessible. For its part, IFA indicated its plans for closer cooperation with OECD and invited OECD to intensify its work on tax neutrality in respect of demerger transactions.

Discussion of the two main topics was followed by seminar discussions covering: NAFTA; transfer pricing corrections; effect of anti-avoidance rules on treaties; recent international transactions; and the OECD model. Seminar A dealt with the alternatives available to remove or reduce barriers to cross-border investment and capital flows in the three NAFTA countries. Seminar B covered secondary adjustments and other aspects of transfer pricing corrections. The question of whether domestic anti-avoidance rules can or should be used to interpret double taxation treaties was discussed in Seminar C. Seminar D outlined three major international business transactions, the Reed/Elsevier merger, the Rothmans/Dunhill demerger and, as an alternative to demerger, the USX/Marathon Oil restructuring. Seminar E covered the current OECD work programme and the OECD model. Finally, a special unscheduled seminar discussed recent treaty developments, including the Canada/USA protocol signed 31 August 1994.

Deductibility of Interest and Other Financing Charges in Computing Income

The deductibility of interest and other borrowing costs in international transactions is an important issue for both taxpayers and governments, particularly in light of the increased use of sophisticated financial instruments and international business and investment techniques. Despite the fact that most countries' tax legislation provides for the deduction of interest, relatively few countries have addressed the international issues of interest and financing costs in their domestic legislation. Further, model and bilateral treaties do not deal with such costs explicitly in the context of non-discrimination.

1. International tax issues

The main international tax issued involved are:
- Deduction of interest paid to non-residents.
- Deduction of interest incurred by residents to earn foreign-source income.
- Deduction of interest by non-residents.

2. IFA-résumé

The résumé adopted by the congress included the following observations and conclusions, among others:
- Taxation of an international business activity should not result in less than all the interest being deductible in either the country of residence, the country of source, or a combination of the two.
- Treating interest expense on debt used to produce exempt foreign-source income as fully deductible against domes-

© 1994 International Bureau of Fiscal Documentation

tic-source income has the effect of a financial incentive to encourage residents to invest abroad.
- Where a country decides to limit deductibility, it may use a tracing method or an allocation method to determine interest deductible against domestic and foreign-source income.
- For countries using a foreign tax credit system, a timing problem may arise if interest is deductible currently while income of a foreign subsidiary is not taxed until repatriated. However, solutions to this problem may involve complex legislation and create administrative problems.
- It is possible, in some cases, for taxpayers to eliminate tax in both the residence and source country by using a tax haven financing subsidiary ("double dip"). If the residence country permits a participation exemption for tax haven operations, it may be appropriate for this country to deny interest deductions for debt related to the tax haven operations.
- It is appropriate for source countries to defer the deductibility of interest attributable to a branch or subsidiary until the time of the imposition of withholding tax.
- In respect of thin capitalization, there is no single conceptually correct and administratively feasible rule to limit interest deductions where debt is excessive, or where an obligation contains elements of both debt and equity. Additional research and analysis on this matter is needed.

The panel was chaired by Prof. Paul R. McDaniel (USA) and included Prof. Cynthia Blum (USA), Friedhelm Jacob (Germany), William R. Lawlor (Canada), Aart Overbosch (Netherlands) and Prof. Richard Vann (Australia).

National and International Tax Consequences of Demergers

In the interests of tax neutrality, it is important that demergers can be effected, both nationally and internationally, without the demerged company or its shareholders realizing taxable income or capital gains. There is often a good business reason for the demerger of a company, particularly during periods of economic recession, however, tax considerations can be decisive in determining whether or not the demerger will proceed.

1. Definition of demergers

Demergers typically include the following three techniques:
- Spin Off: Distribution to shareholders of shares in a subsidiary ("resulting company") without the shareholders returning any of their shares in the demerged company.
- Split Off: Exchange of shares, with shareholders receiving shares in the subsidiary and returning to the demerged company all or part of their shares in the demerged company.
- Split Up: Dissolution of the demerged company (with or without formal liquidation), with shares of the subsidiary transferred to shareholders of the demerged company.

In short, a spin off is effected through a distribution, split off through an exchange of shares, and split up through a dissolution. The economic substance of these three demerger techniques is the same, despite the legal differences.

2. Tax issues

The main tax issues which arise are:
At the level of the demerged company:
- contribution of assets and liabilities to a new subsidiary in anticipation of the demerger must not give rise to current taxation of income or capital gains, rather a carry over of tax bases should be permitted.
- transfer of shares of the subsidiary to shareholders and/or liquidation of the demerged company must not give rise to corporate taxation on distribution.

At the level of the shareholders:
- receipt of new shares must not give rise to taxation of income or capital gains.

3. IFA resolution on demergers

The IFA resolution on demergers adopted by the congress included the following recommendations, among others:
- That domestic and international tax neutrality be available at all three levels of taxpayers (demerging companies, resulting companies and shareholders) for all three typical forms of demerger. This tax neutrality should cover the full range of tax provisions, including deferral of taxation on capital gains, transfer or retention of tax benefits and advantages, deferral of loss recognition and transfer/carry forward of tax loss relief, deferral of or exemption from taxation on share distribution, and corresponding relief for transaction taxes.
- That a financial demerger plan allocating all balance sheet items and their tax attributes be prepared on which an advanced ruling by the tax authorities should be possible. Such ruling should not, however, be a prerequisite to tax neutrality.
- That requirements at both the corporation and shareholder level be based on an objective approach and not be disproportionate, and that rules be specific, clear and precise.
- That countries amend their treaties to provide tax neutrality for taxpayers of a treaty country involved in a tax neutral demerger in the domestic country, and vice versa.

The panel was chaired by Prof. Lieven Denys (Belgium) and included Malcolm J. Gammie (United Kingdom), Mrs Anne Rutberg (Sweden), Prof. William P. Streng (USA), Guillermo O. Teijeiro (Argentina) and Jean-Marc Tirard (France).

For more information on the 48th Congress of the International Fiscal Association, contact Mr J.F. Spierdijk, Secretary General, Telephone: 31-10-4052990, Fax: 31-10-4055031.

The résumé on interest and other financing charges and the resolution on demergers will appear in the November issue of the *Bulletin*.

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

KEITH, Simon H.
Property tax in Anglophone Africa. A practical manual.
Washington, The World Bank. 1993. World Bank technical paper, No. 209, pp. 120.
(B. 13.488)

South Africa

INCOME TAX ACT 1993-1994.
Cross-referenced to Meyerowitz & Spiro on Income Tax.
Cape Town, The Taxpayer. 1993, pp. 288.
Consolidated text of the Income Tax Act 58 of 1962 as amended to 1 October 1993 with reference to Income Tax by Meyerowitz & Spiro.
(B. 13.484)

TAX GUIDE 1993-1994.
Johannesburg, Coopers & Lybrand and SANLAM. 1993, pp. 128.
Information guide on South African individual and corporate income taxes, VAT, international tax, donations tax, estate duty, exchange control, stamp, transfer and company duties.
(B. 13.486)

ASIA & THE PACIFIC

POLICY ANALYSIS THROUGH
macro-models: issues, techniques and applications in selected developing Asian countries.
Bangkok, United Nations Economic and Social Commission for Asia and the Pacific. 1993.
Development Papers, No. 14, pp. 344.
(B. 58.014)

Australia

CCH TAX EDITORS.
Australian capital gains tax. Principles and practice.
North Ryde, CCH Australia Limited. 1992, pp. 834.
Explanation of capital gains tax provisions as of 30 June 1992.
(B. 58.000)

AUSTRALIAN TAX REPORTS.
Volume 25. Court/AAT 1992-93.
North Ryde, Butterworths. 1993, pp. 1204.
Reports of court cases for the year of judgments 1992-93.
(B. 57.993)

POPE, J.; FAYLE, R.; CHEN, D.L.
The compliance cost of wholesale sales tax in Australia.
Sydney, Australian Tax Research Foundation. 1993.
Research Study No. 19, pp. 119.
This is the first study to have been undertaken into the compliance costs of the Australian WST. Compliance costs are simply those costs, such as internal staff time costs and professional fees, imposed on businesses in meeting the requirements of the WST. The WST's compliance costs in 1990/91 amounted to almost 2% of the total WST revenue. This study has quantified the administrative burden placed on taxpayers when government imposes a tax.
(B. 58.006)

China (People's Rep.)

INVESTITIONSRECHT. GESETZ
über Unternehmen mit ausschliesslich ausländischer Kapitalbeteiligung.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 3/93, pp. 63.
Introduction to the law on wholly foreign-owned enterprises. (Adopted on 12 April 1986 at the Fourth Session of the Sixth National People's Congress.)
(T. 22.363A)

FOREIGN INVESTMENT INCENTIVE
Schemes: People's Republic of China.
New York, United Nations, Economic and Social Commission for Asia and the Pacific. 1990, pp. 58.
Booklet giving information on the essential features of policies and regulations relating to foreign investment, incentive schemes, limitations and administrative procedures in the People's Republic of China. It is a useful aid for those involved in foreign investment and joint ventures.
(B. 58.016)

India

INTEREST TAX ACT & EXPENDITURE
Tax Act. With rules.
Delhi, Taxmann Publications Ltd. 1993, pp. 52.
(B. 57.965)

Indonesia

FOREIGN INVESTMENT INCENTIVE
Schemes: Indonesia.
New York, United Nations, Economic and Social Commission for Asia and the Pacific. 1991, pp. 117.
Booklet containing useful information, particularly for those involved in foreign investment and joint ventures, in the ESCAP region. Includes chapters on the essential features of policies and regulations relating to foreign investment, areas where foreign investments are encouraged, incentive schemes, limitations, administrative procedures and sources of investment information.
(B. 58.015)

Japan

GOMI, Yugi.
Japan Corporation Tax Law. Including Chapter III of Special Taxation Measures Law as of 1 April 1993.
Tokyo, Sozeishiryokan, Fujibokaikan Bldg., 3F, 2-10-28 Fujimi, Chiyodaku, Tokyo, 102, Japan. 1993, pp. 907.
English translation of the Corporation Tax Law and its related chapter (Chapter III) of the Special Taxation Measures Law; includes a brief explanation of the key provisions of these laws.
(B. 57.999)

GOMI, Yuji.
Guide to Japanese taxes 1992/93. 5th Edition.
North Ryde, CCH Australia Limited. 1992, pp. 440.
This fifth edition provides practical and up-to-date information on Japanese national and local taxes. It examines the basic structure of Japanese taxation, withholding income tax, assessment income tax, consumption tax, corporation tax, inheritance tax and gift tax. A special chapter covering local and other taxes includes individual and corporation inhabitant taxes, individual and corporation enterprise

© 1994 International Bureau of Fiscal Documentation

taxes, fixed assets tax, enterprise establishment tax and social insurance.
(B. 58.019)

AN OUTLINE OF JAPANESE TAXES 1993.
Tokyo, Ministry of Finance. 1993, pp. 359.
This annual edition incorporates changes in the Japanese taxation made for FY 1993 (1 April 1993-31 March 1994).
(B. 57.995)

Macau

LINHAS DE AÇÃO GOVERNATIVA
Plano de Investimentos.
Macau, Government Printer. 1994, pp. 232.
Government policies investment plan 1994. Analysis of the economic and financial situation in the Territory of Macau.
(B. 58.005)

New Zealand

STAPLE'S GUIDE TO NEW ZEALAND tax practice 1993-94. 54th Edition. Reviewed and updated by C.J. Mancer.
North Ryde, The Law Book Company Limited. 1994, pp. 1053.
This edition has been comprehensively updated to include reference to all the amendments to New Zealand tax law up to January 1994. Commentary is given on new issues, including controlled foreign corporations, depreciation, intercompany dividends, foreign investment funds, foreign investor tax credits, entertainment tax, hire-purchase agreements, non-dividend repatriations, objections, provisional tax, share losses, software, underlying foreign tax credits, bankruptcy, taxation and matrimonial property act, scrip and cash company dividends, superannuation, annuities, pensions and gratuities, estate planning, and GST.
(B. 57.998)

Papua New Guinea

UPPAL, J.S.
Agricultural taxation in Papua New Guinea.
Port Moresby, Institute of National Affairs. 1994, pp. 64.
Study on agricultutal taxation and the tariff system in Papua New Guinea.
(B. 58.009)

McGAVIN, P.A.
Economic security in Melanesia: key issues for managing contract stability and mineral resources development in Papua New Guinea, Solomon Islands and Vanuatu.
Port Moresby, Institute of National Affairs. 1994.
INA Discussion Paper No. 61, pp. 92.
(B. 57.979)

Singapore

BUSINESS PROFILE SERIES:
Singapore. 9th Edition.
Hong Kong, The Hongkong and Shanghai Banking Corporation Limited. 1993, pp. 56.
Introduction guide to the Singapore economic and investment climate, including taxation.
(B. 57.972)

GOODS AND SERVICES TAX:
Do I need to register? How do I prepare my GST return? How do I keep records and accounts?
Singapore, Inland Revenue. 1993, pp. 45.
Three booklets helping a person to decide whether he has to register GST, setting out in detail the GST record-keeping requirement and explaining how to prepare a GST return.
(B. 58.001/002/003)

GST GENERAL GUIDE FOR TRADERS.
Singapore, Inland Revenue. 1993, pp. 65.
(B. 58.004)

Vietnam

FOREIGN INVESTMENT INCENTIVE Schemes: Vietnam.
New York, United Nations, Economic and Social Commission for Asia and the Pacific. 1993, pp. 54.
Booklet containing useful information for those involved in foreign investment and joint ventures in the ESCAP region. Chapters include: essential features of policies and regulations relating to foreign investment, forms of foreign investment, areas where foreign investment is encouraged, incentive schemes, regulation of investment-related factors, relevant administratiove procedures, sources of investment information.
(B. 58.017)

CARIBBEAN

Barbados

DOING BUSINESS IN BARBADOS.
Amsterdam Price Waterhouse. 1994, pp. 133.
Updated information guide on doing business in Barbados including tax aspects based on material assembled in January 1994. Chapters include foreign investment and trade opportunities, banking and finance, exporting to Barbados, labour relations and social security, accounting principles and practices, tax system, taxation of individuals and corporations, tax administration, indirect taxes, taxation of foreign corporations, etc.
(B. 18.837)

Bermuda

INVESTMENT IN BERMUDA.
Amsterdam, KPMG International Headquaters. 1993, pp. 48.
A general guide to the economic and social background of Bermuda; regulatory and tax aspects of investing or setting up a business in Bermuda. All information is up-to-date as of 1 March 1993.
(B. 118.805)

Costa Rica

INVESTITIONSRECHT.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 12/93, pp. 106.
Introduction to the investment laws of Costa Rica, Honduras and Nicaragua. Includes the original Spanish text of Decreto 80-92 dated 12 June 1992 of Honduras and Ley 127-91 of 19 June 1991 of Nicaragua.
(L. 20.036/37A/B)

Netherlands Antilles

NETHERLANDS ANTILLES CORPORATE law. General editor Raymundo H.D. Debrot. 1993/1994 Updated edition.
Amsterdam, New Amsterdam Law Books, P.O.Box 53294, 1007 RG Amsterdam, The Netherlands. 1994. Kingdom of The Netherlands Law Series, Volume 2, pp. 155.
Practical guide for attorneys, tax consultants, accountants and corporate executives interested in maintaining international corporate mobility.
(B. 113.620)

METRY, Faroe.
Invorderingswetgeving in de Nederlandse Antillen. Een samenstelling van invorderingsteksten voor praktijk en studie. 2nd Edition.
Curaçao, Faroe Metry. 1993, pp. 100.
Compilation of legal text concerning the collection of taxes in the Netherlands Antilles.
(B. 18.836)

EUROPE

Austria

KODEX DES ÖSTERREICHISCHEN Rechts: Arbeitsrecht. 12. Auflage. Bearbeitet von Wolfgang Mazal.
Vienna, Linde Verlag Wien GmbH. 1994, pp. 650. 305 AS.
Labour law as of 1 April 1994.
(B. 113.811)

WIEDER, Bernhard.
Grenzkosten- und Absatzsegmenterfolgsrechnung im Versicherungsunternehmen. Theoretische Grundlagen und praktische Anwendungsmöglichkeiten im Rahmen des Vertriebscontrolling.
Vienna, Linde Verlag Wien GmbH. 1993.
Moderne Betriebswirtschaft, No. 8, pp. 276. 358.- AS.

© 1994 International Bureau of Fiscal Documentation

The insurance branch has been considered as a part of the economy where maximizing profits was less important than increasing turnover. The opening of the insurance business for banks, warehouses, etc. has given rise to the necessity of developing modern costs calculation and productivity measure methods for this branch. The author has studied the question of whether the marginal cost method can be used for calculating and quantifying the costs of the productive process product. By using the existing methods in trade and banking, he concludes that the marginal cost method is suitable.
(B. 112.779)

DEIBL, Maria.
Karriereplanung für Aufsteiger.
Vienna, Linde Verlag Wien AG. 1992, pp. 197.
The book deals with various motives concerning career planning. Questions dealt with: what are the motives of persons who wants to make a career, education, and who is a manager? The question of personality development, career behaviour attitude, teamwork, stress, career planning, applying for a job. A complete chapter dealing with the difficulties career women is included.
(B. 113.720)

Belgium

AUTENNE, J.; DE BRÓE, L.; KRINGS, E.; PARENT, X. a.o.
Controverses actuelles dans la jurisprudence fiscale; Knelpunten in de fiscale rechtspraak. Actes du colloque organisé par Jurisprudence Fiscale; Verslagboek van de studiedag georganiseerd door Fiscale Jurisprudentie, 27 November 1992.
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 297. 3950.- Bfrs.
Reports by various authors of a seminar organized on 27 November 1992 on some controversies in current fiscal jurisprudence.
(B. 113.727)

HUYSMAN, Sylvia.
Fiscale winst. Theorie en praktijk van het fiscaal winstbegrip in België.
Kalmthout, Uitgeverij Biblo. 1993, pp. 408.
Extensive study of the concept of profit in Belgian income tax.
(B. 113.615)

PROTECTION DES DROITS
fondamentaux du contribuable. Sous la direction de Robert Andersen et Jacques Malherbe.
Brussels, Etablissements Emile Bruylant SA. 1993.
Bibliothèque Fiscale, Vol. XXIV, pp. 296. 2600.- Bfrs.
Contributions by several Belgian authors on the subject "protection of fundamental rights in tax matters".
(B. 113.589)

FBW – FUNDAMENTALE
Belgische wetgeving. Boekdeel 1: Publiek recht, Burgerlijk recht, Gerechtelijk recht, Strafrecht; Boekdeel 2: Handels- en economisch recht, Fiscaal recht, Sociaal recht.
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 3627.
Belgian Tax Code containing sections on public law, civil law, procedural law, penal law, business law, tax law and social law.
(B. 113.642)

FISCOLEX 1994. WETBOEK VAN DE
Inkomstenbelastingen met uitvoeringsbesluiten en bijzondere wetgeving. Wetboek van de met de Inkomstenbelastingen gelijkgestelde belastingen met uitvoeringsbesluiten.
Samengesteld door S. Sablon.
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 907. 3500.- Bfrs.
Consolidated text of the income taxes (individual income tax, corporate income tax) for 1994 assessment year and other relevant taxes, updated as of 31 January 1994.
(B. 113.628)

VANISTENDAEL, Frans.
Wetboek Fiscaal Recht. Inkomstenbelastingen. Historisch. 2 Volumes.
Brussels, E. Story-Scientia Wetenschappelijke Uitgeverij, E. Bockstaellaan 228, 1020 Brussels. 1994.
Loose-leaf publication containing in chronological order the text of the 1964 Income Tax Code and the Royal Decree implementing the ITC and all the laws by which they were amended.
(B. 113.660)

DEBACKER, Jean-Jacques; GERNAY, Bruno.
Fiscale Wenken: Belgen en belastingparadijzen: mythe of werkelijkheid?
Diegem, CED-Samsom. 1994, pp. 181. 1982.- Bfrs.
Booklet on the use of tax havens in general and from a Belgian perspective.
(B. 113.563)

HINNEKENS, Philippe.
Belasting van niet-inwoners. Overzicht en analyse van het intern recht en impact van het verdragsrecht.
Kalmthout, Uitgeverij Biblo. 1994, pp. 153. 1643.- Bfrs.
Taxation of non-residents in Belgium.
(B. 113.695)

ABC DE LA DECLARATION A L'IMPOT
des personnes physiques 1994.
Diegem, CED Samsom. 1994, pp. 425.
Practical guide for filing the individual income tax return for assessment year 1994.
(B. 113.641)

FISCALE WENKEN: AFTREKBARE
kosten personenbelasting.
Diegem, CED Samsom. 1994, pp. 385. 1982.- Bfrs.
Detailed overview of all deductible expenses in the individual income tax for 1994 assessment year.
(B. 113.564)

LAMBERT, Thierry.
Fiscale Wenken: Huwelijk en fiscus; Signaux Fiscaux: Mariage et fisc.
Diegem, CED Samsom. 1994, pp. 246. 1982.- Bfrs.
An overview of tax consequences of marriage, cohabitation, separation, and divorce.
(B. 113.661)

BETTEN, Rijkele.
Fiscaal emigreren naar België.
Lelystad, Koninklijke Vermande BV. 1994, pp. 180.
Booklet describing fiscal and legal aspects of emigration of Dutch persons to Belgium. Comparison of the principles of the Dutch and Belgian tax systems, including the notion of "residency". Attention is paid to the source of income from employment, immovable and movable property, pensions, and substantial interest. A summary of the inheritance and gift law and an overview of the social security insurance are also given. The appendix contains copies of the double taxation agreement between the Netherlands and Belgium, the Belgian income tax return form for 1993, and a circular concerning taxation of selected foreigners in Belgium.
(B. 113.629)

DEFEYT, Philippe; LANNOYE, Nathalie; MULLENDERS, Martial.
Fiscale Wenken: Milieu en fiscus; Signaux Fiscaux: Ecologie et fisc.
Diegem, CED Samsom. 1994, pp. 210. 1982.- Bfrs.
Description of environmental taxes in Belgium and an overview of environmental taxes in other European countries.
(B. 113.662)

FISCOLEX. REGISTRATIE- EN
successierechten; Droits d'enregistrement et de succession. 1st Edition. Compiled by E. Spruyt.
Brussels, Kluwer Rechtswetenschappen. 1993, pp. 215. 2350.- Bfrs.
Compilation of texts of the Belgian regulation on registration and death duties.
(B. 113.726)

BAEL, J. van.
Fusies en splitsingen.
Deurne, Kluwer Rechtswetenschappen. 1993, pp. 528. 8448.- Bfrs.
Monograph describing the company law aspects of mergers and divisions in Belgium before and after the law of 29 June 1993.
(B. 113.728)

GRAPPERHAUS, F.H.M.
Afkeer van belastingheffing in België en in Nederland, vroeger en nu. Voordracht gehouden aan de Rijksuniversiteit te Gent op 20 maart 1990.
Brussels, E. Story-Scientia, De Jamblinne de Meuxplein 34-35, 1040 Brussels, Belgium; Zwolle, W.E.J. Tjeenk Willink, Koestraat 8, 8011 NK Zwolle, The Netherlands. 1990.
Gandaius Thorbecke Colleges, No. 16, pp. 43. 550.- Bfrs.

© 1994 International Bureau of Fiscal Documentation

Text of speech delivered on 20 March 1990 at the University of Gent by Professor Grapperhaus. Historical overview is given of the aversion of individuals in Belgium and the Netherlands to pay taxes which are considered to be a political instrument. Characteristics of the Belgian and Dutch society are also discussed.
(B. 113.666)

ESSERS, P.H.J.; JANSSEN, O.A.W.J.
Fiscale grensvergelijkingen. De invloed van de ondernemingsbelastingheffing in Nederland, België en Duitsland op de concurrentiepositie en de woon- en vestigingsplaatskeuze van ondernemingen en haar eigenaren.
Deventer, Kluwer. 1994, pp. 178.
Monograph discussing Dutch, Belgian and German corporate taxation as a factor for corporations and their members in choosing the place of residence of the business and its owners. The tax competitiveness of the systems of the three countries is considered.
(B. 113.802)

ANNUAIRE FISCAL 1994.1
Diegem, CED Samsom. 1994, pp. 708.
Annual updated edition of handbook covering description of corporate and individual income taxes, VAT, death duties and similar taxes.
(B. 113.876)

BELGIQUE. JURIDIQUE, FISCAL, social, comptable. 4th Edition.
Levallois-Perret, Editions Francis Lefebvre. 1994.
Dossiers Internationaux Francis Lefebvre, pp. 494. 433.- Ffrs.
Fourth edition of monograph on the Belgian tax system. Also deals with the France–Belgium income tax treaty.
(B. 113.885)

FISCOLEX – BELASTING OVER DE toegevoegde waarde. Actualisering 1993-1994/1. Bijgewerkt tot het Belgisch Staatsblad van 31 december 1993.
Deurne, Kluwer rechtswetenschappen. 1994, pp. 60.
Booklet containing the new and amended value added tax provisions as of 31 December 1993.
(B. 113.815)

Benelux

KAAM, M.J.M. van; MOLIJN, H.
Merkenbescherming in de Benelux. 3rd Edition.
Deventer, Kluwer; The Hague, Fenedex. 1994.
Fiscale en Juridische Documentatie voor Internationaal Zakendoen, No. 8, pp. 201.
Third edition of monograph dealing with trade mark protection in Belgium, Luxembourg and the Netherlands. This booklet is intended for entrepreneurs not dealing with trade mark protection on daily basis, but who need a practical explanation.
(B. 113.745)

Bulgaria

CLEMENS, Markus.
Handelsgesetzbuch.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausl. Wirtschafts- und Steuerrecht, Reihe A: Gesetzestexte und Erl., Heft 21/92, pp. 155.
Introduction to Bulgarian Commercial Law.
(B. 113.758)

Czech Republic

TAXATION IN 1994. CORPORATE and personal income taxes, VAT, excise duties and real estate transfer tax.
Prague, KPMG Reviconsult s.r.o. 1994, pp. 252.
Commentaries by KPMG Reviconsult and legislation translated by Trade Links. The booklet includes English translations of: The Income Taxes Act, No. 586/1992 Coll. of 20 November 1992 as amended by Act No. 323/1993 Coll.; The Value Added Tax Act, No. 588/1992 Coll. of 24 November 1992 in the wording of Act No. 321/1993 Coll.; The Excise Duty Act, No. 587/1992 Coll. of 20 November 1992 in the wording of Act No. 325/1993 Coll.; The Act on Inheritance Tax, Gift Tax and Real Estate Transfer Tax, Act No. 357/1992 Coll. in the wording of Act No. 322/1993 Coll.
(L. 200.254-257)

BOHATA, Petr.
Gesellschaftsrecht in der Tschechischen Republik und der Slowakei. Eine Einführung mit vergleichenden Tabellen. 1. Auflage.
Munich, Verlag Franz Rehm GmbH & Co KG. 1993, pp. 89.
Introduction to the Czech and Slovak company law.
(B. 113.443)

Denmark

LIGNINGSVEJLEDNINGEN 1993.
5 Volumes.
Copenhagen, Government Printer. 1994, pp. 2020.
Official tax assessment guidelines published by the Customs and Taxation Directorate, containing commentaries and explanations on the individual and corporate income tax legislation, decrees, circulars, etc. Volume I – Almindelig del: general part; Volume II – Erhvervsdrivende: business taxation; Volume III – Aktionæerer og selskaber: taxation of companies and their shareholders; Volume IV – Dobbeltbeskatning: unilateral and treaty provisions for the avoidance of double taxation; Volume V – Cirkulærer m.v.: texts of official circulars and indexes to the other volumes.
(B. 113.744)

EEC

HET EUROPEES ECONOMISCH Samenwerkingsverband (EESV).
Amsterdam, Moret Ernst & Young. 1993, pp. 32.
Booklet on fiscal and civil law aspects of the European Economic Interest Grouping (EEIG) with references to the treaty of the European Economic Area.
(B. 113.546)

HAUFLER, Andreas.
Commodity tax harmonization in the European Community. A general equilibrium analysis of tax policy options in the Internal Market.
Berlin, Springer Verlag GmbH., Heidelberger Platz 3, D 14197 Berlin, Germany. 1993.
Studies in Contemporary Economics, pp. 216.
(B. 113.676)

VOGEL, Klaus.
Taxation of cross-border income, harmonization, and tax neutrality under European Community Law. An institutional approach. With commentary by Johan Brands and Kees van Raad.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 50.
This booklet presents the view of Professor Klaus Vogel on the choice between the source principle and domicile principle.
(B. 113.766)

CODICE FISCALE COMUNITARIO.
Raccolta sistematica della legislazione e della giurisprudenza comunitaria in materia fiscale. Directed by Victor Uckmar, Mario Burgio and Paola De Martini.
Milan, Pirola Editore Spa. 1993, pp. 893.
EC tax Code. The book contains EC Tax Directives and the Italian implementing legislation, EC regulations and EC tax decisions.
(B. 112.805)

Corporate taxation in the EC.
London, Arthur Andersen. 1993, pp. 61.
Booklet containing information on harmonizing taxes in the EC, value added tax, direct tax – adopted measures, direct tax – proposed measures.
(B. 113.735)

Estonia

EESTI MAKSUD 1994.
Edited by Enn Roose.
Tallinn, Kirjastanud AS Vaba Maa. 1994, pp. 120.
Bound compilation of Estonian tax laws (in Estonian) enacted by 16 December 1993. The most important laws included are those on income tax, social security contributions, land tax, VAT, excise duties, customs duties, and assessment and collection of taxes.
(B. 113.708)

ESTONIAN TAXES. LAW ON taxation, income tax, value added tax, social tax, land tax, gambling tax, excise taxes, state

© 1994 International Bureau of Fiscal Documentation

fee, customs duty. As of 20 March 1994. Compiled by Enn Roose and edited by Piret Joalaid.
Tallinn, AS Vaba Maa. 1994, pp. 140.
Bound compilation of Estonian tax laws enacted by 20 March 1994, in English. The most important laws included are those on income tax, social security contributions, land tax, VAT, excise duties, customs duties, and assessment and collection of taxes.
(B. 113.760)

HUISKES, C.R.
De Europese vennootschap. Enkele beschouwingen omtrent het ontwerp-Statuut (1991) voor een Europese vennootschap.
Zwolle, W.E.J. Tjeenk Willink. 1993, pp. 331. 70.- Dfl.
Dissertation on the Draft EC Regulation on European company from the historical and practical point of view. The author considers the pros and cons of this multi- and supra-national form of company in various European countries with respect to the differences in the national legal systems. He discusses the following forms: holding company, parent and subsidiary, companies listed on the stock exchange and joint ventures.
(B. 113.616)

SPORTS MARKETING EUROPE.
The legal and tax aspects. Edited by Ian S. Blackshaw and Gillian Hogg.
Deventer, Kluwer Law and Taxation Publishers. 1993, pp. 482. 230.- Dfl.
The book deals with sports marketing, the legal and tax aspects, intellectual property rights, standard contract terms, insurance aspects, advertising and promotion, and many other issues and topics throughout Europe in a clear, concise and practical manner. The book is a useful source of reference to anyone engaged in marketing sports events in Europe.
(B. 113.759)

FISCALIDAD EUROPEA BASICA.
Translated and adapted by A. Maroto Saenz, N. Carmona Fernandez, L. Cisneros Guillem and I. Serret de Murga.
Valencia, Editorial CISS, S.A., Colón 1-5 planta, 46004 Valencia, Spain; Amsterdam, International Bureau of Fiscal Documentation, Amsterdam, The Netherlands. 1992, pp. 706.
Spanish translation of the original title "European Tax Handbook" published annually by the International Bureau of Fiscal Documentation, Amsterdam. Summaries of the taxation of corporations and individuals in European countries. Information on corporate taxes includes: national corporate income tax, other income taxes, net worth tax, payroll taxes, social security contributions, value added tax, withholding (plus treaty charts listing withholding tax rates) and non-resident corporations. Information on individual taxes includes: individual tax, national income tax, wage tax, other income taxes, net wealth tax, social security contributions, inheritance and gift taxes and non-residents. Particular attention is given to non-residents and relief from double taxation.
(B. 113.696)

EUROPEAN TAX HANDBOOK 1994.
Amsterdam, International Bureau of Fiscal Documentation. 1994, pp. 531. 350.- Dfl.
Annual handbook containing extensive, up-to-date summaries of the taxation of corporations and individuals in European countries. From Russia to Gibraltar, the taxation systems of over 30 countries are covered, together with a chapter on the EC. Information on corporate taxes includes: national corporate income tax, net worth tax, payroll taxes, social security contributions, VAT, withholding tax, and non-resident corporations. Information on individual taxes includes: individual tax, national income tax, wages tax, net wealth tax, social security contributions, inheritance and gift taxes and non-residents. Particular attention is given to non-residents and relief from double taxation.
(B. 113.754)

HOLDING COMPANIES IN EUROPE.
London, Arthur Andersen. 1993, pp. 25.
Updated edition of booklet containing brief overview of the current tax treatment of holding companies in Europe. Includes two important developments: tax exemption in Germany of gains arising on the disposal of shares in a foreign company, with effect from 1 January 1994; and the UK proposals for substantial changes to the tax imputation system in an attempt to solve the problem of surplus ACT.
(B. 113.736)

HEADQUARTERS LOCATIONS IN Europe.
London, Arthur Andersen. 1993, pp. 26.
Brief overview of the tax treatment of headquarters companies in some of Europe's favoured locations for this type of entity. The brochure also highlights what the incentives offered and other special concessions which may influence the decision to locate in a particular jurisdiction.
(B. 113.734)

FINANCIAL SERVICES IN THE new Europe. The Comparative Law Yearbook of International Business. Special issue, 1992. Editors Dennis Campbell and Mickela Moore.
London, Graham & Trotman; Dordrecht, Martinus Nijhof. 1993, pp. 377. £ 78.
Overview of the European response to the European Commission's attempt to create a "single market" in the areas of banking, securities and insurance. This issue also explains in detail the provisions of important EC Directives, such as the First and Second Banking Directives, the Investment Services Directive, and the numerous Directives relating to insurance.
(B. 113.858)

Finland

FINLANDS LAW.
Skatteförfattningarna 19994.
Helsinki, Juristförbundets Förlag. 1994, pp. 443.
Compilation of tax laws of Finland up to and including No. 179/1994 (23 February 1994) of the Finnish Official Gazette. The most important tax laws included in this book relate to income tax, net wealth tax, social security contributions, municipal income tax, turnover tax, VAT, stamp tax, inheritance and gift tax, customs duties and excises, as well as to tax assessment and collection of taxes. The book also contains a list of tax treaties in effect and the text of the Nordic income tax treaty. In addition, the text of the Accounting Law is reproduced. A chronological index and a topical index are included.
(B. 113.781)

NIEMINEN, Auvo; ANTTILA, Raimo.
Arvonlisäiverotus. Verovelvollisen opas.
Helsinki, WSOY Tietopalvelut. 1994, pp. 300.
Practical guide on VAT for taxpayers. Topics dealt with include liability to tax, taxable supply of goods and services, exemptions, credit mechanism, refunds, international aspects, filing of tax return (sample forms included). The text of the VAT Law and VAT Decree, as well as Circulars of the National Tax Board are appended.
(B. 113.663)

France

PRATIQUE LAMY FISCAL 1994.
Paris, Lamy SA. 1994, pp. 1696. 330.- Ffrs.
Annual practical guide to all aspects of French taxation.
(B. 113.525)

BRACHET, Bernard.
Le système fiscal français. 5th Edition.
Paris, Librairie Générale de Droit et de Jurisprudence. 1993, pp. 196.
Revised and updated edition of introductory book on the development of the present tax system in France and survey of the major current taxes.
(B. 113.617)

OPERATIONS INTERNATIONALES.
Pays et zones à fiscalité privilégiée. Mesures anti-évasion.
Levallois, Editions Francis Lefebvre. 1994, pp. 300. 445.- Ffrs.
Concise description of the tax systems or special tax incentives available in a number of foreign jurisdictions and the applicable French anti-avoidance rules. Covers European (including Cyprus, Malta and Tunisia), Caribbean and Asian territories offering various incentives or qualifying as tax havens.
(B. 113.683)

BANQUES. NORMES ET réglementations comptables.
Levallois, Editions Francis Lefebvre. 1994, pp. 1637. 685.- Ffrs.
Accounting regulations and standards of banks and financial institutions.
(B. 113.550)

BLANC, Jacques; MARZIALS, Alain.

© 1994 International Bureau of Fiscal Documentation

Les relations financières entre l'Etat et les collectivités locales.
Paris, Librairie Générale de Droit et de Jurisprudence. 1993, pp. 152. 95.- Ffrs.
Financial relations between the State and local and regional authorities.
(B. 113.618)

TRAVAIL HORS DE FRANCE.
Protection sociale.
Levallois, Editions Francis Lefebvre. 1994, pp. 620. 351.- Ffrs.
The social protection regime of French nationals seconded abroad.
(B. 113.682)

CODE PRATIQUE FRANCIS
Lefebvre: Fiscal. Code général des impôts. Livre des procédures fiscales. Directives et autres textes. A jour au 31 Mars 1994.
Levallois, Editions Francis Lefebvre. 1994, pp. 1280.
One binder including the French Tax Code, the annexes to the Tax Code and the Tax Procedures Code with reference, for each article, to the "Documentation Rapide" of Lefebvre covering the relevant article.
(B. 113.807)

VESTIGING ALS ZELFSTANDIGE.
Samengesteld o.l.v. J.A.M. Bartholomeus.
The Hague, Nederlands-Franse Kamer van Koophandel, Bezuidenhoutseweg 181, 2594 AH Den Haag. 1994, pp. 125.
Brochure giving information to those who intend to establish a business in France as an independent professional (including traders, ambulant traders and workers in the handicraft sector), a statutory overview of the legal and financial aspects.
(B. 113.672)

UW HUIS IN FRANKRIJK.
Samengesteld door Nederlands-Franse Kamer van Koophandel.
The Hague, Nederlands-Franse Kamer van Koophandel. 1991, pp. 106. 75.- Dfl.
Booklet dealing with various aspects of buying, owning and selling a house in France, from a legal and notarial, fiscal and insurance, banking and financial point of view.
(B. 113.671)

PHILIPPE, Jean-Jacques.
La TVA à l'heure Européenne.
Paris, Editions Litec. 1993, pp. 383. 235.- Ffrs.
France was the first country to introduce a VAT. This book begins with the historical development of the TVA introduced in France in 1954. Then it discusses VAT harmonization and the removal of fiscal frontiers in the EC under the VAT Directives. The majority of the book is devoted to the French VAT system.
(B. 113.803)

Germany

SCHAUM, Wolfgang.
Steuerpolitik durch Aufdeckung stiller Reserven.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 471. 86.- DM.
The author shows how considerable tax advantages may accrue by strategic disclosure of hidden reserves. At the time of reorganization, spin-offs, business lease out and inheritance planning, the requirements can be fulfilled.
(B. 113.414)

SAUER, Otto.
Schlagwortregister zur Rechtsprechung und Literatur des gesamten Steuerrechts 1993.
Bonn, Stollfuss Verlag. 1994, pp. 1850.
258.- DM.
1993 list of keywords in taxation. The manual provides in alphabetical order information and sources of tax law publications in 1993.
(B. 113.717)

FOLKES, Erika.
Steuer Paradiese für Deutsche.
Vienna, Verlag Orac. 1994, pp. 192.
39.80 DM.
How tax paradises can be used by German resident individuals. Tips, practical considerations and pitfalls are all described in an easy-to-read manner.
(B. 113.677)

KLINKENBERG, Dagmar.
Stichprobenverfahren zur Schätzung von Differenzen im Prüfungswesen.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 130. 58.- DM.
Sampling procedure to estimate the differences in case of inspection of auditing. To increase an auditor's efficiency, a sampling procedure is presented.
(B. 113.574)

ESSERS, P.H.J.; JANSSEN, O.A.W.J.
Fiscale grensvergelijkingen. De invloed van de ondernemingsbelastingheffing in Nederland, België en Duitsland op de concurrentiepositie en de woon- en vestigingsplaatskeuze van ondernemingen en haar eigenaren.
Deventer, Kluwer. 1994, pp. 178.
Monograph discussing Dutch, Belgian and German corporate taxation as a factor for corporations and their members in choosing the place of residence of the business and its owners. The tax competitiveness of the systems of the three countries is considered.
(B. 113.802)

KAPITEL "AUSSENSTEUERRECHT".
Sonderdruck aus "WP-Handbuch der Unternehmensbesteuerung". 2. Auflage.
Düsseldorf, IDW Verlag GmbH. 1990, pp. 206.
Reprint of chapter "Foreign Tax Law" of the "Manual for enterprise taxation".
(B. 113.697)

BÖTTGES-PAPENDORF, D.; DANKMEYER, U.; TILLMANN, J.
ABC der Bilanzierung nach neuem Handels- und Steuerrecht. 4. Auflage.
Bonn, Stollfuss Verlag. 1992, pp. 465.
Explanation of the basic aspects of the German law with regard to balancing business and tax law. Jurisprudence and policy of the tax authorities are taken into consideration. Examples from practice are used to provide an explanation.
(B. 111.984)

Hungary

DOING BUSINESS IN HUNGARY.
London, Kogan Page Limited. 1991, pp. 346, £ 16.95.
Detailed information book on doing business in Hungary. The material includes information on business infrastructure, foreign investment, economic reform and current policies, process of privatization, commercial law, the fisal regime, the labour market, options for British business, export and import, taxation and accounting issues.
(B. 113.784)

PRIVATISIERUNGSGESETZGEBUNG 1992.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausl. Wirtschafts- und Steuerrecht, Reihe A: Gesetzestexte und Erl. Heft 1/93, pp. 62.
Introduction to the Hungarian Privatization Law of 1992.
(B. 113.757)

Ireland

BRENNAN, Frank; MOORE, Paul; CARR, Padraic.
Corporation tax. 5th Edition.
Dublin, The Institute of Taxation in Ireland, 19 Sandymount Avenue, Dublin 4, Ireland. 1994,.pp. 500. £ 26.-.
Detailed explanation of the principles and practice of corporation tax in the Republic of Ireland. The book is based on legislation in force as of March 1994. Subjects considered include computation of profits, stock and other tax relief, distributions and advance corporation tax, companies' capital gains, double taxation and special classes of companies, self-assessment and administration.
(B. 113.769)

SOMERS, James D.
Irish value added tax.
Dublin, Butterworth Ireland Ltd. 1994, pp. 1416.
Commentary on the Irish VAT Law as of 30 April 1994; contains detailed examples showing how the law applies in practice.
(B. 113.836)

BUDGET 1994. FINANCIAL
statement of the Minister for Finance, 26 January 1994.
Dublin, Government Printer. 1994, pp. 229.
(B. 113.779)

© 1994 International Bureau of Fiscal Documentation

Italy

HILPOLD, Peter; STEINMAIR, Walter; ZANDANEL, Paul.
Grundriss des italienischen Steuerrechts.
Vienna, Manzsche Verlags- und Universitätsbuchhandlung. 1993, pp. 256. 560.- AS.
Principles of Italian tax law. Analysis of the Italian Income Tax Code.
(B. 113.767)

Malta

HANDELSVERTRETERRECHT.
Cologne, Bundesstelle für Aussenhandelsinformation. 1994.
Internationales und ausländisches Wirtschafts- und Steuerrecht, pp. 66.
Monograph describing the commercial law of Malta.
(B. 113.690)

Netherlands

FISCAAL MEMO 2.
Deventer, Kluwer. 1994, pp. 219. 27.75 Dfl.
Booklet containing the most important parts of the fiscal legislation applicable in 1994.
(B. 113.778)

AFTREKPOSTEN EN VRIJSTELLINGEN 1994. Checklist voor belastingbetalers.
Amsterdam, Lexico BV/Fiscoloog, Herengracht 503, 1017 BV, Amsterdam. 1994, pp. 256. 30.- Dfl.
Annual updated guide describing all the deductible expenses and exemptions for 1994 in the corporate income tax, individual income tax, net wealth tax and inheritance and gift taxes.
(B. 113.647)

TOL, M.C. van der; WOLF, Th.M. van der.
Fiscale problematiek rond de buitenlandse vaste inrichting of dochter.
The Hague, Delwel Uitgeverij BV. 1993, pp. 136.
Overview of tax consequences for Dutch entrepreneurs starting a business abroad. The authors consider and compare two forms of companies: foreign permanent establishment and foreign subsidiary of a Dutch BV, with reference to case law and relevant articles of Dutch tax law.
(B. 113.656)

HUIJSSOON, W.J.
De ontwikkeling van het begrip "vaste inrichting" in modelverdragen sinds 1925. De ontwikkeling van de definitie van de term "vaste inrichting" met nadruk op de geschiedenis van art. 5, leden 1, 2 en 7 OESO-modelverdrag 1977.
Rotterdam, Stichting Moret Fonds, P.O.Box 488, 3000 AL Rotterdam. 1994, pp. 76.
Reprint of a paper describing the historial development of the concept of "permanent establishment" used in model conventions of the League of Nations since 1925 and of the OECD. Includes a short bibliography and a list of cases referred to in the commentary.
(B. 113.790)

KLUWER LOONBELASTINGGIDS 1994.
Editor G.W.B. van Westen.
Deventer, Kluwer. 1994, pp. 219.
Annual guide for employer and employees relating to the wage tax law.
(B. 113.747)

BETTEN, Rijkele.
Fiscaal emigreren naar Belgie.
Lelystad, Koninklijke Vermande BV. 1994, pp. 180.
Booklet describing fiscal and legal aspects of emigration of Dutch persons to Belgium. Comparison of the principles of the Dutch and Belgian tax systems, including the notion of "residency". Attention is paid to the source of income from employment, immovable and movable property, pensions, and substantial interest. A summary of the inheritance and gift law and an overview of the social security insurance are also given. The appendix contains copies of the double taxation agreement between the Netherlands and Belgium, the Belgian income tax return form for 1993, and a circular concerning taxation of selected foreigners in Belgium.
(B. 113.629)

SCHEMATISCH OVERZICHT VAN de sociale verzekeringswetten. Samengesteld door L. Opheikens en H.C. de Groot. 67th Edition.
Deventer, Kluwer. 1994, pp. 26.
Social security premiums and payments for 1994.
(B. 113.519)

DE INVLOED VAN DE AWB OP het fiscale procesrecht (2). Bespreking van het rapport van de Commissie ter bestudering van de betekenis van de Algemene wet bestuursrecht voor het fiscale procesrecht.
Deventer, Kluwer. 1994. Geschriften van de Vereniging voor Belastingwetenschap, No. 194, pp. 34.
Commentary on the Commission's report studying the influence of the General Management Law on tax case procedure.
(B. 113.777)

LOUPPEN, H.G.J.
Het pensioen antwoordenboek. Antwoorden op de 250 meest gestelde vragen van werknemers over pensioenen.
Alphen a.d. Rijn, Samsom Bedrijfsinformatie. 1994, pp. 210.
Answers to the 250 most frequently asked questions of employees about old age pensions. Includes: different forms and systems of pensions for different persons, insurance possibilities and techniques, legal framework and role of the legislator.
(B. 113.791)

GRAPPERHAUS, F.H.M.
Afkeer van belastingheffing in België en in Nederland, vroeger en nu. Voordracht gehouden aan de Rijksuniversiteit te Gent op 20 maart 1990.
Brussels, E. Story-Scientia, De Jamblinne de Meuxplein 34-35, 1040 Brussels, Belgium; Zwolle, W.E.J. Tjeenk Willink, Koestraat 8, 8011 NK Zwolle, The Netherlands. 1990. Gandaius Thorbecke Colleges, No. 16, pp. 43. 550.- Bfrs.
Text of speech delivered on 20 March 1990 at the University of Gent by Professor Grapperhaus. Historical overview is given of the aversion of individuals in Belgium and the Netherlands to pay taxes which are considered to be a political instrument. Characteristics of the Belgian and Dutch society are also discussed.
(B. 113.666)

ALBERT, P.G.H.
Vaste inrichting.
Deventer, Fed. 1994.
Fed Fiscale Brochures, pp. 134. 61.50 Dfl.
Brochure describing the concept of permanent establishment as defined in the OECD 1963, 1977 and 1993 models of double taxation convention on income and capital and as defined in the national legislation. A bibliography and a register of tax cases are appended.
(B. 113.841)

ESSERS, P.H.J.; JANSSEN, O.A.W.J.
Fiscale grensvergelijkingen. De invloed van de ondernemingsbelastingheffing in Nederland, België en Duitsland op de concurrentiepositie en de woon- en vestigingsplaatskeuze van ondernemingen en haar eigenaren.
Deventer, Kluwer. 1994, pp. 178.
Monograph discussing Dutch, Belgian and German corporate taxation as a factor for corporations and their members in choosing the place of residence of the business and its owners. The tax competitiveness of the systems of the three countries is considered.
(B. 113.802)

DIJCK, J.E.A.M. van.
Genieten van inkomsten (art. 33, 34 en art. 38 Wet IB). 3rd Edition.
Deventer, Fed. 1994.
Fed Fiscale Brochures, pp. 233. 69.50 Dfl.
Third edition of monograph dealing with the concept of "receipt of income" provided by Secs. 33, 34 and 38 of the Income Tax Law, including an extended list of tax cases.
(B. 113.842)

FISCAAL MEMO 1, JANUARI 1994.
Deventer, Kluwer. 1994, pp. 238. 27.75 Dfl.
Information booklet on factual regulations in Dutch tax law as of 1 January 1994.
(B. 113.476)

VESTIGING ALS ZELFSTANDIGE.
Samengesteld o.l.v. J.A.M. Bartholomeus.
The Hague, Nederlands-Franse Kamer van Koophandel, Bezuidenhoutseweg 181, 2594 AH Den Haag. 1994, pp. 125.
Brochure giving information to those who intend to establish a business in France as an

© 1994 International Bureau of Fiscal Documentation

independent professional (including traders, ambulant traders and workers in the handicraft sector), a statutory overview of the legal and financial aspects.
(B. 113.672)

FISCALE SIGNALEN 1993/1994.
Rotterdam,.Loyens & Volkmaars. 1993, pp. 51.
Brochures mentioning the new tax developments for 1994. Summary of the most important items is given: depreciation allowances, employer savings plans, immovable property tax, gift and succession duties and disbursements from capital insurance.
(B. 113.372)

UW HUIS IN FRANKRIJK.
Samengesteld door Nederlands-Franse Kamer van Koophandel.
The Hague, Nederlands-Franse Kamer van Koophandel. 1991, pp. 106. 75.- Dfl.
Booklet dealing with various aspects of buying, owning and selling a house in France, from a legal and notarial, fiscal and insurance, banking and financial point of view.
(B. 113.671)

REUGEBRINK, J.; HILTEN, Mariken E. van.
Omzetbelasting. 7th Edition.
Deventer, Fed. 1993.
Fed Fiscale Studieserie, No. 6, pp. 405.
87.50 Dfl.
Seventh edition of book dealing with the general theory of turnover tax and practical aspects of VAT. This edition focuses more than the previous editions on the European Directives and case law, due to the provisions with respect to the abolition of fiscal frontiers within the EU.
(B. 113.839)

SMIT, J.A.
Borgtocht. Civielrechtelijke en fiscale aspecten.
Deventer, Fed. 1993.
Fed Fiscale Brochures, pp. 111. 54.50 Dfl.
Brochure dealing with the legal and tax aspects of security deposits, security guarantees and guarantors.
(B. 113.840)

BROUWER, R.; SPIEGEL, M.
Procederen tegen de fiscus.
Deventer, Fed. 1994.
Fed Fiscale Actualiteiten, No. 22, pp. 94.
37.50 Dfl.
As of 1 January 1994 there is a legal basis regulating the refund of a part of the costs incurred by the winning party. This brochure deals with the general aspects of procedures against the tax authority, and with specifics of this new development.
(B. 113.838)

Norway

REFSLAND, Thor.
Merverdiavgiftsloven av 19. juni 1969 med kommentar. Femte utgave Del I.
Oslo, Norsk Skattebetalerforening. 1994, pp. 724. 590.- NKr.
Value Added Tax Act annotated. 5th Edition of Part I, dealing with Secs. 1-28A of the Act, as amended up to April 1994.
(B. 113.814)

Poland

KODEKS PODATKOWY. ZBIOR
przepisow podatkowych.
Torun, Dom Organizatora. 1994, pp. 682.
Fiscal Code updated to 31 January 1994, including the consolidated texts of tax laws and parts of other legislation concerning taxes: tax obligations, income tax, corporate income tax, VAT, agricultural tax, forest tax, inheritance and gift tax, gambling duties, local taxes, etc.
(B. 113.845)

BRZEZINSKI, B.; KALINOWSKI, M.; OLESINSKA, A.
Zobowiazania podatkowe. Komentarz do ustawy.
Torun, Dom Organizatora, Towarzystwo Naukowe Organizacji i Kierownictwa. 1994, pp. 288.
Tax obligations prescribed by Law of 19 December 1980, as amended. The authors give article-by-article explanation and make references to current case law. Polish text of the relevant law and regulation is appended.
(B. 113.849)

BRZEZINSKI, B.
Zobowiazania podatkowie. W swietle orzecznictwa sadow.
Torun, Dom Oragnizatora. 1993, pp. 93.
Booklet on tax obligations as interpreted by the court in tax cases.
(B. 113.847)

OLESINSKA, A.
Odpowiedzialnosc osob trzecich za zobowiazania podatkowe podatnika.
Torun, Dom Organizatora. 1994, pp. 63.
The author's interpretation of the responsibility of third persons for another taxpayer's tax obligation, as provided by the law. Third person means husband/wife, members of the family, devisees, legatees, lessors, members of joint ventures, and firms.
(B. 113.846)

BRZEZINSKI, B.
Odpowiedzialnosc podatnika, platnika i inkasenta w prwie podatkowym.
Torun, Dom Organizatora. 1993, pp. 34.
The author's interpretation of the responsibilities of a taxable person, a taxpayer and the tax collector in the tax law.
(B. 113.848)

Portugal

GUIA FISCAL 1994.
Lisbon, Fisco. 1994, pp. 483.
This "Tax guide for 1994" contains a summary of the most relevant tax provisions in the individual and corporate income taxes, VAT, death duties, etc.
(B. 113.731)

THE PORTUGUESE TAX SYSTEM.
Lisbon, Centro de Estudios Fiscais, Direção Geral das Contribuições e Impostos. 1993, pp. 135.
A descriptive and comprehensive information about some major aspects of tax legislation on the main taxes in Portugal. The present text is in reference to 31 December 1992 and will be updated each year.
(B. 113.732)

Russia

SCHULUS, Alexej.
Standortbedingungen für ausländische Investitionen in Russland.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 174.
Location conditions for foreign investments in Russia. Description of all the formalities when doing business in Russia. Focus on the investment climate in general, legal organization forms, and the tax system.
(B. 113.575)

Slovak Republic

TAXATION IN 1994.
Corporate and personal income taxes, VAT, excise duties and real estate transfer tax.
Prague, KPMG Reviconsult s.r.o. 1994, pp. 252.
Commentaries by KPMG Reviconsult and legislation translated by Trade Links. The booklet includes English translations of: The Income Taxes Act, No. 586/1992 Coll. of 20 November 1992 as amended by Act No. 323/1993 Coll.; The Value Added Tax Act, No. 588/1992 Coll. of 24 November 1992 in the wording of Act No. 321/1993 Coll.; The Excise Duty Act, No. 587/1992 Coll. of 20 November 1992 in the wording of Act No. 325/1993 Coll.; The Act on Inheritance Tax, Gift Tax and Real Estate Transfer Tax, Act No. 357/1992 Coll. in the wording of Act No. 322/1993 Coll.
(L. 200.254-257)

BOHATA, Petr.
Gesellschaftsrecht in der Tschechischen Republik und der Slowakei. Eine Einführung mit vergleichenden Tabellen. 1. Auflage.
Munich, Verlag Franz Rehm GmbH & Co KG. 1993, pp. 89.
Introduction to the Czech and Slovak company law.
(B. 113.443)

Sweden

HANDLEDNING FÖR BESKATTNING
av inkomst och förmögenhet m.m. vid 1994 ars taxering.

© 1994 International Bureau of Fiscal Documentation

Stockholm, Skatteförvaltningen – Riksskatteverket. 1994, pp. 1277.
Tax handbook in two volumes for 1994 assessment year (year of income 1993), published by the National Tax Board. Volume I deals with the taxation of income and net wealth of individuals. Volume II covers the taxation of business income of companies and individuals.
(B. 113.681)

FÖRFATTNINGAR OM punktskatter 1994.
Stockholm, Riksskatteverket. 1994, pp. 242.
Compilation of material and procedural laws and regulations regarding exise taxes, etc. as they apply on 1 January 1994. Taxes dealt with include general and specific taxes on energy, tax on advertisements, excise taxes on alcoholic beverages and tobacco, taxes on winnings, tax on insurance premiums and stamp taxes.
(B. 113.782)

FÖRFATTNINGAR OM UPPBÖRD 1994.
Stockholm, Skatteförvaltningen – Riksskatteverket. 1994, pp. 332.
Compilation of material and procedural laws and regulations regarding collection of direct taxes and duties, as they apply on 1 January 1994.
(B. 113.694)

REGISTER ÖVER GÄLANDE SFS författningar, 1 januari 1994.
Stockholm, Justitiedepartementet. 1994, pp. 358.
Chronological and subject matter index to the Swedish Official Gazette listing laws in force as of 1 January 1994.
(B. 113.723)

MALMER, Håkan; PERSSON, Annika; TENGBLAD, Åke.
Århundradets skattereform. Effekter pa skattesystemets driftskostnader, skatteplanering och skattefusk.
Stockholm, Skatteförvaltningen & CE Fritzes AB. 1994, pp. 414.
Follow-up of the tax reform of 1990-1991 ("tax reform of the century"). The book contains two research reports. The first is written by Malmer and Persson, and studies the tax reform's effects on the administrative costs of the tax system, as well as various aspects on tax planning and tax evasion. The second, by Tengblad, studies the black market economy and the erosion of tax base in Sweden during 1980-1991. Both reports include an English summary.
(B. 113.768)

LODIN, Sven-Olof; LINDENCRONA, Gustaf; MELZ, Peter; SILFVERBERG, Christer.
Inkomstskatt – en läro- och handbok i skatterätt. 4th Edition.
Lund, Studentlitteratur. 1994, pp. 596. 722.- Skr.
Fourth edition of handbook on Swedish income taxation. The book covers all main aspects of: income and capital taxation of individuals, income taxation of companies (including groups of companies), international taxation, as well as methods for the avoidance of double taxation.
(B. 113.835)

Switzerland

CASTI-WERGENSTEIN, Peter Johannes Michael von.
Der Steuer- und Abgabebetrug im schweizerischen Recht.
St. Gallen, Hochschule St. Gallen für wirtschafts- und Sozialwissenschaften, Bibliothek, Dufourstrasse 50, 9000 St. Gallen, Switzerland. 1992. Schriftenreihe "Finanzwirtschaft und Finanzrecht", Band 59, pp. 360.
Tax and duty fraud according to Swiss law. Dissertation on fraud as a special topic of penal law.
(B. 112.321)

Turkey

GEWERBLICHER RECHTSSCHUTZ UND Wettbewerbsrecht.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993. Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 22/93, pp. 80.
Survey on the Turkish law on protection of patents and other intangible rights.
(B. 113.279)

United Kingdom

WHILLANS'S TAX TABLES 1994-95.
47th Edition. Edited by Sheila Parrington.
London, Butterworths. 1994, pp. 62. £ 3.50.
(B. 113.773)

FOREMAN, A.
Tax handbook 1994-95.
London, Longman Group UK Ltd., 21-27 Lam's Conduit Street, London WC1N 3NJ. 1994, pp. 592. £ 19.99.
The book deals with income tax, capital gains tax, inheritance tax, corporation tax and VAT. It also covers stamp duty and national insurance contributions.
(B. 113.832)

DOUBLE TAXATION RELIEF FOR companies.
London, Inland Revenue. 1994. International Series IR 6, pp. 34.
(B. 113.691)

BAKER, Philip.
Double taxation conventions and international tax law. A manual on the OECD Model Tax Convention on Income and on Capital of 1992. 2nd Edition.
London, Sweet & Maxwell. 1994, pp. 513.
The book, based on the OECD Model Double Taxation Convention, assesses the practical implications of treaty interpretation and uses both domestic and international case law to help explain how the treatises operate. This second edition has been updated to include the text of the 1992 OECD Model Tax Convention (in both English and French) which replaced the 1977 Model, along with the official OECD commentary.
(B. 113.804)

FRAMPTON, Dennis.
Practical tax administration.
Bath, Fiscal Publications, Old Coach House, Fersfield, Perrymead, Bath MA2 5AR. England. 1993, pp. 122.
The book provides tax administrators, including those in developing countries, with a comprehensive background to recent developments not readily available elsewhere. This book looks first at the older established practices of tax administration, examines the latest developments and then considers possible further changes in the decade ahead.
(B. 113.693)

DILNOT, A.; DISNEY, R.; JOHNSON, P.; WHITEHOUSE, E.
Pensions policy in the UK. An economic analysis.
London, The Institute for Fiscal Studies. 1994, pp. 225. £ 12.50.
The authors attempt to unravel the complexities of pension policy and provide answers or alternative options to the questions raised.
(B. 113.765)

SIMON'S TAXES FINANCE ACT 1994 Handbook. The provisions relating to income tax, corporation tax and capital gains tax with explanatory notes.
London, Butterworths. 1994, pp. 442. £ 20.-.
(B. 113.813)

ISSUES IN BUSINESS TAXATION.
Editor John Pointon.
Aldershot, Avebury Ashgate Publishing Ltd., Gower House, Croft Road, Aldershot, Hants GU11 3HR, England. 1994, pp. 229. £ 35.
The book is divided in three parts: the UK, Europe and multinational aspects. Contributions by various authors on UK taxation and capital investment, UK taxation and finance leasing, tax-induced investment incentives and leverage gains in the EC, capital structure, the harmonization of corporate taxation within the EC, controlled foreign companies, multinational capital budgeting and finance decisions.
(B. 113.857)

BUTTERWORTHS YELLOW TAX Handbook 1994-95. Income tax, corporation tax, capital gains tax. 33rd Edition. Editors Malcolm Gammie and Moiz Sadikali.
London, Butterworths. 1994, pp. 6000. £ 20.-.
(B. 113.875)

HOMER, Arnold; BURROWS, Rita.
Tolley's tax guide 1994/95. 12th Edition.
Croydon, Tolley Publishing Co Ltd. 1994, pp. 566. £ 24.50.

© 1994 International Bureau of Fiscal Documentation

Annual updated edition dealing with income tax, corporation tax, capital gains tax, inheritance tax, value added tax and stamp duty. Also chapters on council tax and business rates, national insurance contributions and statutory sick pay and statutory maternity pay. This edition gives the position for the year 1994/95 and covers all legislation, statements of practice and other relevant sources of information including the Finance Act 1994.
(B. 113.800)

BUTTERWORTHS ORANGE TAX
Handbook 1994-95. Inheritance tax, national insurance contributions, stamp duties, VAT. 19th Edition. Editors Malcolm Gammie and Moiz Sadikali.
London, Butterworths. 1994, pp. 4850. £ 20.-.
(B. 113.874)

BUTTERWORTHS UK TAX GUIDE
1994-95. Income tax, capital gains tax, corporation tax, inheritance tax, national insurance contributions, stamp duties, value added tax. 13th Edition. Editor John Tiley.
London, Butterworths. 1994, pp. 2715. £ 19.95.
(B. 113.860)

INTERNATIONAL

Developing Countries

HASHIM, Ali; ALLAN, Bill.
Core function requirements for fiscal management systems.
Washington, International Monetary Fund. 1994.
IMF Working Paper WP/94/27, pp. 37.
This paper presents a framework for planning the development of computerized government budgeting and accounting systems in economies in transition and developing economies.
(B. 58.008)

DERIVATIVES. AN INTERNATIONAL tax survey.
Amsterdam, KPMG International Headquarters. 1994, pp. 75.
This survey provides relevant and timely information for formulating an overview of the state of world derivative markets. It does not cover all aspects of the tax treatment, but concentrates on important features and highlights territorial differences.
(B. 113.730)

1994 INTERNATIONAL TAX summaries. A guide for planning and decisions. Coopers & Lybrand International Tax Network. Editor George J. Yost.
New York, John Wiley & Sons, Inc. 1994, pp. 1550.
An overview of the tax systems of 114 countries with emphasis on individual and corporate income taxes as of 31 July 1993.
(B. 113.786)

TAX AND FINANCIAL INCENTIVES for business around the world. 1994 Edition.
Amsterdam, KPMG International Headquarters. 1993, pp. 487.
Country-by-country summary of significant tax and financial incentives offered by national (and in some cases, state, provincial or local) governments. Topics examined include: tax-related reliefs and incentives, tax deductions for capital expenditure, grant aid or other financial assistance for overseas enterprises setting up locally, tax-based sources of finance, tax incentives and special reliefs for expatriates working locally, business relief available from taxes, double taxation agreements, infrastructure and business environment in each country.
(B. 113.729)

OPERATIONS INTERNATIONALES.
Pays et zones à fiscalité privilégiée. Mesures anti-évasion.
Levallois, Editions Francis Lefebvre. 1994, pp. 300. 445.- Ffrs.
Concise description of the tax systems or special tax incentives available in a number of foreign jurisdictions and the applicable French anti-avoidance rules. Covers European (including Cyprus, Malta and Tunisia), Caribbean and Asian territories offering various incentives or qualifying as tax havens.
(B. 113.683)

SANDLER, Daniel.
Pushing the boundaries: the interaction between tax treaties and controlled foreign company legislation.
London, The Institute of Taxation. 1994, pp. 152. £ 19.95.
This book reviews the potential conflict between the controlled foreign company legislation found in the US, Germany, Canada, Japan, France, the UK, New Zealand, Sweden, Australia and Norway and the tax treaties of each of these countries. These ten countries have enacted specific statutory regimes to counteract the perceived abuse of controlled foreign companies located in "tax havens".
(B. 113.692)

WORLD INVESTMENT REPORT 1993.
Transnational corporations and integrated international production.
New York, UN – United Nations. 1993, pp. 288.
Report providing data and analysis on recent trends in foreign direct investment, the activities of transnational corporations and relevent policy issues, along with in-depth examinations of selected themes regarding the role of transnational corporations in worldwide economic development.
(B. 113.707)

HORWATH INTERNATIONAL
International tax planning. Expatriates & Migrants.
North Ryde, CCH Australia Limited. 1992.
Loose-leaf publication (updated up to February 1994) provides an in-depth country-by-country review of the important considerations for individuals contemplating transborder migration. In addition to the general introductory section, a more detailed survey is provided for 25 countries. Each country chapter is divided into inbound and outbound subsections, and each subsection discusses the most relevant tax consequences of moving from one tax jurisdiction to another.
(B. 113.487)

BILATERAL INVESTMENT TREATIES 1959-1991.
New York, UN – United Nations. 1992, pp. 46.
An updated list of bilateral investment treaties concluded to mid-1991.
(B. 113.756)

HICKS, Alan.
Foreign exchange options. An international guide to options trading and practice.
Cambridge, Woodhead Publishing Limited, Abington Hall, Abington, Cambridge CB1 6AH, England. 1993, pp. 370. £ 55.-.
This book examines the over-the-counter (OTC) market in detail and covers the two dominant exchanges for currency options: The Philadelphia Stock Exchange (PHLX) and The Chicago Mercantile Exchange (CME). The book contains chapters on: option combinations, option pricing, option trading risks, hedging and trading a portfolio of options, OTC market practice, management control of an active portfolio, international currency options market (ICOM) terms and conditions, counter-praty credit risk (OTC), accounting for currency options, option derivatives and the future.
(B. 113.673)

RIVETT, Phil; SPEAK, Peter.
The financial jungle. A guide to financial instruments. 2nd Edition. Editors Phil Rivett and Peter Speak.
London, Coopers & Lybrand, Plumtree Court, London EC4 4HT, England. 1992, pp. 684.
Guidance to understanding financial instruments and their risks and benefits in a way to render the subject accessible to both the designers and users of the instruments. This book is a useful publication for finance directors, treasurers, lawyers, accountants and financial advisors. Chapters include: debt instruments, asset-backed securities, equity and equity linked instruments, hedging instruments, country accounting and taxation framework, and a glossary of terms.
(B. 113.685)

YOUNGMAN, Joan M.; MALME, Jane H.
An international survey of taxes on land and buildings.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 225. 85.- Dfl.
This comparative survey of property tax law and administration is a successor to the 1983 OECD publication "Taxes on immovable property".
(B. 113.763)

THE EUROPA WORLD YEARBOOK 1994. Volume I. Part one: International organizations; Part two: Afghanistan–Jordan.

© 1994 International Bureau of Fiscal Documentation

London, Europa Publications Limited. 1994, pp. 1670.
(B. 113.770)

FILM FINANCING AND TAXATION.
Amsterdam, KPMG International Headquarters. 1994, pp. 162.
Summaries of the taxation systems in 10 countries as they apply to the film industry. Each chapter first provides a description of commonly used film financing structures and their commercial and tax implications for the parties involved. It then discusses in detail the tax and financial incentives available from central and local governments in that country. Further it sets out the applicable corporate tax, indirect tax, and personal tax rules from the perspective, in turn, of investors, producers, distributors, artistes and employees.
(B. 113.870)

CORPORATE TAXES.
A worldwide summary.
Amsterdam, Price Waterhouse. 1994, pp. 671.
Summary of basic information about corporate taxes in 115 countries and territories. (Tax rates and rules in effect as of 1 January 1994.)
(B. 113.872)

INTERNATIONAL TAX AND
Business Guide: Corporate and withholding tax rates.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 161.
Compilation of overviews provided by the staff of Deloitte Touche Tohmatsu International member firms in thirty-nine major nations. The book is intended to reflect conditions in the countries covered in April 1994.
(B. 113.859)

SHAREHOLDERS' LIABILITY.
The comparative law yearbook of international business. Special issue, 1993. Editors Dennis Campbell and Jennifer Powers.
London, Graham & Trotman Ltd., England; Dordrecht, Kluwer Academic Publishers Group, The Netherlands. 1993, pp. 505.
280.- Dfl.
This volume examines one of the key aspects of corporate responsibility – the rights, duties and liabilities of corporate management and of shareholders. Provides an in-depth exposition of the rights, duties and liabilities of shareholders vis-à-vis the company and other shareholders. The book has contributions from eminent legal practitioners and scholars from several countries.
(B. 113.837)

DEDUCTIBILITY OF INTEREST AND
other financing charges in computing income. 48th Congress of the International Fiscal Association, Toronto, 1994.
Deventer, Kluwer. 1994.
IFA Cahiers de Droit Fiscal International, Volume LXXIXA, pp. 729.
A summary in French, English, German and Spanish of each country report is appended. The report by the general reporter Prof. Brian J. Arnold is published in full in the four languages.
(B. 113.864)

BIN XU
Tax policy implications in endogenous growth models.
Washington, International Monetary Fund. 1994.
IMF Working Paper WP/94/38, pp. 31.
This paper surveys the tax policy implications in various endogenous growth models. The focus is on the long-run growth effects of income, consumption, and investment taxation in models whose engine of growth is the accumulation of human capital, technological innovation, and/or public infrastructure.
(B. 113.749)

NATIONAL AND INTERNATIONAL
tax consequences of demergers. 48th Congress of the International Fiscal Association, Toronto, 1994.
Deventer, Kluwer. 1994. IFA Cahiers de Droit International, Volume LXXIXb, pp. 689.
A summary in English, French, German and Spanish of each report is appended. The report by the general reporter Prof. Dr A.J. Rädler is published in full in the four languages.
(B. 113.865)

INDIVIDUAL TAXES.
A worldwide summary.
Amsterdam, Price Waterhouse. 1994, pp. 432.
This guide is intended mainly for the expatriate employee and the multinational employer. It provides a summary of basic information about individual taxes and tax rates in 114 countries and territories. The guide reflects tax rates and rules as of 1 January 1994.
(B. 113.871)

GUPTA, S.; MAHLER, W.
Taxation of petroleum products: theory and empirical evidence.
Washington, International Monetary Fund. 1994.
IMF Working Paper WP/94/32, pp. 27.
This paper surveys different considerations advanced for taxing petroleum and presents petroleum tax rate data in 120 countries.
(B. 113.748)

OECD

CNOSSEN, Sijbren.
What kind of corporation tax? Issues in adopting and designing a value added tax.
Rotterdam, Erasmus University. 1993. OCFEB Reprint No. 9306, pp. 105.
(B. 113.725)

TAX INFORMATION EXCHANGE
between OECD member countries. A survey of current practices. A report by the Committee on Fiscal Affairs; Echange de renseignements fiscaux entre les pays membres de l'OCDE. Vue d'ensemble des pratique actuelles.
Paris, OECD Organisation for Economic Co-operation and Development. 1994, pp. 110.
This bilingual book examines the exchanges of tax information under Article 26 of the OECD Model Tax Convention on Income and on Capital from a legal administrative and practical standpoint.
(B. 113.689)

TAXATION AND SMALL BUSINESSES.
Paris, OECD Organisation for Economic Co-operation and Development. 1994, pp. 125.
This report summarizes the way OECD countries have balanced conflicting aims and provides information on the importance of the small business sector and its tax treatment.
(B. 113.778)

TAXATION OF NEW FINANCIAL
instruments.
Paris, Organisation for Economic Co-operation and Development. 1994, pp. 111.
Results of an analysis of the application of domestic laws and tax treaties to four particular types of instruments: interest rate swaps, financial futures, options to buy shares, and bonds issued at a deep discount.
(B. 113.877)

THE OECD GUIDELINES FOR
multinational enterprises.
Paris, Organisation for Economic Co-operation and Development. 1994, pp. 81.
Report explaining the nature and scope of the OECD Guidelines.
(B. 113.816)

OECD ECONOMIC STUDIES:
Employment regulation and patterns of work in EC countries; Unemployment persistence; The role of real and nominal rigidities in macro-enonomic adjustment: a comparative study of the G3 economies; Interpreting unemployment: the role of labour force participation; Centralization of wage bargaining and macro-enonomic performance - a survey.
Paris, Organisation for Economic Co-operation and Development. 1994.
OECD Economic Studies, No. 21, Winter 1993, pp. 207. 170.- Ffrs.
(B. 113.805)

THE OECD JOBS STUDY.
Facts, analysis, strategies. Unemployment in the OECD area, 1950-1995.
Paris, Organisation for Economic Co-operation and Development. 1994, pp. 50.
This study sets out the facts that depict today's unemployment, analyses the fundamental factors that produce it and that could move OECD economies towards full employment. It put forward a menu of measures that will help create jobs.
(B. 113.806)

TRANSFER PRICING GUIDELINES
for multinational enterprises and tax administrations. Report of the OECD Committee on Fiscal Affairs. Part I: Principles and methods. Discussion draft.

© 1994 International Bureau of Fiscal Documentation

Paris, Organisation for Economic Co-operation and Development. 1994, pp. 142.
(B. 113.902)

LATIN AMERICA

INVESTITIONSRECHT.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 12/93, pp. 106.
Introduction to the investment laws of Costa Rica, Honduras and Nicaragua. Includes the original Spanish text of Decreto 80-92 dated 12 June 1992 of Honduras and Ley 127-91 of 19 June 1991 of Nicaragua.
(L. 20.036/37A/B)

ECONOMIC AND SOCIAL
progress in Latin America. 1993 Report.
Special section: Investing in human resources.
Washington, Inter-American Development Bank. 1993, pp. 308.
This special section looks at the current condition of Latin America's human resources and its relation to economic growth, technology and poverty.
(B. 18.826)

Brazil

REGULAMENTO DO IMPOSTO
sobre a renda e proventos de qualquer natureza. Decreto No. 1.041 de 11/01/94.
Brasilia, Government Printer. 1994, pp. 345.
Decree 1.041 of 11 January 1994 approving the (new) regulation on the taxation of income and capital gains.
(B. 18.835)

Colombia

REGIMEN DEL IMPUESTO A LA
renta y complementarios.
Bogota, Legis Editores S.A. 1994, pp. 1020.
Loose-leaf publication on the taxes on income, supplementary taxes and succession tax.
(B. 18.827)

REGIMEN COLOMBIANO DE
Impuesto a las Ventas. Incluye impuesto de timbre.
Bogota, Legis Editores S.A., Avenida Eldorado 81-10, Apartado 98888, Bogota.
1994, pp. 974.
This loose-leaf publication "Colombian Regime on Sales Tax" includes the stamp tax.
(B. 18.828)

Mexico

ORTIZ GOMEZ, G.; SAINZ ALARCON, J.; TRON,
M.E.; ERREGUERENA A, J.M.
Boletin sobre la Reforma Fiscal para 1992.
Mexico, Ortiz, Sainz y Tron, Porfirio Diaz 102, Colonia del Valle, Delegacion Benito Juarez, Mexico, D.F. 03100. 1992, pp. 174.
Explanation of the federal and federal district tax reform which entered into force on 1 January 1992. (An English translation of the most important items is appended.)
(B. 18.830/831)

ORTIZ GOMEZ, G.; SAINZ ALARCON, J.; TRON,
M.E.; ERREGUERENA A, J.M.
1994 Tax reform.
Mexico, Ortiz, Sainz y Tron. 1994, pp. 37.
Comments on federal and federal district tax reforms, various international treaties, and other related laws.
(B. 18.833)

NORMATIVIDAD EN MATERIA DE
deuda pública estatal y municipal.
Guadalajara, Indetec. 1994, pp. 336.
Legal provisions in respect of State and municipal public debt.
(B. 18.829)

LA JUSTICIA ADMINISTRATIVA
fiscal en Mexico.
Federación, estado y municipio.
Guadalajara, Indetec. 1994, pp. 228.
The administrative/fiscal justice in Mexico (at the federal, state and municipal levels).
(B. 18.834)

MIDDLE EAST

ARABISCHE STAATEN:
Das Recht der Forderungsabtretung. 3rd Edition.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993. Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 5/93, pp. 90.
Legal provisions concerning the transfer of claims.
(B. 57.860)

ARABISCHE STAATEN:
Übersicht über die wichtigsten Gesetzesbestimmungen. 4th Edition.
Cologne, Bundesstelle für Aussenhandelsinformation. 1993.
Ausländisches Wirtschafts- und Steuerrecht, Reihe A: Heft 4/94, pp. 75.
Summary of the most important statutes in 20 member countries of the Arabic Liga on commerce, civil, economic, labour, court procedures.
(B. 57.859)

Bahrain

BUSINESS PROFILE SERIES: BAHRAIN.
Hong Kong, The Hongkong and Shanghai Banking Corporation. 1994, pp. 48.
Revised and updated edition of information booklet on doing business in Bahrain with some reference to taxation.
(B. 58.022)

NORTH AMERICA

Canada

TAX FACTS AND FIGURES 1993.
Toronto, Coopers & Lybrand. 1993, pp. 27.
Sixteenth annual edition of Tax facts and figures updated to take into account the proposals contained in the Federal Budget of April 1993. This brochure provides ready answers to many practical questions that arise in the course of tax or financial planning.
(B. 113.231)

BURBIDGE, J.B.; SCARTH, W.M.
Eliminating interest taxation and tariffs: the underpinnings for recent Canadian policy.
Rotterdam, Erasmus University. 1993.
OCFED Research Memorandum 9308, pp. 20.
(B. 113.724)

TAX PLANNING CHECKLIST 1993-1994.
Don Mills, CCH Canadian Limited. 1993, pp. 122.
Booklet containing a number of income tax planning considerations, tips and traps for individuals, businesses and some suggestions for corporations.
(B. 113.230)

1994 CANADIAN MASTER
Tax Guide. 49th Edition.
North York, CCH Canadian Limited, 6 Garamond Court, North York, Ontario M3C 1Z5, Canada.
1994, pp. 1182.
Complete, accurate and up-to-date guide to Canadian federal taxation, with comprehensive commentary on the Income Tax Act and Regulations, including all amendments to the Act and Regulations to 31 December 1993.
(B. 113.737)

PLAMONDON, Robert.
GST compliance costs for small business in Canada. A study for the Department of Finance Tax Policy.
Ottawa, Department of Finance Distribution Centre. 1994, pp. 143.
This study is divided into the following sections: executive summary, research objectives, literature review, research methodology, data results and analysis, qualitative comments by participants, reliability of results, areas for further study, limitations of the research, conclusions, and bibliography.
(B. 113.539)

DOMINION TAX CASES.
Volume 47, 1993. The full text of all reported judgments on federal tax questions.
Don Mills, CCH Canadian Limited. 1994, pp. 2080.
(B. 113.722)

CORPORATE MANAGEMENT
Tax Conference 1993: Tax planning for Canada-US and international transactions.
Toronto, Canadian Tax Foundation. 1993, pp. 700. $ 120.

© 1994 International Bureau of Fiscal Documentation

The book contains the papers presented at the conference on the topic.
(B. 113.810)

WARD'S TAX TREATIES 1993-1994.
Scarborough, Carswell Thomson Professional Publishing. 1993, pp. 1055 $ 82.-.
Compilation of English text of double taxation treaties concluded by Canada with other countries.
(B. 113.873)

USA

ERNST & YOUNGS'S OIL AND gas federal income taxation. Editor John R. Braden. 30th Edition.
Chicago, CCH Commerce Clearing House, Inc. 1993, pp. 692.
An introduction to the taxation of natural resources in the US federal income tax system.
(B. 113.670)

1994 GUIDEBOOK TO CALIFORNIA taxes. 45th Edition. By the CCH Tax Law Editors.
Chicago, CCH Commere Clearing House, Inc. 1993, pp. 637.
Quick reference guide on California state taxes, including a guide to the preparation of California individual income tax returns, including who must file, filing status, exemptions, standard deduction, modifications to federal items, itemized deductions, rates, credits, where and when to file, extensions, and estimated tax.
(B. 113.668)

REPORTS OF THE UNITED STATES Tax Court. Volume 100, January 1, 1993 to June 30, 1993. Reporter John T. Fee.
Washington, Government Printer. 1993, pp. 688.
(B. 113.675)

IFA – INTERNATIONAL FISCAL Association USA branch 1994 annual meeting, Atlanta, Georgia, 3-4 March 1994.
Rotterdam, IFA – Erasmus University. 1994, pp. 300.
Conference papers containing contributions on the following topics: legislative, administrative, and judicial developments, treaty developments, use of holding companies and other special-purpose entities around the world, use of holding companies for operations in the EEC and Eastern Europe, the new US–Netherlands tax treaty, demergers: a US international tax perspective, special issues in structuring international joint ventures, deductibilbity of interest and other financing charges in computing income, Section 482 rules on services, new IRS transfer pricing documentation requirements. Contributors: J.P. Fuller, Mary C. Bennett, Patrick O.Leary, Brainard Patton, Delattre, O., Furnier, C., T. Töben, Kevin Dolan, a.o.
(B. 113.650)

FEDERAL ESTATE AND GIFT TAXES explained. 1993 Edition.
Chicago, CCH Commerce Clearing House Inc. 1993, pp. 505.
Guide for tax advisors and for estate owners and estate representatives involved in federal estate and gift tax return preparation and tax payment. The explanations and coordinated filled-in form excerpts reflect all major new federal estate, gift and generation-skipping transfer tax developments to the date of publication, including changes made by the Revenue Reconciliation Act of 1993.
(B. 113.669)

AMERICAN FEDERAL TAX REPORTS. Second series. Volume 71A.
New York, RIA Research Institute of America. 1994, pp. 1600.
This volume contains unabridged federal and state court decisions arising under the federal tax laws.
(B. 113.776)

KING, Elizabeth.
Transfer pricing and valuation in corporate taxation. Federal legislation vs. administrative practice.
Dordrecht, Kluwer Academic Publishers Group, P.O.Box 989, 3300 AZ Dordrecht, The Netherlands. 1994, pp. 284. 185.- Dfl.
The book analyses the disparities both between federal statutes and regulations, and regulations and administrative practices, in two highly controversial areas of corporate tax policy: intra-company transfer pricing and intangible asset valuations.
(B. 113.764)

HELLERSTEIN, Jerome R.; HELLERSTEIN, Walter.
State taxation. Volume II: Sales and use, personal income, and death and gift taxes.
Boston, Warren Gorham Lamont. 1992.
Loose-leaf publication updated by 1993 Supplement which covers all pertinent cases, rulings, regulations, and legislation.
(B. 113.795A)

HELLERSTEIN, Jerome R.; HELLERSTEIN, Walter.
State and local taxation. Cases and materials. 5th Edition. 1993 Supplement.
St. Paul, West Publishing Co. 1993. American Casebook Series, pp. 106.
(B. 113.775)

HELLERSTEIN, Jerome R.; HELLERSTEIN, Walter.
State taxation. Volume I: Corporate income and franchise taxes. 2nd Edition.
Boston, Warren Gorham Lamont. 1993.
Loose-leaf publication updated by 1993 Supplement which includes a cumulative table of cases and cumulative index.
(B. 113.795)

WHITE, George L.
Dividends – Cash and Property.
Washington, Tax Management Inc. 1994.
Tax Management Portfolios No. 764, pp. 55.
Portfolio discussing tax consequences of corporate distributions, either of money or other assets (in kind distributions), to the distributing corporation and its shareholders.
(B. 113.861)

ETATS-UNIS. JURIDIQUE, FISCAL, social, comptable. 5th Edition.
Levallois-Perret, Editions Francis Lefebvre. 1994.
Dossiers Internationaux Francis Lefebvre, pp. 499. 438.- Ffrs.
Revised and updated edition on the US tax system. The book also deals with the France–USA income tax treaty.
(B. 113.886)

DOERNBERG, Richard L.
International taxation in a nutshell.
St. Paul, West Publishing Company. 1993.
West Nutshell Series, pp. 394. $ 22.50.
(B. 113.834)

CHARACTERISTICS AND RISKS OF standardized options.
New York, American Stock Exchange Inc. 1994, pp. 94.
(B. 113.652)

Loose-leaf Services

Received between 1 May and 31 July 1994

AFRICA

FIDAFRICA
releases 3 and 5
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 7-11
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIAN TAX PRACTICE
- International agreements release 20
- Rulings and guidelines release 148
- Legislation release 74

Butterworths, North Ryde.

AUSTRALIAN STAMP DUTIES LAW
Tolhurst - Wallace - Zipfinger
release 129
Butterworths, North Ryde.
AUSTRALIAN SUPERANNUATION PRACTICE
Brown - Edstein
release 32
Butterworth Pty., North Ryde.

© 1994 International Bureau of Fiscal Documentation

AUSTRIA

DIE EINKOMMENSTEUER:
- Rechtsprechung
  release 7

Wirtschaftsverlag Anton Orac, Vienna.

DIE EINKOMMENSTEUER 1972
Hofstätter - Reichel
release 39
Wirtschaftsverlag Anton Orac, Vienna.

KOMMENTAR ZUM GEWERBESTEUERGESETZ
release 35
Wirtschaftsverlag Anton Orac, Vienna.

KOMMENTAR ZUR MEHRWERTSTEUER
Kranich - Waba - Siegl
release 31
Wirtschaftsverlag Anton Orac, Vienna.

STEUERLICHE TABELLENSAMMLUNG
release 80
Wirtschaftsverlag Anton Orac, Vienna.

BELGIUM

COMMENTAAR OP HET WETBOEK VAN DE INKOMSTENBELASTING
release 7
Ministry of Finance, Brussels.

COMMENTAIRE DU CODE DES IMPOTS SUR LES REVENUS
release 7
Ministry of Finance, Brussels.

FUNDAMENTELE BELGISCHE WETGEVING
releases 57 and 58
Kluwer Rechtswetenschappen, Deurne.

IMPORT – EXPORT. GUNSTREGELINGEN EN PROCEDURES IN DE BTW- EN DOUANEREGLEMENTERING
release 15
Kluwer Rechtswetenschappen, Deurne.

L'INDICATEUR FISCAL
releases 91 and 92
CED Samsom, Diegem.

MODELES FISCAUX
release 38
CED Samson, Diegem

VENNOOTSCHAP EN BELASTINGEN
release 23
Kluwer Rechtswetenschappen, Deurne

WETBOEK VAN DE INKOMSTENBELASTING
releases 98, 99 and 101
Ministry of Finance, Brussels.

CANADA

CANADA'S TAX TREATIES
release 48
Butterworths, Scarborough.

GLOBAL TAXATION OF CHARITIES AND DONATIONS
A. Drache
releases 103-107
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAX REFERENCES/ REFERENCES A LA LOI DE L'IMPOT SUR LE REVENUE
release 54
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 882-899
Prentice-Hall of Canada Ltd., Scarborough.

TAXATION OF REAL ESTATE IN CANADA
Atlas
release 1
Carswell Thomson Professional Publishers, Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Moms
  releases 3 and 4
- Skattenyt – Kronologisk
  releases 10 – 15
- Skattebestemmelser – Systematisk
  releases 5 – 10

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  releases 343, 344 and 345

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – DROITS D'ENREGISTREMENTS ET DE TIMBRE
release 2
Editions Francis Lefebvre, Levallois Perret.

FISCALITE PRATIQUE – FISCAL
releases 2 and 3
Editions Francis Lefebvre, Levallois Perret.

FISCALITE PRATIQUE – IMPOTS INDIRECTS
release 1
Editions Francis Lefebvre, Levallois Perret.

JURIS CLASSEUR – CODE FISCAL
release 250
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – CODE GENERAL DES IMPOTS
release 73
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – COMMENTAIRES – IMPOTS DIRECTS
releases 1188 and 1189
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – FISCALITE IMMOBILIERE
release 84
Editions Techniques, Paris.

REGLEMENTATION SOCIALE PRATIQUE/SECURITE SOCIALE LEGISLATION DU TRAVAIL
releases 2 and 3
Editions Techniques, Paris.

GERMANY

ABC FÜHRER SOZIALVERSICHERUNG
release 47
Verlag Schäffer & Co., Stuttgart.

ABGABENORDNUNG – FINANZGERICHTSORDNUNG
Tipke - Kruse
release 72
Verlag Dr Otto Schmidt, Cologne.

AUSSENSTEUERGESETZ
release 16
Verlag Schäffer & Co., Stuttgart.

BONNER HANDBUCH GMBH
Brandmüller/Küffner
release 28
Stollfuss Verlag, Bonn.

DEUTSCHE STEUERPRAXIS – NACHSCHLAGWERK PRAKTISCHER STEUERFÄLLE
Felix
releases 155 and 156
Verlag Dr Otto Schmidt, Cologne.

DOPPELBESTEUERUNG
Korn - Dietz - Debatin
release 63
Verlag C.H. Beck, Munich.

DOPPELBESTEUERUNGSABKOMMEN DEUTSCHLAND – SCHWEIZ
Flick - Wassermeyer - Wingert
release 16
Verlag Dr Otto Schmidt, Cologne.

EINKOMMENSTEUER- UND KÖRPERSCHAFTSTEUERGESETZ MIT NEBENGESETZEN
Raupauch - Herrmann
release 175
Verlag Dr Otto Schmidt, Cologne.

EINKOMMENSTEUERGESETZ – KOMMENTAR
Kirchhof - Sohn
release 52
C.F. Müller Juristischer Verlag, Heidelberg.

© 1994 International Bureau of Fiscal Documentation

DAS EINKOMMENSTEUERRECHT. KOMMENTAR ZUM EINKOMMENSTEUERGESETZ
Littmann - Bitz - Meincke
release 19
Verlag Schäffer & Co., Stuttgart.

FORMULAR DER STEUER UND WIRTSCHAFTSPRAXIS
release 33
Erich Schmidt Verlag, Bielefeld.

HANDBUCH DER AKTIENGESELLSCHAFT
release 23
Verlag Dr Otto Schmidt, Cologne.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBIEL-KAPITALANLAGEN
releases 66 and 67
C.F. Müller Juristischer Verlag, Heidelberg.

HANDBUCH DER EINFÜHRNEBENABGABEN
releases 2 and 3
Von der Linnepe Verlagsgesellschaft, Hagen.

HANDBUCH DER GMBH
Eder - Heuser - Tillmann - Gaul
release 64
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM BEWERTUNGSGESETZ – VERMÖGENSTEUERGESETZ
release 73
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM AUSSENSTEUERRECHT
Flick - Wassermeyer - Becker
release 34
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM GEWERBESTEUERGESETZ
Lenski - Sternberg
release 71
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
Hübschmann - Hepp - Spitaler
release 141
Verlag Dr Otto Schmidt, Cologne.

SOZIALVERSICHERUNGS HANDBUCH FÜR DIE BETRIEBLICHE PRAXIS
Figge
release 54
Verlag Dr Otto Schmidt, Cologne.

STEUERERLASSE IN KARTEIFORM
releases 388-392
Verlag Dr Otto Schmidt, Cologne.

STEUERRECHTSPRECHUNG IN KARTEIFORM
releases 506-508
Verlag Dr Otto Schmidt, Cologne.

UMSATZSTEUERGESETZ (MEHRWERTSTEUER) – KOMMENTAR
Rau - Dürrwachter - Flick - Geist
releases 76 and 77

UMWANDLUNGSRECHT
Widmann - Mayer
release 24
Stollfuss Verlag, Bonn.

INTERNATIONAL

INTERFISC TAX TREATY SERVICE
John Dewhurst
releases 59-61
J.F. Chown, London.

THE INTERNATIONAL TAX TREATIES
release 60
The International Tax Treaty Service – In-Depth Publishing Ltd., Dublin.

INTERNATIONAL TAX SYSTEM AND PLANNING TECHNIQUES
Saunders
release 26
Oyez Longman Publishing Ltd., London.

LUXEMBOURG

ETUDES FISCALES
releases 90-92
Imprimerie Saint Paul, Luxembourg.

NETHERLANDS

BELASTINGHEFFING IN LAND EN TUINBOUW
release 18
Kluwer, Deventer

BELASTING PRAKTIJKBOEK VOOR DE ONDERNEMER
release 14
Kluwer, Deventer

BELASTINGHEFFING VAN NV'S EN BV'S EN VAN HAAR AANDEELHOUDERS
release 42
Samsom, Alphen a.d.Rijn.

BELASTINGWETTEN (DE BELASTINGGIDS)
releases 164, 165 and 166
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
Editie J.M.M. Creemers
release 102
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
- Algemene wet inzake rijksbelastingen
  release 82
- Omzetbelasting 1968 (BTW/1978)
  releases 91 and 92
- Vermogensbelasting 1964
  releases 49 and 50

Noorduijn BV, Arnhem.

CURSUS BELASTINGRECHT
Mobach
releases 215, 216 and 217
Gouda Quint/D. Brouwer, Arnhem.

DUTCH BUSINESS LAW
Schuit - Beek - Zevenboom - Schifman
release 9
Kluwer, Deventer.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Gemeentelijke belastingen e.a.
  release 185

Kluwer, Deventer.

FISCAAL FUNDAMENT
release 4
Kluwer, Deventer.

FISCALE MODELLEN
release 59
Fed, Deventer.

FISCALE WETTEN
releases 211-215
Fed, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Algemene wetgeving inzake douane
  releases 5-10
- Belastingheffing bij invoer
  release 453
- Gecombineerde nomenclatuur
  releases 89-91
- Tarief van invoerrechten
  releases 110-113

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 373-376
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 149 and 150
Kluwer, Deventer.

LEIDRAAD BIJ DE BELASTINGGIDS
Van Soest - Meering
releases 127 and 128
Gouda Quint/D. Brouwer, Arnhem.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
releases 173-175
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
releases 144 and 145
Gouda Quint/D. Brouwer, Arnhem.

PERSONENASSOCIATIES
release 10
Kluwer, Deventer.

PRAKTIJKBOEK SOCIALE VERZEKERINGEN
releases 8 and 9

© 1994 International Bureau of Fiscal Documentation

SDU, The Hague.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  releases 77 and 78
- Coord. SV/Premieheffing
  release 27
- Heffing over uitkeringen en loon
  releases 50-53
- AOW/AWW
  release 66
- AKBW
  releases 49 and 50
- AWBZ
  releases 111-116

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
releases 297-299
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  releases 238 and 239
- Inkomstenbelasting 1964
  releases 902-912
- Investeringsregelingen
  releases 165 and 166
- Invorderingswet
  release 58
- Lokale belastingen en milieuheffing
  releases 15-17
- Loonbelasting
  releases 577-584
- Omzetbelasting
  releases 252-255
- Vennootschapsbelasting 1969
  releases 324-332
- Vermogensbelasting 1964
  release 161

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, releases 4, 5 and 6
B, release 5
Norsk Skattebetalerforening, Oslo.

PERU

CODIGO TRIBUTARIO
releases 48 and 49
Editorial Economica y Finanzas, Lima.

IMPUESTO A LA RENTA
release 69
Editorial Economica y Finanzas, Lima

IMPUESTO A LAS VENTAS
releases 77 and 78
Editorial Economica y Finanzas, Lima.

TRIBUTOS MUNICIPALES
release 30
Editorial Economia y Finanzas, Lima.

SOUTH AFRICA

JUTA TAX SERVICE – LEGISLATION SECTION – SOUTH AFRICA
release 55
Juta & Co., Kenwyn.

SWEDEN

SKATT PA ARV OCH SKATT PA GAVA
Bratt - Fogelklou - Nordell - Waller
release 12
Norstedts Förlaget, Stockholm.

SWITZERLAND

DIE STEUERN DER SCHWEIZ/LES IMPOTS DE LA SUISSE
Band IV, release 83
Verlag für Recht und Gesellschaft AG, Basel.

RECHTSBUCH DER SCHWEIZER BUNDESSTEUERN
release 91
Verlag für Recht und Gesellschaft AG., Basel.

UNITED KINGDOM

BRITISH TAX ENCYCLOPEDIA
Wheatcroft
release 142
Sweet & Maxwell Ltd., London.

SIMON'S TAX CASES
releases 15-24
Butterworth & Co., Sevenoaks.

SIMON'S TAXES
releases 199-201
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE
releases 17-28
Butterworth, London.

TAX HAVENS ENCYCLOPEDIA
Spitz
release 37
Butterworth, London

VALUE ADDED TAX – DE VOIL
releases 225-227
Butterworth & Co., Sevenoaks.

USA

UNITED STATES TAX REPORTER
releases 19-27
RIA – Research Institute of America, New York.

TAX TREATIES – REPORT BULLETIN
releases 3-5
Warren Gorham Lamont, Boston.

TAX IDEAS – REPORT BULLETIN
releases 4-6
Warren Gorham Lamont, Boston.

US TAXATION OF INTERNATIONAL OPERATIONS
releases 10 and 11
Warren Gorham Lamont, Boston.

ZIMBABWE

JUTA'S TAX SERVICE LEGISLATION
release 45
Juta & Co., Kenwyn, South Africa

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Australia:
Ann O'Connell:
Capital Gains Tax Amendments 176

Abe. I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Benelux:
Paul Sleurink, Hans Decleir and Veronique Sway:
Holding Companies 271

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

Canada:
Nathan Boidman:
Transfer Pricing: Current Canadian Perspective 457

Marianne Burge:
The Conduit Regulations: Canadian Investors Beware! 469

Robert Couzin:
The Ontario Fair Tax Commission: Tax reform in Action 380

Blair P. Dwyer and Katherine A. Thiessen:
The Division of Canadian Taxing Powers: A Tug of War, with Taxpayers in the Middle 392

James S. Hausman and Kathleen V. Penny:
Cross-Border Reorganizations Involving Canadian Corporations 442

Allan R. Lanthier:
Acquiring, Holding and Financing Canadian Corporations 419

Stephen S. Ruby:
Highlights of the 1994 Canadian Budget 402

Ingrid Sapona:
Taxation of Foreign Affiliates 430

Jacques Sasseville:
Interpretation of Double Taxation Conventions in Canada: An Update 374

Gary J. Webb:
Structuring International Joint Ventures: Canadian Tax Issues to Consider 448

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Implementing Regulations for the New Income Tax Law 250

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Olivier Delattre and Clotilde Fournier:
Tax Regime of Holding Corporations 281

Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Germany:
Dr Thomas Töben:
Holding Companies 285

Hong Kong:
Ian Harris:
Budget Bonanza 257

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Lynette V. Eastmond:
Public International Law Aspects of Some Transfer Pricing Issues 351

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shoma and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Vito Tanzi and Parthasarathi Shome:
A Primer on Tax Evasion 328

Israel:
Taxation of Corporations 141

Latin America:
Ruben Diaz, Jr.:
Selected Tax Aspects of Investment 306

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

New Zealand:
Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

© 1994 International Bureau of Fiscal Documentation

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Russia:
Dr Elena Markina:
Results of Initial Implementation of Tax Reform 338

Qatar:
Finbarr Sexton:
Taxation Regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

Singapore:
Lee Fook Hong:
1994 Budget 347

Switzerland:
Dr Nico H. Burki:
Holding Companies 292

Wiliam Bush:
Low Tax Opportunities 183

United Kingdom:
Michael McGowan:
Setting up a UK International Holding Company 296

United States:
David M. Benson and Matthew M. McKenna:
Deductibility of Interest and Other Financing Charges in Computing Income 310

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Kenneth J. Krupsky, Esq.:
New IRS Transfer Pricing Documentation Requirements 321

Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

James J. Tobin and William R. Seto:
Hybrid Entities 315

II. REPORTS AND DOCUMENTS

III. IFA NEWS 41, 200, 260, 269, 371

IV. CONFERENCE DIARY 55, 81, 137, 207, 267, 327, 483

V. BIBLIOGRAPHY
- Books 45, 103, 150, 201, 261, 358, 476
- Loose-leaf services 49, 107, 154, 205, 266, 366, 480
- List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 11 NOVEMBER 1994

INTERNATIONAL:
FINANCING PARTICIPATION IN CARIBBEAN BASIN INVESTMENTS AND TRADE IN THE AFTERMATH OF REDUCED SECTION 936 567
Bruce Zagaris

The Omnibus Budget and Reconciliation Act significantly reduced the availability of financing for Caribbean Basin projects under Section 936 of the Internal Revenue Code. The reduced financing and changes that have occurred in Section 936 funds must be viewed in the context of the alternatives to finance Caribbean Basin projects. This article briefly surveys the history of Section 936 and then examines how financing opportunities remain despite the reduced Section 936 provisions.

DENMARK:
JOINT TAXATION: A UNIQUE WAY OF REDUCING CORPORATE TAX 574
Bente Møll Pedersen

A Danish company may elect to be jointly taxed with its wholly-owned Danish and foreign subsidiaries. The primary benefit of such taxation is that tax losses in one company may be set off against the profits of other companies. This article highlights the major benefits of joint taxation and outlines the general requirements for such taxation in Denmark.

LIECHTENSTEIN:
THE DIFFERENTIAL TAX TREATMENT OF OFFSHORE AND DOMESTIC COMPANIES 579
Dr Norbert Seeger

Investors can maximize tax savings by transferring their holdings or the administration of operations to a Liechtenstein offshore company. In view of Liechtenstein's imminent entry to the EEA, investors may consider relocating operations to Liechtenstein in order to take advantage of the low corporate taxes applicable to offshore and domestic companies.

NEW ZEALAND:
A PROPOSED BINDING RULING REGIME 582
Adrian J. Sawyer

A discussion document issued in June provides for the introduction of a system of binding rulings on tax matters. This article overviews the proposed regime, with a discussion of contentious issues and suggestions for improvement. Also discussed are the reasons underlying the change in direction.

PAKISTAN:
1994-95 BUDGET 592
Ahmad Khan

Along with the usual tax measures, the 1994-95 budget seeks to introduce structural reforms in the tax system, in particular by taking measures to broaden the tax base and through administrative reforms.

ASEAN:
A PRIMER ON THE ASEAN FREE TRADE AREA 594
Victor T. Chew

The ASEAN Free Trade Area, using the Common Effective Preferential Tariff Scheme as its primary mechanism, was formally established in 1992. Further cooperative agreements have since been signed, under which ASEAN member countries agreed to reduce intra-regional tariffs on all manufactured items, and to remove non-tariff barriers.

© 1994 International Bureau of Fiscal Documentation

IFA NEWS 598

BIBLIOGRAPHY

– Books 606
– Loose-leaf services 613

CONFERENCE DIARY 578

CUMULATIVE INDEX 615

ERRATUM

BULLETIN, OCTOBER 1994 PAGE 505

The fifth line in the table on this page should read:
Subscribed Capital (paid in cash) 1,500 (1,000 shares)

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

INTERNATIONAL

FINANCING PARTICIPATION IN CARIBBEAN BASIN INVESTMENTS AND TRADE IN THE AFTERMATH OF REDUCED SECTION 936

Bruce Zagaris

Mr Zagaris is a partner in the Washington, D.C. firm of Cameron & Hornbostel. He received a BA, JD and LLM (taxation) from the National Law Center of the George Washington University, and an LLM in comparative law from Stockholm University in Sweden, and in international law from the Free University of Brussels. Mr Zagaris' practice includes structuring international business transactions, in particular the international tax aspects. His practice also includes counselling and participation in litigation of international white collar crime matters, particularly those involving the regulation of international money movement. He has represented 12 governments and three international organizations in international tax matters.

Mr Zagaris has authored and edited numerous books and articles on international law and frequently lectures on this topic. From 1989-92 he was chair, Committee on International Tax Law, Section of International Law & Practice, of the ABA. He is chair, Committee on International Criminal Law, Criminal Justice Section, ABA and founder and editor in chief of the *International Enforcement Law Reporter*. Mr Zagaris is an adjunct professor at the Fordham Law School in New York.

This paper was presented at the Second Caribbean Tax Conference held on 17-18 February 1994, in Cancun, Mexico.

I. INTRODUCTION

The Omnibus Budget and Reconciliation Act has significantly reduced the availability of financing for Caribbean Basin projects under Section 936 of the Internal Revenue Code ("IRC"). The reduced financing and changes that have occurred in Section 936 funds must be viewed in the context of the alternatives to finance Caribbean Basin projects, especially those from the US Government.

Simultaneous with the reduction of Section 936 funds, the Clinton administration has eliminated most of its foreign assistance to the Caribbean as a result of a concerted effort to shift its limited foreign assistance to Central and Eastern Europe. Concomitantly, the Clinton administration has told civil servants not to spend their limited resources on the Caribbean Basin Initiative ("CBI"), which after all is a Reagan administration programme. Since much of the CBI was only a commitment by the Reagan administration to use US Government resources to help attract investment in and develop US trade with the Caribbean Basin, the Bush administration had already reduced the administrative resources towards the CBI. Hence, except for a small debt-for-development programme within the Enterprise for Americas programme, little US financing remains for Caribbean investment and trade outside of Section 936 funds.

Nevertheless, the financial performance, requirements and prospects of Caribbean Basin countries, in the context of the rapid growth of population and labour force projections, requires improvement. Investment ratios are relatively low and fairly stable. They need to be substantially increased if the savings-investment gap is not to be a major constraint on future economic growth. The region suffers from a sizeable foreign exchange gap with a few exceptions. Trends in foreign exchange resource deficiency indicate that economic growth will be severely constrained by the availability of foreign capital.

The net revenue positions of the public sector have also depressed national savings. Efforts have been and are under way to provide innovations in the financial systems to provide more mechanisms for commercial projects. However, the low investment content of commercial bank credit and the high consumption content in most countries limits financial institutions from raising the aggregate savings rate to the full extent possible on the basis of financial accumulation.

Foreign capital has played an important role in strengthening aggregate financial capacity. Multilateral development banks and many donor countries have observed that significant portfolio capital and direct foreign investment cannot be attracted unless some policy changes are made to improve the overall investment community.

II. REDUCED SECTION 936

In recent years Section 936 has served as a principal source of US funding for Caribbean projects. Effective 1 January 1987, amendments to Section 936[1] provide a tax exemption for certain investments in qualified Caribbean Basin countries.

Before discussing the reduced Section 936 due to OBRA, it is useful to consider the birth and young childhood of the Caribbean Basin programme of Section 936.

1. 6 USC Sec. 936.

© 1994 International Bureau of Fiscal Documentation

In 1986 Congress was preparing to reduce the benefits of Section 936. To retain Section 936 for Puerto Rico and persuade Congress of its potential utility to the region, the Governor of Puerto Rico, Rafael Hernandez Colon, proposed expanding Section 936 to permit a portion of the funds to be invested in other countries of the Caribbean.[2]

After discussing various levels of Section 936 support for the region, the Government of Puerto Rico proposed a programme to provide $ 100 million per year in 936 funds to the Caribbean in return for the retention of Section 936.[3] The US Congress retained Section 936 and expanded its use to permit for the investment of 936 funds in eligible Caribbean countries.[4] On 30 July 1990, Congressional concern about the investing of significant funds into the Caribbean resulted in Congress amending Section 936 to require the Government of Puerto Rico to ensure that at least $ 100 million be contributed to qualified Caribbean Basin investments annually.[5]

Although not part of the legislative package, the Puerto Rican Government also started a twin-plant programme, which is now referred to as Puerto Rico's Caribbean Development Programme. It promoted the relocation of companies, especially from the Far East to the Caribbean to establish "twin plants": one plant in a Caribbean country to take advantage of the low-cost labour available in these areas and a "twin plant" in Puerto Rico where the more capital-intensive portion of the operation might be carried out. Some existing Puerto Rican companies also formed twin plants in Caribbean countries. The Dominican Republic especially benefited from the "twin plant" programme.

III. OPERATION OF SECTION 936

A US 936 corporation that earns income operating an active trade or business in Puerto Rico may obtain a tax credit to offset the US tax otherwise attributable to the income earned from its Puerto Rico operations. The 936 corporation can obtain this credit regardless of whether the active income so generated is immediately repatriated to the United States or is retained in Puerto Rico.

Puerto Rican law also exempts the qualified income earned from the Puerto Rico operations when a corporation has obtained a tax exemption grant from the Puerto Rican Government, thereby exempting up to 90 percent of the income.[6] Puerto Rican law does impose a toll gate tax if a corporation transfers the 936 funds out of Puerto Rico as earned. The rate depends on the type of operations that generated the income and when the repatriation takes place. For instance, a 10 percent rate is imposed on 936 manufacturing corporations that immediately repatriate income.

Under Section 936 an eligible corporation can also invest the active income in certain eligible activities in Puerto Rico. If so invested, the passive income generated will be exempt from US tax. This is known as Qualified Possession Source Investment Income ("QPSII").[7] Puerto Rico law also exempts certain QPSII from Puerto Rico tax.[8] If a 936 corporation invests 936 funds in Puerto Rico for longer periods of time (e.g. five years or more) and in qualified investments deemed to be of benefit to the economic development of Puerto Rico, then the Puerto Rico Government will reduce or eliminate the toll gate tax when the funds are ultimately repatriated.[9]

IV. BENEFITS OF SECTION 936 FUNDS AND THE PUERTO RICO TAX EXEMPTION

The impact of the Section 936 and the Puerto Rico tax incentives enabled Puerto Rico to attract manufacturing and other investment, especially in the pharmaceutical industry. The Puerto Rico per capita GNP rose from 1947-73 from $ 586 to $ 2,112.[10]

Borrowers can access Section 936 funds directly from 936 corporations or indirectly from eligible depository institutions. Because the base rate of interest charged for such funds is generally lower than for conventional loans due to the exempt interest from both US and Puerto Rico tax received by the lender of 936 funds, the lender can pass a portion of the tax benefit on to the borrower in the form of a lower interest rate. The benefit to the borrower in receiving 936 funds instead of conventional funds might equal a lowering of the interest cost by 1.2 percent (120 basis points) per year.

V. CARIBBEAN FUND RULES

The expanded Section 936 rules that became effective 1 January 1987 to permit favourable tax treatment for the investment of Section 936 funds in eligible activities in qualified Caribbean countries allow funds generated by the operation of an exempted business in Puerto Rico to be invested in a qualified Puerto Rican financial institution for investment in the Caribbean. The income generated by such investment qualifies as QPSII and is exempt from both US and Puerto Rican tax.[11]

Section 936(d)(4) allows 936 funds to be invested only in qualified Caribbean Basin countries designated under the Caribbean Basin Economic Recovery Act of 1983.[12] The US Department of Commerce has designated 23 countries as

2. House Comm. on Ways and Means, Tax Reform Act of 1985, H.R. Rep. No. 426, 99th Cong., 1st Sess. 419 (1985).
3. Draft Memorandum of Agreement, United States–Puerto Rico, 14 November 1985.
4. IRC Sec. 936(d)(4).
5. See IRC Sec. 936(4)(D) (effective for calendar years after 1989).
6. Puerto Rico Tax Incentives Act Sec. 3, 13 LPRA Sec. 256b(a)(Supp. 1988) (approved 24 January 1987).
7. IRC Sec. 936(d)(2).
8. 13 LPRA Sec. 356a(j)(3).
9. *Id.* Sec. 256(j).
10. Department of the Treasury, Sixth Report, *The Operation and Effect of the Possessions Corporation System of Taxation* (1989), at 22.
11. 13 LPRA Sec. 256a(2)(j)(A).
12. Caribbean Basin Economic Recovery Act ("CBERA") Sec. 212, 19 USC Sec. 2702 (1988). For background on the CBERA, see Zagaris, "A Caribbean Perspective of the Caribbean Basin Initiative", 18 *Int'l Lawy.* (1984), at 563.

© 1994 International Bureau of Fiscal Documentation

qualified.[13] To be eligible for Section 936 funds, the CBI qualified countries must conclude a tax information exchange agreement ("TIEA") with the United States.[14] Eleven CBI countries are currently qualified.[15] The purpose of TIEAs is to enable the United States to exchange tax information in admissible form with Caribbean countries in order to assist in civil and criminal tax investigations, including circumstances where non-tax crimes are involved.[16]

Section 936 also requires that for the qualified investment of 936 funds in the Caribbean, such funds be invested in "active business assets" or "development projects" in a qualified CBI country.[17] The Treasury regulations permit qualified investment in tangible personal property used in a trade or business in qualified CBI countries, including reasonable incidental expenditures, such as installation costs.

Section 936 funds must be provided to qualified CBI projects for new investments although the Regulations allow the construction, rehabilitation, improvement or upgrading of qualified CBI assets. An investment in tangible personal property used in the same CBI country within the last five years may not qualify.[18] Section 936 funds cannot be used to refinance existing project facilities.[19] However, the US Treasury can approve the use of Section 936 funds to refinance some privatization transactions on a case-by-case basis.[20] In general, a borrower can only use up to 10 percent of the qualified investment of Section 936 funds in a CBI project to finance working capital.[21]

To obtain favourable tax treatment, a 936 company must invest its funds in qualified CBI projects only through a qualified financial institution.[22] The latter is defined as the Government Development Bank for Puerto Rico, the Puerto Rico Economic Development, a "banking, financing or similar business" that is "organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch" of such a business,[23] and which is an eligible depository institution for 936 funds as qualified by the Commissioner under Puerto Rican regulations,[24] "such other entity as may be determined by the Commissioner of Financial Institutions for Puerto Rico", or a "single-purpose entity" established in Puerto Rico as an eligible institution solely to invest 936 funds in qualified CBI assets.[25]

A borrower of 936 funds must also open its books and records to the US and Puerto Rican Governments so that they can verify the use of the funds in accordance with the law.[26] The Commissioner of Financial Institutions for Puerto Rico must also approve the lending of 936 funds to a qualified Caribbean recipient.[27]

The Commissioner of Financial Institutions for Puerto Rico has issued regulations for the investment of 936 funds in the Caribbean.[28] These regulations require the project to be endorsed by the Economic Development Administration of Puerto Rico ("Fomento") and to obtain the approval of the Commissioner for the specific CBI investment.[29] The financial institution making a CBI investment must also follow strict due diligence requirements.[30]

Once the investment receives the endorsement of Fomento and the approval of the Commissioner, Puerto Rican law provides beneficial tax and regulatory treatment to such investment. A qualified 936 CBI investment can be used by an eligible depository institution to fulfil Puerto Rico reserve requirements.[31] All financial institutions with 936 funds must invest at least 7 percent of such funds in a list of preferred investments, of which qualified CBI investments are included.

VI. QUALIFIED CARIBBEAN BASIN COUNTRY LAWS AND POLICIES

An important aspect of making 936 loans is that most host governments will require the project to obtain their approval. Budgetary and deficit-of-trade problems have resulted in severe restrictions on companies within CBI countries obtaining and paying cross-border loans. The central bank of the CBI country normally must approve the loan. The International Monetary Fund also has made structural adjustment loans with many CBI countries with conditionality clauses that limit the amount of allowable indebtedness.

Some CBI countries impose withholding taxes on the interest income or dividends repatriated from enterprises in their countries, thereby impacting the repayment of 936 loans.

13. Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Panama, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago.
14. IRC Sec. 936(d)(4)(B).
15. Barbados, Bermuda, Costa Rica, Dominica, The Dominican Republic, Grenada, Guyana, Honduras, Jamaica, St. Lucia, and Trinidad & Tobago.
16. For the text of the TIEAs, see R. Rhoades and M. Langer, 3-4 *Income Taxation of Foreign Related Transactions* (1985). For additional discussion of the TIEA programme at its inception, see Foster and Penick, "Barbados Signs the First Exchange of Information Agreement under the Caribbean Basin Initiative", 114 *Tax Mgmt. Int'l J.* (1985), at 100; Sharp and Steele, "The Caribbean Basin Exchange of Information Draft Agreement – A Technical Analysis", 19 *Int'l Lawy.* (1985), at 949; Zagaris, "The Caribbean Basin Initiative", 28 *Tax Notes* (1985), at 102.
17. IRC Sec. 936(d)(4)(A)(i).
18. Treas. Reg. § 1.936-10(c)(4)(ii).
19. Use of Sec. 936 Funds for Loans in the Caribbean Region Before the Subcommittee on Oversight of the House Committee on Ways and Means, 101st Cong., 2nd Sess. 100-97 (1990), at 4 (statement of Kenneth W. Gideon, Assistant Secretary for Tax Policy, US Department of the Treasury).
20. *Id.* at 5.
21. Treas. Reg. § 1.936-10(c)(4), (5).
22. IRC Sec. 936(d)(4)(A).
23. Treas. Reg. § 1.936-10(c)(3).
24. Treas. Reg. § 1.936-10(c)(3)(ii)(B); Puerto Rico Reg. 3582, Eligible Institutions Regulation, § 4.2.13, Commissioner of Financial Institutions, 29 January 1988.
25. IRC Sec. 936(d)(4)(A)(ii).
26. IRC Sec. 936(d)(4)(C)(iii).
27. IRC Sec. 936(d)(4)(A)(ii).
28. Puerto Rico Reg. 3703, Qualified CBI Loans Regulation, Commonwealth of Puerto Rico, Office of the Commissioner of Financial Institutions, Financial Board, Economic Development Administration, 22 June 1988.
29. *Id.* Reg. 3582; Sec. 5.1.3; § 6.2.4(e)(ii).
30. Reg. 3703, Art. 6; Reg. 3582, § 6.4.
31. Reg. 3582, § 6.1.3.

© 1994 International Bureau of Fiscal Documentation

VII. THE OMNIBUS BUDGET AND RECONCILIATION ACT ("OBRA")

Although Section 936 loans had been growing in amounts disbursed and in the financing of small projects, the amount of Section 936 funds has reached its limit as the result of the Revenue Reconciliation Act. Although funds will remain available, they will not grow in the future. In 1993 Congress enacted the OBRA which diminished the availability of Section 936 funding.[32]

The new Section 936 provides that the credit permitted to a possession corporation for a taxable year against US tax on its active business income (i.e. income derived from the active conduct of a possession-based business, or from the sale of assets used in such a business) is subject to either of two alternative limitations.[33] One limitation is based on factors that reflect the corporation's economic activity in the possession (the "economic activity limitation"), and the other limitation is based on a statutorily defined percentage of the Section 936 credit that would be permissible under the rules prior to the enactment of the OBRA (the "percentage limitation").

The taxpayer has the option of applying one of the alternative limitations.[34] To use the percentage limitation, a corporation must elect to use that limitation for its first taxable year beginning after 1993 for which it claims a Section 936 credit.[35] Once a possession corporation elects to use the percentage limitation, it must continue to compute its Section 936 credit under that limitation for all subsequent taxable years unless the taxpayer revokes the election.[36]

The OBRA has a consistency rule that requires all affiliated possession corporations to utilize the same alternative limitation.[37] For instance, if a possession corporation that uses the percentage limitation becomes a member of an affiliated group that contains a second possession corporation that uses the economic activity limitation, then the first corporation will be deemed to have revoked its election to use the percentage limitation. The determination of whether a possession corporation is a part of an affiliated group is generally made by reference to the consolidated return rules, except that stock owned by attribution under the rules of IRC Section 1563 is treated as owned directly, and the exclusions from the definition of "includible corporation" listed in IRC Section 1503(b) are disregarded. The Treasury has authority to develop rules that would treat two or more possession corporations as members of the same affiliated group to prevent avoidance of the consistency rule through deconsolidation or other means.[38]

A. Economic activity limitation

1. General

The economic activity limitation grants the credit to a possession corporation for a taxable year against US tax on its business income, but provides it may not exceed the sum of the following three components:

(1) 95 percent of qualified compensation;
(2) an applicable percentage of depreciation deductions claimed for regular tax purposes by the corporation for the taxable year with respect to qualified tangible property (i.e. tangible property located in a possession and used there by the corporation in the active conduct of its trade or business); and
(3) if the corporation does not elect the profit-split method for computing its income, a portion of the possession income taxes it incurs during the taxable year.

In computing the US tax liability, if any, on the active business income of a possession corporation under the economic activity limitation, the sum of the three components listed above is subtracted from an amount of pre-credit US tax that would be owed if taxable income of the possession corporation were grossed up by qualified possession compensation and depreciation of qualified tangible property.

2. Compensation

In computing the economic activity limitation, qualified compensation in general is the sum of the aggregate amount of the possession corporation's qualified possession wages for the taxable year, and its allocable employee fringe benefit expenses for the taxable year.[39]

"Qualified possession wages" are defined as wages paid or incurred by the possession corporation during the taxable year to any employee for services performed in a possession, but only if the services are performed while the principal place of employment of the employee is within that possession.[40]

The term wages refers to the Federal Unemployment Tax Act definition of wages, and the cumulative amount of wages for each employee that are taken into account for a taxable year in computing the credit limitation may not exceed 85 percent of the maximum earnings subject to tax under the OASDI portion of social security (currently $ 57,600).[41]

The Treasury will provide rules for making appropriate adjustments to this limit in the cases of part-time employees and employees whose principal place of employment is not within a possession for the entire year.

Qualified possession wages do not include amounts paid to employees who are assigned by the employer to perform services for another person, unless the principal trade or business of the employer (and any related possession corporations) is to make employees available for temporary periods to other persons in return for compensation.[42]

32. P.L. 103-66 (OBRA of 1993).
33. IRC Sec. 936(a)(4).
34. IRC Sec. 936(a)(4)(B).
35. IRC Sec. 936(a)(4)(B)(iii)(I).
36. IRC Sec. 936(a)(4)(B)(iii)(II).
37. IRC Sec. 936(a)(4)(B)(iii)(III).
38. *Id.*
39. IRC Sec. 936(a)(4)(A)(i).
40. IRC Sec. 936(i)(1)(A).
41. IRC Sec. 936(i)(D).
42. IRC Sec. 936(i)(1)(C).

© 1994 International Bureau of Fiscal Documentation

Allocable employee fringe benefit expenses are equal to the aggregate amount permissible to the possession corporation as a deduction for the taxable year of the fringe benefits listed below, multiplied by a fraction, the numerator of which is the aggregate amount of the corporation's qualified possession wages (as defined above) for the year, and the denominator of which is the aggregate amount of the wages it pays or incurs during that year. However, the corporation's allocable employee fringe benefit expenses for a taxable year cannot exceed 15 percent of the aggregate amount of its qualified possession wages for that year.[43]

Fringe benefit expenses that are taken into account for purposes of determining the credit limitation are: (1) employer contributions under a stock bonus, pension, profit-sharing or annuity plan; (2) employer-provided coverage under any accident or health plan for employees; and (3) the cost of life or disability insurance provided to employees. Fringe benefit expenses do not include any amount that is treated as wages.[44]

3. Depreciation

With respect to short-life qualified tangible property (i.e. qualified tangible property to which IRC Section 168 applies and which is three-year or five-year property as classified under Section 168(e)), 15 percent of the depreciation deductions permissible to the possession corporation for the taxable year are taken into account.

With respect to medium-life qualified tangible property (i.e. qualified tangible property to which Section 168 applies and which is classified as seven-year or ten-year property under Section 168(e)), 40 percent of such deductions are taken into account.

With respect to long-life qualified tangible property (i.e. all other qualified tangible property to which Section 168 applies), 65 percent of such deductions are taken into account.[45]

4. Possession income tax

As a general rule, if possession corporations do not elect the profit-split method, taxes paid or accrued to a possession with respect to taxable income which is taken into account in computing the Section 936 credit are factored into the credit limitation base.[46] However, possession income taxes paid over a 9 percent effective rate of tax are not included for purposes of determining the limitation.[47] Additionally, only the portion of taxes fulfilling the effective rate requirement that are allocable (on a *pro rata* basis taking all possession income taxes into account) to non-sheltered income are so included. The fraction of possession income taxes allocated to non-sheltered income is determined by computing the ratio of two hypothetical US tax amounts that are computed under the assumption that no credit or deduction is permitted for possession income taxes.

The numerator of the ratio described above is the US tax liability of the possession corporation that would arise under the bill because of the economic activity limitation determined without regard to any credit or deduction for possession income taxes. The denominator of the ratio is the pre-Section 936 credit US tax liability of the possession corporation that would be imposed on the income of the corporation (such income being computed under the rules that apply under former Section 936) without regard to any credit or deduction for possession income taxes.

If a possession corporation uses the profit-split method to allocate any income from intangible property of the taxable year, it may not include any taxes in its credit limitation base.[48] However, this corporation can obtain a deduction for a portion of its possession income taxes paid or accrued during that taxable year. The deductible portion of possession income taxes is the portion that is allocable (on a *pro rata* basis) to the corporation's taxable income (computed before taking into account any deduction for such taxes), the US tax on which is not offset by the Section 936 credit as a result of the Senate amendment's limitation.[49]

5. Denial of double benefit

For purposes of computing the pre-Section 936 credit, US income tax liability of a possession corporation that employs the economic activity limitation, the new Section 936 requires the corporation to compute taxable income by reducing its otherwise deductible amounts of compensation and depreciation by the amounts that are included in its credit limitation base.

6. Election to treat affiliated corporations as one corporation

For purposes of computing the economic activity limitation, the new Section 936 permits an affiliated group of corporations (which are generally defined in IRC Section 1504, but treating possession corporations and foreign corporations as includible corporations) to elect to treat all affiliated possession corporations as one corporation. For a group so electing, the available consolidated credit amount must be allocated among the possession corporations of the group under rules prescribed by the Treasury Secretary.[50] Any election to consolidate applies to that taxable year and to all succeeding taxable years unless revoked with the consent of the Treasury Secretary.[51]

B. Percentage limitation

The percentage limitation permits the Section 936 credit to a possession corporation against US tax on business income for a taxable year up to an applicable percentage (40 percent once fully phased in) of the credit that would be permissible under present law rules. Under a transition rule that provides

43. IRC Sec. 936(i)(2)(A).
44. IRC Sec. 936(i)(2)(B).
45. IRC Sec. 936(i)(4).
46. IRC Sec. 936(a)(4)(iii).
47. IRC Sec. 936(i)(3)(A)(ii).
48. IRC Sec. 936(i)(3)(A).
49. IRC Sec. 936(i)(3)(B).
50. IRC Sec. 936((i)(5)(A).
51. IRC Sec. 936(i)(5)(B).

© 1994 International Bureau of Fiscal Documentation

a five-year phase-in, the applicable percentage is the following:

Taxable years beginning in	*Applicable Percentage*
1994	60%
1995	55%
1996	50%
1997	45%
1998 and thereafter	40%[52]

A taxpayer who employs the percentage limitation can deduct a portion of its possession income taxes paid or accrued during the taxable year. The portion of the taxes so deductible is the portion that is allocable (on a *pro rata* basis) to the corporation's taxable income (computed before taking into account any deduction for possession tax), the US tax on which is not offset by the Section 936 credit as a result of the limitation.[53]

1. Foreign tax credit limitation for dividends from possession corporations

The new Section 936 provisions establish a new separate foreign tax credit limitation category for purposes of computing the alternative minimum tax foreign tax credit. The new category includes the portion of dividends received from a possession corporation for which the dividend-received deduction is disallowed, and hence is included in alternative minimum taxable income.[54]

2. Excise tax cover over

The new Section 936 provisions temporarily increase the cover over of rum excise taxes to Puerto Rico and the Virgin Islands from $ 10.50 per proof gallon to $ 11.30 per proof gallon. This increased cover over rate applies in the case of distilled spirits brought into the United States during a five-year period starting 1 October 1993.

VIII. TRENDS IN THE USE OF SECTION 936 FUNDS

Section 936 funds are increasingly directed towards small-scale private business ventures while those for large-scale projects are holding steady.[55] A group of US industrial companies with Puerto Rican operations established the Caribbean Basin Partners for Progress with a $ 100 million fund for lending to small private business under Section 936. The fund and group was designed to complement the Section 936 Caribbean funding since the Puerto Rican Government traditionally has focused the $ 16 billion-plus Section 936 funding on large-scale projects in Puerto Rico and elsewhere in the region.

As of November 1993, Partners for Progress had made 30 loans, averaging more than $ 500,00 each, with several more in the pipeline at year-end. However, the availability of funding in the region appears limited because of the changes made in Section 936. The changes mean that Section 936 as a whole and the Partners for Progress will have less funds due to the diminishment of the Section 936 programme.

Before the amendments to Section 936, there existed an informal but open commitment for $ 100 million of lending to the Caribbean. Although there is a higher formal limit of $ 200 million, it is a serious limit. As of August 1993, the Section 936 programme had disbursed $ 778 million for 137 projects, worth $ 1.2 billion when all fund sources are included. At the August 1993 accounting, there was another $ 153 million worth of loans pending for disbursement. Up until August 1993, the Caribbean Development Programme had disbursed $ 104.3 million for 23 projects in five countries.

IX. ANALYSIS AND CONCLUSION

Financing opportunities remain despite the reduced Section 936 provisions as a result of OBRA. The smaller loans under the Partners for Progress are quite useful. Clearly the politics of Section 936, especially in the Clinton administration, do not permit any further use of the Section 936 programme. In fact, only a last minute lobbying campaign prevented further reduction in the Section 936 programme.

The pressures to reduce further the US budget and deficit along with the comments by the President and Hillary Clinton about the unfair profits realized by the pharmaceutical industry may mean even further reductions in Section 936. From a tax policy perspective the ability to use tax legislation to provide economic benefits for non-US activities has always been limited. US policy towards the Caribbean normally is one of neglect until a crisis occurs. In the Kennedy administration, the Bay of Pigs debacle led to the Alliance for Progress, while in the Reagan administration the preoccupation with the loss of Nicaragua, Grenada and the potential fall of other Central American countries to the communists during the Cold War led to the Kissinger Report and the call for a CBI. It will take another major crisis in the Caribbean before the US national security advisers concoct another Caribbean economic programme. Because of the importance to economic development and investment, the new economic programme, which is somewhere behind the clouds and not yet visible, is likely to contain a component to facilitate private investment.

The stimulus may well be in the form of tax treaty provisions such as those found in the Mexico–US tax treaty, whereby persons from one country (US taxpayers) can deduct from their taxes contributions made to a non-profit organization recognized by the other country (e.g. Mexico). However the Chair of the Senate Foreign Relations Committee, Senator Paul Sarbanes, strongly indicated the Committee's abhorrence of the usurpation by treaty negotiators of the tax committee's and Congress' right to tax and of the prospective loss of revenue due to these provisions.

52. IRC Sec. 936(a)(4)(B)(ii).
53. IRC Sec. 936(a)(4)(B)(i).
54. IRC Sec. 936(a)(4)(B)(c).
55. For background to Sec. 936 financing, see Thurston, "Commercial Financiers Warm to Smaller CBI Deals", *Journal of Commerce* (29 November 1993), at 8A, col. 1.

© 1994 International Bureau of Fiscal Documentation

The politics of Section 936 may result in action by Caribbean countries to terminate, or at least to reduce, their cooperation under the TIEAs, since the bulk of such TIEAs were concluded either after the enactment of the Caribbean programme of Section 936 was imminent or after enactment. Indeed CBI TIEA signatories concluded TIEAs primarily to take advantage of Section 936 funding opportunities.[56]

In the meantime, as a result of the reduced financing available under Section 936, counsellors are being creative in the use of private voluntary organizations and the use of debt-for-development swaps.

In the efforts to ratify the Uruguay Round changes to the GATT, an initiative is again afoot to obtain revenue by further reducing the benefits of Section 936, thereby repeating the politics and economics that occurred with the enactment of OBRA.

56. The other benefits of a TIEA, eligibility for North American convention deductions and for hosting foreign sales corporations, are not comparatively useful to Caribbean countries.

TAXATION & INVESTMENT IN THE CARIBBEAN

A unique guide providing reliable, up-to-date information on company law and tax regimes in the Caribbean.

A general introduction to the Caribbean area includes details of regional organizations and international agreements, such as Caricom, the Caribbean Basin Initiative, Caribcan, GATT and the Lomé Convention.

Country chapters give comprehensive taxation and investment information, following the same format for easy reference and comparison:

- Country survey, including economic situation and principal types of business activity
- Business organization, including relevant company law, exchange control regulations, business licence fees and other essential information
- Systematic review of all relevant forms of taxation, including income, indirect, transaction and property taxes
- Additional relevant information: social security, intellectual property and other taxes
- Details of offshore economies

English language texts of tax treaties concluded by Caribbean countries are also included.

Loose-leaf, three binders, updated twice a year

New subscription: NLG 1,500

Residents of the Netherlands, and residents of the EC without a VAT number, are liable to value added tax on the price of this item

IBFD Publications BV, PO Box 20237, 1000 HE Amsterdam, the Netherlands
Tel.: +31 (0)20 626 7726 Fax: +31 (0)20 622 8658

© 1994 International Bureau of Fiscal Documentation

DENMARK

JOINT TAXATION: A UNIQUE WAY OF REDUCING CORPORATE TAX

Bente Møll Pedersen

Attorney-at-law, Kromann & Münter, and lecturer on Tax Law at the University of Copenhagen, Denmark.

I. INTRODUCTION

A Danish holding company may be jointly taxed with its wholly-owned subsidiaries. Both Danish and foreign subsidiaries are eligible for joint taxation regardless of the domicile of the subsidiary. Subsidiaries engaged in an entirely different line of business than the holding company are also eligible for joint taxation.

When joint taxation applies tax losses in one company may be offset against the profits of other companies.[1] This article highlights the major benefits of joint taxation and outlines the most important requirements and terms and conditions to qualify for such taxation in Denmark.

II. BENEFITS OF JOINT TAXATION

As mentioned above the primary benefit of joint taxation is that tax losses of Danish and foreign subsidiaries can be offset against profits of the Danish parent company and profitable subsidiaries. Another benefit is that under certain circumstances the Danish parent may be entitled to relief for foreign-source income (however, this is gradually being abolished),[2] double taxation relief under tax treaties or unilaterally under Section 33 of the Danish Tax Assessment Act ("TAA"),[3] as well as relief for subsidiaries.[4] The relief, which reduces the tax, is calculated on the basis of the jointly taxed income and the tax assessed thereon.

Jointly taxed companies remain independent entities for tax purposes, each affiliate calculating its own taxable income according to Danish tax rules. The jointly taxed income is determined by adding the individual results, which is the taxable income for joint taxation purposes. The income of foreign affiliates is included in the taxable income subject to joint taxation. Thus, a tax loss in one company may be offset against the profits of other companies. No group tax as such is levied.

Danish joint taxation has no effect on the taxation of a foreign subsidiary in the subsidiary's country of residence, meaning that the subsidiary must file its normal tax return in that country according to domestic rules. Losses may be carried forward according to the rules of the country of residence even if such losses have been absorbed by the Danish parent company for Danish tax purposes.

Joint taxation is granted upon fulfilment of certain requirements and after application to the tax authorities. Application is particularly advisable if companies in a group show a tax loss. The loss may be an ordinary business loss or a loss from depreciation of assets.[5] However, tax losses in connection with the sale of shares, the sale of real estate, the sale of goodwill, etc. can not be offset against taxable income of other companies in the group.

III. REQUIREMENTS FOR JOINT TAXATION

A number of requirements are set out in the Danish Corporate Tax Act ("CTA") in order to qualify for joint taxation,[6] and

1. The tax political argument for joint taxation is probably that from a tax perspective it is irrelevant that income is derived by one or more companies when such companies are taxed on the same economic interest.
2. This is a national calculation rule which provides that a company with foreign jointly taxed subsidiaries may obtain relief amounting to 50% of the Danish corporation tax levied on the net taxable income of the foreign subsidiary. The effective Danish tax rate of 34% may therefore be reduced for a company with jointly taxed foreign subsidiaries. However, the relief for foreign-source income will be gradually abolished between 1994 and 1999. The relief will be reduced by 1/7 in each of the income years in question.
3. According to TAA Sec. 33, relief from double taxation may be granted under a credit principle. It may be relevant to apply this rule in case of an existing double tax treaty affording relief on the basis of the exemption principle in order to avoid recapture of losses.
4. Under CTA Secs. 17(2) and (3) relief from double taxation is granted if the parent company owns at least 25% of the share capital of the subsidiary either for the entire fiscal year in which the dividends were received, or if the parent company held the qualifying shares for a continuous period of not less than two years when the dividend is received. In addition, the parent and the subsidiary must be included within the term "company" in a member state according to the terms of the parent/subsidiary directive.
Relief is granted upon application, and is effected on a credit basis, the parent company being granted relief in respect of the proportion of tax corresponding to the dividends received and the taxable income, or an amount corresponding to the tax paid on the dividends abroad, whichever is lower. If the subsidiary is resident in another EC member state, however, relief is granted without application.
5. This distinction is relevant in Denmark, but not in other jurisdictions. However, since Danish taxpayers may vary the amount of depreciation on machinery, equipment, etc. from year to year (up to a maximum of 30%) they are free to increase or reduce the annual overall loss.
6. CTA Sec. 31.

© 1994 International Bureau of Fiscal Documentation

the Danish Tax Assessment Board determines whether a company qualifies.[7] The main requirements are discussed below.

A. Accounting year

The accounting years of all of the companies involved must coincide. As a general rule the accounting years of the relevant companies must begin and end on the same dates. However, joint taxation is still available if the accounting years of the companies do not begin on the same date provided they end on the same date, and provided the parent company held the shares in the subsidiary throughout the entire income year of both the parent and the subsidiary.

The requirement that the parent company hold the shares in the subsidiary throughout its income year is deemed to have been met if the companies involved have a common accounting year and the parent company acquires the shares in the subsidiary on the first day of the accounting year.

If the parent company has held the shares from the date the subsidiary was established, joint taxation is available if the accounting years of the companies end on the same date. Joint taxation is also available if the parent company acquires shares in a company which has been inactive (except for deriving income from its capital) since it was established.

In the case of a newly-established parent company, joint taxation will be available immediately even though the accounting years of the companies do not begin on the same date, provided the parent company is established by the contribution of shares in the subsidiary (non-cash contributions), the parent has held the shares in the subsidiary throughout the entire income year of the subsidiary, and the accounting years of the companies end on the same date.

In cases where the parent company holds the shares until the liquidation of the subsidiary, joint taxation is available if the accounting years begin on the same date.

B. Holding of all shares

A Danish company may apply for joint taxation if it owns all of the shares in another company, or if the shares in the latter company are owned by a number of companies to which joint taxation applies.

This requirement is modified for foreign subsidiaries, i.e. if one or more of the subsidiaries are registered abroad, joint taxation is permitted if the Danish parent, either alone or together with its Danish and foreign subsidiaries and the Industrialization Fund for Developing Countries or the Investment Fund for Central and Eastern Europe, holds the maximum proportion of share capital in the foreign subsidiaries allowable under the legislation of the foreign subsidiaries' countries of residence.[8] If some of the shares in a foreign subsidiary are held by other shareholders without any statutory maximum shareholder requirement, joint taxation will generally not be permitted. However, the shareholdings in real terms are decisive, and if a Danish parent company can establish that part of the share capital in a foreign subsidiary is held on a pro forma basis by shareholders resident in the country in question, permission for joint taxation may be granted.[9]

Joint taxation may be permitted even if a subsidiary issues shares to employees.[10] However, the shares must be issued subject to the requirement that in the event of assignment or death of an employee, the shares can only be sold to the company which is required to purchase them.

In the case of issues of warrants or convertible debentures in a jointly taxed subsidiary to holders other than the parent company, joint taxation will continue until the year the holders of the warrants or convertible debentures exercise their rights to acquire shares in the subsidiary.[11]

As noted above, the shares must be held by the parent company throughout its income year, except in the following cases:

- the parent company has held the shares from the date the subsidiary was established;
- the parent company acquires shares in a company which has been inactive (except for the return of capital) since it was established;
- the parent company owns the shares until the subsidiary is liquidated.

If shares are transferred between related parties strict requirements are usually placed on evidence of the existence of any agreement to transfer the shares.

C. Intercompany debt claims

Taxpayers who are engaged in the business of the sale and purchase of debt claims or who are engaged in the business of financing, and who have established a group association solely with a view to operating the debtor's business on a temporary basis in order to repay previously granted loans or to contribute to a reorganization of the business, are entitled to deduct losses on claims against group companies.[12] If losses on claims against the subsidiary have been deducted or will be deductible according to these rules joint taxation will not be permitted.

D. Application for joint taxation

Application for joint taxation must be made with the tax return for the relevant fiscal year. In practice, this requirement is interpreted strictly so that regardless of the cause an untimely application for joint taxation will be denied.

7. The Danish Tax Assessment Board issued a Circular on 3 May 1994 from which the current requirements appear.
8. The reason for this rule is that according to legislation of some countries a specific, often minor, proportion of the share capital in a company registered there must be held by shareholders who are resident in that country. See Finn Hansen and Ove Lykke Zeimer, *Skat Udland* (February 1993), at 42.
9. Erna Christensen, Alex Dalgaard and Erik M. Hansen, *Selskabsbeskatning*, 13th ed. (1993), at 394.
10. TAA Sec. 7A.
11. *Tidskrift for Skatteret* ("TfS") 1992.100.
12. Capital Gains Tax Act Sec. 6 B(5).

© 1994 International Bureau of Fiscal Documentation

IV. TERMS AND CONDITIONS DURING THE PERIOD OF JOINT TAXATION

During the period of joint taxation the companies are subject to the regulations issued from time to time by the Danish Tax Assessment Board, the most significant of which are outlined below.[13]

A. Dividends

Under CTA Article 13 dividends received by a Danish parent company from a Danish subsidiary are exempt from tax if the parent owns at least 25 percent of the share capital for the entire fiscal year in which the dividends were received, or if the parent company held the qualifying number of shares for a continuous period of at least two years prior to the time the dividends were received.[14] This rule applies regardless of whether the companies are jointly taxed.

This exemption is extended to dividends received from a foreign subsidiary, subject to the additional requirement that the parent company show that the dividends derived from one or more companies, whose profits out of which the dividends were paid, were subject to tax under provisions not substantially different from rules applying in Denmark. These rules also apply in the case of joint taxation.

In determining whether the profits out of which the dividends were paid were subject to tax under rules which do not differ substantially from Danish rules, an overall assessment of the relevant corporate tax regime is made. The exemption will not apply if:[15]

- the foreign corporation tax is not an income tax proper, but rather a tax in the form of duties, etc. which are levied on a flat rate basis, regardless of the amount of income; or
- the foreign tax regime allows for a full deduction of distributed dividends; or
- the foreign corporation tax is substantially lower than the corresponding Danish tax payable had the subsidiary been fully liable to tax in Denmark.[16]

If the dividends are not exempt under these rules, they may be deducted from the group's taxable income to the extent that the dividends represent the taxable income of the subsidiary (calculated according to Danish rules) for the accounting year for which the dividends were declared. If the dividends cannot be deducted in this manner and do not qualify for the above exemption, the parent company will be granted tax credit relief under CTA Section 17(2) and (3),[17] under the relevant tax treaty, or under TAA Section 33 in respect of dividend tax paid.[18]

Deduction of dividends is not allowed for the first year of joint taxation.

The above only applies if the individual company holds not less than 25 percent of the share capital in the subsidiary.

B. Initial values

When joint taxation with a foreign subsidiary commences, a decision must be made as to the valuation of the assets and liabilities of the subsidiary for tax purposes. Initial values for depreciable assets, etc. acquired by the foreign subsidiary before commencement of joint taxation are fixed at the market value of the assets in question at the time joint taxation commences. It is not possible to depreciate assets not established by the subsidiary (e.g. goodwill or other rights established by the subsidiary).

C. Capital gains

Gains and losses derived by a parent company on the sale of shares in a jointly taxed subsidiary are treated according to the general rules on taxation of capital gains. Capital gains realized on the sale of shares are tax exempt if the shares are sold more than three years after acquisition. Deductible losses may therefore be incurred in connection with the sale of shares in a subsidiary if losses have been deducted from the joint taxation income on a continuing basis. Under current capital gains rules the deduction of losses incurred in connection with the sale of shares is subject to certain restrictions, i.e. it is not possible to set off losses on the sale of shares in a company against profits on the sale of shares in another jointly taxed company.

D. Losses

1. Annual losses

Annual losses are allocated according to specific guidelines. To prevent companies from buying companies with tax losses in order to take advantage of joint taxation, rules have been adopted to prevent the inclusion of losses sustained prior to the commencement of joint taxation.

Unused losses of one of the Danish companies which relate to the pre-joint taxation period may only be set off against the profits of the company sustaining the loss. Losses of foreign subsidiaries relating to the period prior to joint taxation may not be set off against profits generated after commencement of joint taxation.

2. Recapture of losses

Political parties have periodically expressed the desire to amend and/or abolish joint taxation with foreign subsidiaries. With effect from income year 1992 provisions were introduced for the recapture of deducted losses in foreign jointly taxed subsidiaries.

13. See *supra* note 7.
14. CTA Sec. 13(1), no. 2.
15. Notice No. 903 of 12 November 1992.
16. As a general rule an effective foreign tax rate of more than 25% is sufficient.
17. See *supra* note 4.
18. Sec. 33 grants a direct credit for foreign tax on the dividend only.

© 1994 International Bureau of Fiscal Documentation

For jointly taxed subsidiaries resident in countries where double tax relief is based on the exemption system, losses are recaptured if the subsidiary shows a profit in subsequent years or if the foreign subsidiary is later excluded from joint taxation.

Where the parent company has other taxable profits deriving from the same country during the same income year in which the jointly taxed subsidiary shows a loss, recapture will apply only up to the amount by which the loss incurred by the jointly taxed subsidiary exceeds taxable profits from other sources.

Losses in subsequent years will not be recaptured to the extent that, in the calculation of the parent's taxable income, the profit from the jointly taxed subsidiary reduces a loss which was otherwise attributable to a jointly taxed company or could have been carried forward to future income years.

The recapture provision only applies in case of reduction of Danish taxation of gains or profits according to an exemption system. However, it is possible to elect for relief under domestic Danish rules (i.e. foreign tax credit) rather than claiming relief under the exemption system, in which case losses in subsequent income years will not be recaptured.

In the case of jointly taxed subsidiaries resident in countries where double taxation relief is granted under the credit system, recapture will only be applicable on termination of joint taxation. Recapture is limited to the gain and profit to be included for the year of termination in the calculation of the taxable income of the jointly taxed subsidiary, or in the calculation of the tax payable where the subsidiary has been dissolved by liquidation.

If the parent company undergoes a tax-free merger with the subsidiary, there will be no recapture of losses if the companies have been jointly taxed for five years or more.

E. Financial records

The Danish parent company must ensure that the financial accounting, etc. undertaken in respect of the foreign company is such that the profit and loss account and the balance sheet can form the basis of the assessment of the parent company, and that financial records, etc. of the foreign company are kept in compliance with Danish rules.

F. Translation from foreign currency

As at the balance sheet date, accounts prepared in foreign currencies must be converted into Danish kroner at the exchange rate prevailing on the date of the balance sheet or on an average basis for purposes of the tax return.

G. Thin capitalization or reduction of losses by acquisition of subsidiaries

As a general rule no thin capitalization rules apply in Denmark. However, the Danish joint taxation rules include a thin capitalization component which applies to losses of the parent company, but not to losses of the subsidiary.[19]

If income of the parent company in a jointly taxed group is negative, the loss is generally deductible against profits of the jointly taxed subsidiaries. However, if a parent company's taxable income is negative a proportion of the loss corresponding to the net financing expenses of the company cannot be set off against the profits of companies which the loss-making company holds directly or indirectly.

If an acquisition is financed with debt, when the parent company calculates its tax losses it must include a notional return on its costs of investment in the relevant subsidiary. Such costs are reduced for purposes of this calculation by $^1/_7$ annually, so the limit on the deduction of losses disappears after seven years. A well-capitalized parent company may also include notional interest on its equity in the calculation; only a thinly capitalized parent company will be penalized.

H. Termination

Joint taxation may be terminated at the request of the taxpayer. A request to terminate joint taxation must be made within the time stipulated for filing a tax return for the fiscal year in question.

Since joint taxation is only permitted after application, a parent company has the right in any tax year to exclude a subsidiary from joint taxation. Once joint taxation has been terminated, however, it may not be resumed regardless of the reason for termination.[20]

If a company resident abroad ceases to be jointly taxed with a Danish resident parent company, the amounts written down in respect of inventory of the foreign subsidiary during the last income years in which the companies were jointly taxed will be included in the parent company's taxable income for the following year.

If a foreign subsidiary company sells assets which have been depreciated during the period of joint taxation, the general rules on the taxation of recapture of depreciation will be applied to the amounts depreciated during the period of joint taxation.

V. TAXES UNDER JOINT TAXATION

The taxes paid by the group are allocated according to specific rules. According to recently introduced rules, the total amount of tax payable by jointly taxed companies is calculated and levied on the parent company.[21]

19. Therefore if a loan is taken by the subsidiary and not the parent company these rules do not apply.
20. For example, resumption of joint taxation was denied in a case where a company had mistakenly requested that joint taxation be terminated. TfS 1992.203.
21. See Income Taxation of Companies, etc. Order dated 11 January 1994.

© 1994 International Bureau of Fiscal Documentation

Jointly taxed companies are jointly and severally liable for income taxes, advance taxes, outstanding taxes and any additional interest charged in respect of the period of joint taxation.

Likewise, companies which are jointly taxed in the income year preceding the income year during which a bankruptcy order is made are liable for taxes payable in respect of any income generated by the insolvent estate during the insolvency proceedings period. However, it is not certain whether this rule applies only to Danish companies. In principle, foreign companies taxed jointly with a Danish parent company are liable to pay taxes in Denmark under general Danish tax rules. However, it will be difficult to enforce the provisions against the foreign companies unless such companies have declared specifically that they are prepared to accept tax liability.

VI. RELIEF RULES

As is clear from the above, foreign companies which are taxed jointly with a Danish parent company are liable to pay taxes in Denmark. Insofar as a jointly taxed foreign company has positive income, assessed according to Danish rules, it is possible to obtain relief for foreign-source income, relief under an applicable double tax treaty, relief under TAA Section 33, or tax relief for subsidiaries.

If relief is granted under the above rules, relief will be granted in the following order:
(1) relief for foreign-source income;
(2) relief according to a double tax treaty or TAA Section 33;
(3) relief granted to subsidiaries under CTA Section 17(2) and (3).

VII. CONCLUSION

The main advantage of joint taxation is that losses sustained by a company may be set off against profits made by other group companies. When a foreign subsidiary is taxed jointly with a Danish parent company, the foreign company is covered by the joint taxation and becomes tax liable to Denmark which is basically a disadvantage that is offset by the various rules on relief.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

NOVEMBER 1994

American Tax Institute in Europe 17th Annual Congress, Cannes, 14-16 November 1994 (English):

The American Tax Institute in Europe, Falmer Court, London Road, Uckfield, East Sussex TN22 1HN. Tel.:(0825) 760-901, Fax: (0825)760-903.

101 Offshore Tax Planning Ideas and Traps for Individuals, Trusts and Companies, London, 17 November 1994 (English):

Attn: Vicki Goffin or Evie Kinane, Conference Bookings, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

New Tax Techniques for Venture Capital, London, 18 November 1994 (English):

Attn: Kate Roberts, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

European Holding Companies as an Instrument of Tax Planning, Brussels, 19 November 1994 (German and English):

Dr W. Kessler, Rheinischer Arbeitskreis für Steuerrecht, RWTH-Aachen, Lehrstuhl für Steuerlehre, 52056 Aachen, Tel: 49-241 806149, Fax: 49-241-806816.

11th Asian-Pacific Tax Conference, Structuring Investment and Cross-border Transactions in the Asian-Pacific Region, Singapore, 21 and 22 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Tax Conference, Paris, 23-24 November 1994;

Ernst & Young, Attn: Niels Dejean. Tel.:33-1-46 93 62 32.

US International Taxation course, Amsterdam, 24-25 November 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Valuation of Companies and Mergers and Acquisitions, Zurich, 29 November through 1 December 1994 (German), although interpreters services will be available for the first day of the conference):

Zentrum für Unternehmungsführung AG, Attn: Dr Fritz Haselbeck, Im Park 4, CH-8800 Thalwil, Switzerland, Tel.: 41-1-720 8888, Fax 41-1-720 0888.

DECEMBER 1994

Derivatives – the New Frontier of Tax Planning, London, 2 December 1994 (English):

Attn: Kate Roberts, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

Practical Tax Treaties – the latest developments and strategies in international tax planning for groups of companies, London, 5 December 1994 (English):

Attn: Vicki Goffin or Kate Roberts, IBC Legal Studies and Services Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 7TD, Tel.: 71-637 4383, Fax: 71-631 3214.

Holding Companies, Amsterdam, 8-9 December 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JANUARY 1995

Internationales Steuerseminar, St. Moritz, Switzerland, 9-13 January 1995 (German):

Attn: Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postbach, CH-8022 Zürich, Switzerland, Tel.: 01-2-192399.

© 1994 International Bureau of Fiscal Documentation

LIECHTENSTEIN

THE DIFFERENTIAL TAX TREATMENT OF OFFSHORE AND DOMESTIC COMPANIES

Dr Norbert Seeger

Dr Seeger received his Licentiate of Economics from the St. Gallen School of Economics in 1978. He graduated from the University of Berne in 1980 with his Licentiate of Law and in 1986 was conferred his Doctorate of Law. He is a sole practitioner in Vaduz.

I. INTRODUCTION

Businessmen and investors can maximize tax savings by transferring their holdings or the administration of operations to a Liechtenstein offshore company. In view of Liechtenstein's imminent entry to the EEA, investors may consider relocating operations to Liechtenstein in order to take advantage of the low corporate taxes applicable to offshore and domestic companies.

Liechtenstein tax law distinguishes between domestic and offshore companies. Holding and domiciliary companies as well as domestic companies are special tax concepts which are not dependent upon any particular corporate structure. Domestic companies are companies which actively carry on business in Liechtenstein. Offshore companies are companies whose operations and/or assets are situated abroad although their corporate headquarters are in Liechtenstein.

The Liechtenstein tax code provides for two types of offshore companies: a holding company which is primarily used for portfolio management, and a domiciliary company which is used to manage company activities in foreign jurisdictions.

For tax purposes holding companies are defined as legal entities entered in the Public Register, as well as non-registered foundations, whose objects consist primarily or exclusively of portfolio management, the acquisition of equity participations in other corporate entities or the management of other companies. A holding company is exempt from property, income and capital earnings taxes. An offshore holding company may own and administer movable property located within or outside Liechtenstein, including patents, trade marks, copyrights, models, etc.

Domiciliary companies are defined as companies entered in the Public Register, which maintain administrative headquarters in Liechtenstein. Whether or not such companies maintain actual offices or merely an address with an agent for service is irrelevant. Under no circumstances may domiciliary companies actively carry on business or engage in any commercial or industrial activity relative to Liechtenstein. They may, however, manage foreign operations from Liechtenstein as well as establish profit centres in Liechtenstein.

The tax code does not provide a definition of domestic companies as such. However, it does provide that all corporate entities including clubs, joint stock companies, anstalts, foundations, etc. which carry on business or a trade, or an industrial activity within the country, are subject to capital tax and income tax.

II. CAPITAL TAXES LEVIED ON OFFSHORE COMPANIES

Companies which qualify as offshore companies (holding or domiciliary companies) are exempt from property, income or capital earnings taxes. They are only required to remit an annual capital tax which is calculated as 0.1 percent of the paid-up capital and other assets held by the company, including retained earnings and taking into account any liabilities and accrued losses. However, such a tax may not be less than Sfr. 1,000 in any year. The capital tax paid by an offshore incorporated estate (foundation) which qualifies as an offshore holding company, is reduced to 0.075 percent for foundations with assets in excess of Sfr. 2,000,000 (including reserves and accumulated income) and to 0.05 percent for companies with assets in excess of Sfr. 10,000,000 (including reserves).

If an offshore company invests in industrial operations or fixed assets located in Liechtenstein which generate income from domestic sources, the offshore holding company is subject to tax on its capital earnings as well as income tax and capital tax on the Liechtenstein assets and the income which may be attributed to the operations located in Liechtenstein, at the same rate as domestic companies.

III. TAXES LEVIED ON DOMESTIC COMPANIES

For domestic companies the obligation to paid taxes begins with registration in the Companies Register and continues until liquidation proceedings have been concluded. If the company has not existed for the entire year in respect of which taxes are payable, capital taxes will be levied *pro rata* relative to the period during which the company existed. Income taxes, however, are payable in each year without having regard to whether or not the company has existed for the entire year.

© 1994 International Bureau of Fiscal Documentation

Capital taxes are assessed on the net assets of the company, including declared and undeclared retained earnings, less accrued earnings or assets, the acquisition whereof may be attributed to the tax year in question. Separately managed funds which have been allocated by a company for *inter alia*, charitable purposes, pension funds, etc. are excluded from the tax base. The capital tax payable is 0.2 percent of the net assets.

Corporate income tax is levied on annual net income. Net income is derived on the basis of established and internationally recognized accountancy practices. Appreciation and payments to funds as well as retained earnings are included in net income to the extent that the same cannot be justified for commercial reasons and may be considered a creation of non-allowable, undeclared retained earnings. Dividend income, including income earned abroad and interest income (as well as income earned by foreign branches), is included in calculating net income.[1] Taxes paid to a foreign tax authority, however, may be deducted as an expense. A reserve may be made for stock-in-trade and work-in-progress.

Income tax is calculated as follows. It is one-half of the percentage amount according to which the net income constitutes a percentage of the taxable capital. However, the tax rate may never be less than 7.5 percent of net income, nor may it ever be greater than 15 percent of net income. The tax rate is calculated as follows:

$$\frac{\text{taxable net income} \times 100}{\text{taxable capital} \times 2}$$

The marginal rate of corporate tax payable rises progressively by 1 to 5 percent when the dividends or profits distributed in each year are greater than 8 percent of taxable capital. Thus the total corporate income tax payable can be a maximum of 20 percent of net income.

In view of the coupon taxes which are levied on distributed earnings, the greatest possible tax burden on income earned by a company is 23.2 percent. Liechtenstein residents pay no income tax on dividend income.

IV. COUPON TAX ON DISTRIBUTIONS

Coupon tax is levied in respect of all securities which have been issued by a resident company, or by a company having its official head office in Liechtenstein, or by a company which is registered in the Liechtenstein Public Registry, regardless of whether or not the company qualifies as a domestic company or an offshore company. The following types of securities are subject to coupon tax: stocks, bonds, deeds, debentures, medium-term notes, annuities, mortgage bonds, bills of exchange as well as discounted bills such as borrower's notes, which are issued in series for the purpose of trading.

The coupon tax is levied on and due from the payor. Therefore the tax becomes due upon payment or distribution, regardless of the identity or residence of the recipient.

Under Liechtenstein law it is possible to incorporate legal entities whose capital is not divided into shares. Such entities (foundations and business trusts) may serve as holding companies, or, as in the case of business trusts and anstalts, either as domiciliary or domestic companies. Entities, whose capital is not divided into shares, and in which the right to participate in the equity is not evidenced by a certificate of title, are not subject to any tax (in particular coupon tax) in respect of distributions made to the beneficiaries or equity participants. Such distributions are tax-free. The distribution of dividends to shareholders of a Liechtenstein joint stock company are subject to coupon tax in all cases.

The rate of coupon tax is currently 4 percent. The amount paid by the debtor in redemption of a security or debenture, or a distribution on account thereof, forms the tax base for the purpose of calculating the coupon tax. The tax is levied on the amount paid, compensated or credited as per the terms of a security or analogous document of title.

V. PRACTICAL APPLICATIONS FOR OFFSHORE COMPANIES

The distinction between an offshore company and a domestic company has thus far not been adequately drawn by the courts or fiscal authorities. Basically, the offshore privilege is available to companies which exclusively export their services regardless of whether such services originate exclusively from Liechtenstein. The privilege applies to service companies who realize their turn-over exclusively with clients, companies or operations residing outside Liechtenstein.

Preferential tax treatment may be extended to the administrative activities carried out by coordination companies which offer their pooled services to a group of companies located abroad. Such companies, although never defined by the courts, the legislative, the administrative or fiscal authorities, are in fact resident multinationals whose corporate purposes are limited to administrative activities performed on behalf of foreign operations such as centralized organizational and secretarial services, advertising, monitoring of international markets, marketing and market studies, supplies, collecting and processing of technical or administrative data, responsibility for international business contacts and public relations work, public relations with national and foreign authorities, centralized accounting, financial and administrative operations, research and development, computer-aided data processing, legal evaluation and assistance as well as any services directly or indirectly related to the above activities. Such activities may, however, only be performed for the exclusive benefit of operations and enterprises abroad. Services billed by such companies to companies abroad are not subject to income, turnover or value added taxes in Liechtenstein.

1. The only exception is the treatment of income originating from Austria which treatment is subject to the specific provisions in the double tax treaty between Liechtenstein and Austria.

© 1994 International Bureau of Fiscal Documentation

Some further interesting applications for the offshore holding or domiciliary company are the licensing of patents, trade marks, know-how and other intellectual property, intercompany financing and intercompany transfer pricing.

The use of offshore companies offers interesting possibilities to companies operating in the construction industry or in the installation of factory equipment, ski lifts, etc. In all cases where considerable time (three to six months) may be spent on a construction site installing equipment or building (the installation of rotogravure printing presses, ski lifts, elevators, automatic storage systems, etc.), the interposition of an offshore company may be considered. Such installations can often represent 15-30 percent of the finished price of a product. Service and spare parts may often equal as much as 10 percent of the original price annually. Construction, installation and services can be channelled through a Liechtenstein domiciliary company by way of sub-contracting to such a company which directly employs such employees as are necessary to effect the installation or construction work. Such a Liechtenstein domiciliary company would continue to qualify for the preferential tax treatment accorded to an offshore company for so long as the construction sites are located abroad. Generally speaking, in almost all OECD countries a company which has no presence beyond a construction site for a limited period of time, which varies from country to country (six to 12 months), is not subject to tax in the country where the construction takes place.

Other purposes to which an offshore company may be put without incurring taxation as a domestic company in Liechtenstein or abroad (provided that all activities emanate from the Liechtenstein office) are the management of subsidiaries, the establishment of subsidiaries, as well as film production and film distribution provided the filming occurs outside Liechtenstein.

At this time offshore companies may only employ Swiss or Liechtenstein nationals and residents. This restriction substantially limits the possibilities for establishing corporate headquarters in Liechtenstein. An alternative which is often resorted to, however, is to retain free-lance personnel. Although highly qualified, the population of Liechtenstein is only 29,500. However, after expiry of the relevant transitional periods provided for in the EEA treaty, offshore companies will be able to employ all nationals of an EU or EEA country. In addition to the highly qualified potential commuter workforce from Switzerland, nationals from neighbouring Austria and Germany will also be available. It will also be possible for any national of an EEA or EU country to settle in Liechtenstein in order to take up employment with a Liechtenstein employer, including an offshore company.

Domestic companies may employ nationals, residents or commuters from neighbouring Austria and Switzerland. Moreover, to the extent that domestic companies cannot find qualified staff in Liechtenstein, they may import labour.

VI. SUMMARY

In most OECD countries the transfer of corporate profits to offshore companies is only disallowed from a tax point of view when the offshore company serves no economic purpose other than to reduce taxes. However, when the factual administrative headquarters of a multinational company group is moved to a low tax jurisdiction, such a move is generally not considered to be tax evasion.

Investors wishing to relocate or re-organize their business activities are well advised to consider the favourable tax treatment from which they may benefit should they decide to transact business or provide services from Liechtenstein.

There are particular incentives for businessmen and professionals to form a domestic company in Liechtenstein. Not only is such a company practically exempt from all local taxes, but, depending on the tax laws of the recipient, dividends paid out of active business income of the company earned in Liechtenstein will be considered to come out of the exempt surplus of the payor and hence may, depending on the tax rules of the country of residence, be tax exempt to the recipient.

From an investor perspective, Liechtenstein offers significant advantages as a site for international investment and other activities that generate active business income. These advantages may extend to amounts deemed to be active business income under several foreign income tax rules because they are paid as interest, royalties or other charges on the active business income of another foreign affiliate of the taxpayer. However, it is essential that "mind and management" of the company be in Liechtenstein to ensure exemption of its active business income in other tax jurisdictions.

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND

A Proposed Binding Rulings Regime

Adrian J. Sawyer

M. Com (Hons), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand. **Adrian Sawyer** is a lecturer in taxation and business law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch, New Zealand. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a New Zealand correspondent for the *Bulletin*, and is a consultant for the New Zealand Treasury on effective tax rate research and is a member of the New Zealand Society of Accountants and is on the Canterbury/Westland Branch of the Society's Tax Committee. Previously he was an investigating accountant with the New Zealand Inland Revenue Department.

I. INTRODUCTION

New Zealand tax advisers and taxpayers have operated in an environment which is frequently tainted by uncertainty, complexity and rapid change in tax legislation and regulations. Administrative and compliance requirements have normally closely followed these developments. While a number of other jurisdictions have initiated changes to improve the environment for taxpayers and their agents by introducing binding rulings regimes, New Zealand has only recently resolved to venture down this path.

Until 1982, there was only an ad hoc form of rulings system in New Zealand. In June 1982, the Commissioner of Inland Revenue ("the Commissioner") formally introduced an advance rulings regime for taxpayers.[1] This was instigated by the Commissioner as a mechanism to improve certainty for taxpayers and to provide a more formal system for requesting opinions from the Commissioner. Taxpayers under this regime must supply all relevant information for contemplated or incomplete transactions after first seeking professional advice on the matter. A ruling may then be forthcoming but the Commissioner may refuse to issue a ruling on a number of grounds, including situations where the application, in his opinion, was on a frivolous or vexatious matter, or the application was based upon a completed transaction.

The resulting ruling cannot be binding upon the Commissioner since the Commissioner is directed to collect the correct amount of tax as required under the relevant revenue statutes.[2] Parliament has granted upon itself the sole ability to levy tax. Therefore rulings may be altered prospectively and if necessary, retrospectively to the time when they were issued in order to allow the correct amount of tax to be collected. Evidence of previous ruling applications indicates a significant number of retrospective revocations of advance rulings, with a number of disputes concerning retrospective alterations receiving a hearing in the courts. A rulings regime with these characteristics lacks certainty and does not facilitate business confidence in the tax system, while at the same time it frustrates business activity and entrepreneurship, and can leave the Commissioner in a very unfortunate position. Calls for change were made during the mid-1980s, but they fell upon deaf ears until 1989.[3]

In 1989, as part of the tax simplification process instigated by the then Labour Government, a change to the rulings system was raised in a number of submissions. These submissions received favourable treatment by the Taxation Simplification Consultative Committee, chaired by John Waugh (an Auckland accountant), and in 1990 the Waugh Committee recommended that a binding rulings regime be introduced. The change in government saw the recommendations take a back seat until clear signals of progress emerged in 1992.

The New Zealand Government recognized that there were problems with this system of providing rulings and announced in the 1992 Budget that it intended to introduce a system for issuing binding rulings on tax matters.[4] It was not until June 1994 that a discussion document[5] emerged from the work undertaken by the Inland Revenue Department, Treasury and other government officials.

In the discussion document, issued on 7 June 1994, the Commissioner is permitted to issue rulings on the interpretation of tax law which bind him on the future application of that law. The result of this approach, the discussion document states is

1. See Public Information Bulletin ("PIB") 117 issued in June 1982.
2. PIB 117 states the general legal position:
"Whilst every endeavour will be made to give a ruling which will stand, an advance ruling or interpretation can only be an expression of opinion and is not binding on the Department. If it is later found to be incorrect for any reason, e.g. incomplete facts given, the operation of a scheme not being in accord with the stated position as set out in an agreement and/or other documents, changes in the law or interpretation of the law, the Department is bound to correct the position and apply the law".
3. For further discussion on the advance rulings regime and its associated problems, see A. Sawyer, "The Potential Liability of the Commissioner for Tax Rulings", (1994) 37 *Current Taxation*, 78-80, 85-88, 89-92 (Parts I, II and III).
4. For a discussion of the policy issues addressing whether there should be a binding rulings regime, see *The Report of the Working Party on Tax Disputes* (NZ Government, Wellington, June 1990); *Final Report of the Consultative Committee on Tax Simplification* (Wellington, September 1990); J. Prebble, *Advance Rulings on Tax Liability*, (1986, Victoria University of Wellington, Institute of Policy Studies); and M. Smith, "Binding Rulings" (NZ Society of Accountants, 1993 Tax Conference).
5. New Zealand Government, "Binding Rulings on Taxation – A discussion document on the proposed regime" (Wellington, June 1994).

© 1994 International Bureau of Fiscal Documentation

that "... more taxpayers will be able to conduct their affairs with certainty about the Commissioner's view of the law".[6]

With an increasing amount of recent major developments in tax law and practice, the New Zealand Government is making extensive use of the consultation process prior to enacting legislation. The proposed binding rulings regime is no exception with the proposed regime open to public consultation (which closed on 11 July 1994, providing a period of 34 days for submissions).

In the process of designing the proposed regime, the system was required to reflect the balance between the benefits of increased certainty to taxpayers, with the need to reduce the fiscal risk to the Crown. A risk may arise as a result of rulings which are later found to understate the true liability, such as through a court decision on the matter. It is emphasized that fine balancing of these factors frequently underlies a number of the components of the regime and by implication, moves to modify a feature of the regime would have implications for its overall design. It is unfortunate that there is a degree of competition between the aspirations of increasing taxpayer certainty and minimizing fiscal risk on occasions.

The ruling regimes in Australia, Canada and the United States were extensively reviewed in the process of devising this proposed regime. The resulting features of the proposed New Zealand regime closely resemble the attributes of the recently introduced binding rulings regime in Australia.[7]

There remains a further opportunity for consultation on the proposed regime. After submissions on the discussion document's proposed regime are reviewed by the Government, a Bill will be introduced to the New Zealand Parliament, and considered by the Finance and Expenditure Select Committee for the hearing and evaluation of further submissions. The regime is intended to take effect from 1 April 1995 for all public rulings and for private rulings on proposed transactions, and from 1 April 1996 for private rulings on current and completed transactions.

This article overviews the proposed binding rulings regime for New Zealand, with a discussion of the contentious issues and suggestions for improvement (or at least clarification) of some aspects. Part II discusses the reasons for the change in direction towards binding rulings and overviews the regime as set out in the discussion document. The components of the regime are explored and presented in Part III, with some conclusions and implications of the regime set out in Part IV.

II. THE UNDERLYING PHILOSOPHY: THE BALANCE BETWEEN AN EFFICIENT SERVICE TO TAXPAYERS AND ENHANCING BUSINESS CERTAINTY AND PROTECTING THE REVENUE BASE

As with most draft tax legislation prepared by governments, there will always be trade offs between the aspirations of taxpayers and protecting the revenue base. With the existing taxpayer compliance environment in New Zealand submerged in uncertainty and virtual ineffectiveness in many areas, the need for change is exceedingly obvious.

The binding rulings regime is the blueprint arising from a balancing of benefits to both taxpayers and the Inland Revenue Department ("IRD"). The Government contends that the benefits include more certainty, reduced litigation and improved information flows to the IRD (the latter may be a "cost" to taxpayers). However, as will be discussed in Part III, a number of the benefits introduce subtle costs and potential uncertainties. Nevertheless, the proposed regime is an excellent step forward and indicates that the New Zealand Government has considered the interest of taxpayers as well as the fiscal purse. The clarity of discussion and succinct presentation of the issues, coupled with the improved drafting style in the draft legislation included in the discussion document, are most welcome. However, it is important to clarify the reasons for change and then overview the regime.

A. Reasons for change

In order to understand the reasons for a change in focus in the proposed regime, the current rulings environment must open any discussion. It has been accepted for some time in New Zealand that it is the New Zealand Parliament through the revenue statutes that imposes the liability for tax and that the Commissioner has the role of quantifying the amount of tax duly payable.[8] The IRD has been able to issue general statements or (general rulings) through its Tax Information Bulletins and certain booklets. The Commissioner is not bound by these documents and may in fact alter his stance retrospectively (although experience indicates this is rare rather than the norm). It should be noted that the Commissioner does not gain by refusing to follow his general statements, but rather both he and the system receive criticism and lose support from the taxpaying public. As mentioned above, the Commissioner has made it an administrative practice to issue advance rulings to taxpayers upon request. In light of the legal position regarding the imposition of tax in New Zealand, such rulings cannot bind the Commissioner.[9]

With the increasing strain on the system, pressure for change and the substantial level of adverse comment concerning the current status of rulings, a change in tax policy had to eventuate at some stage. The result of this pressure is the binding rulings regime set out in the discussion document, a document which represents the Government's attempt to deal with these concerns and reflect its change in tax policy.

6. *Id.* at 1.
7. The regime was introduced with effect from 1 July 1992 in Australia.
8. See *Reckitt and Colman v. TBR* [1966] NZLR 1,032 and Sec. 22 of the Constitution Act 1986 (NZ).
9. This situation has been confirmed by case law. See, for example, the decision in *C of IR v. Lemmington Holdings* (1982) 5 NZTC 61,268, where Woodhouse P. And Richardson J. said:

> ... the Commissioner cannot be estopped by past conduct from performing his statutory obligation to make assessments as and when he thinks proper. It is his present judgement as to the statutorily imposed liability for tax that counts.

© 1994 International Bureau of Fiscal Documentation

Underlying the impetus for change is a recognition of the need for certainty for taxpayers. The discussion document sets out to increase certainty in two ways. Firstly, through "transaction certainty", whereby business certainty can be enhanced by taxpayers knowing the tax treatment of proposed transactions in advance (and eventually with current and completed transactions to assist with determining the relevant tax status of the transaction). Secondly, "compliance certainty" will be enhanced by taxpayers receiving assurance that transactions that comply in all respects with the terms of the ruling will not be subject to a higher tax liability or to penalties for non-compliance.

Political contentions have frequently surfaced that the regime should facilitate and enhance investment and economic growth, increase employment and influence the way in which transactions are structured.[10] The existing system adds to the complexity of the tax system and builds upon the already high level of taxpayer compliance costs.

The IRD's benefits will include reduced litigation (which is also a benefit to taxpayers, but primarily for the IRD in that this will reduce its administrative costs and improve its relationship with taxpayers), although this benefit may prove illusory in the cold light of day. The IRD also stands to benefit from a closer and more intimate knowledge of business activities through improved information flows in "grey areas" of the law. This information should frequently be up-to-date rather than "dated" when information is acquired during the review and audit process. Knowledge about taxpayer behaviour patterns will be enhanced with the IRD receiving contemporary information on the latest business techniques and practices; that is, the IRD may only be weeks behind the latest developments rather than many months or even years!

The proposed regime is intended to reflect fiscal, time and human resource constraints since the proposed regime provides that private rulings will initially be limited to proposed and incomplete transactions. It should be recognized that the draft legislation reflects the over-riding principle that Parliament retains the ultimate authority and power over levying tax.

B. Overview of proposed regime

The binding rulings regime in the discussion document is offered as a complete package, a system which incorporates the positive attributes of the rulings systems in other jurisdictions while recognizing the specific characteristics of the New Zealand tax environment. The regime will permit the Commissioner to make rulings dealing with the Estate and Gift Duties Act 1968, Gaming Duties Act 1971, Stamp and Cheque Duties Act 1971, Income Tax Act 1976, and Goods and Services Tax Act 1985. The draft legislation in the discussion document is entitled, "Binding Rulings Act 1994 (NZ)", although it is intended to form part of the new Tax Administration Act when the rewrite of New Zealand's revenue statutes is complete. In essence the proposed regime has the following key features:[11]

- The Commissioner will be able to issue binding public (general) and private (taxpayer-specific) rulings. Private rulings will be charged for a full cost recovery basis.
- Public rulings will apply to all transactions and arrangements entered into for the income year or years for which the ruling is issued.
- For resource reasons, private rulings will initially be limited to specific transactions and arrangements entered into after the issue of the ruling. Twelve months later the regime will be extended to provide private rulings on current and completed transactions and arrangements.
- The Commissioner will be bound to assess taxpayers in accordance with an applicable ruling.
- Taxpayers will not be bound by either a public or private ruling but will be required to disclose in their returns that they applied for a private ruling and whether or not they followed it.
- There will be no separate right to appeal against a ruling.
- Public rulings will be published.
- Private rulings will be published in summary form without identifying the recipients.

Rulings will not be available in certain areas, including the Commissioner's penal powers (and exercise of prosecution procedures and debt recovery); certain procedural and administrative matters; binding determination procedures contained elsewhere in statute; and gaps in the legislation.

III. THE PROPOSED BINDING RULINGS REGIME

The proposed regime is comprehensive and to discuss its essential characteristics and implications for taxpayers and the Commissioner, the discussion will largely follow the segments utilized in the discussion document. The principle areas in the discussion document address: implications for the Commissioner; implications for taxpayers; application of rulings; ambit of the regime; implications for the courts; source of rulings; procedural aspects of the regime; duration of rulings; and publication of rulings.

A. Structure of the draft legislation

The draft legislation is provided at the conclusion of the discussion document. The overall structure of the draft legislation is as set out below:

Part I: Preliminary, which includes definitions and interpretation of key terms;

Part II: Public Rulings, which includes issue, application, withdrawal and termination;

Part II: Private Rulings, which includes application and disclosure requirements, withdrawal, termination and offences and penalties.

10. For example, see the comments of the then Minister of Finance, Hon. Ruth Richardson, in "The Budget 1992", B6A, at 93-94.
11. *Id.* at 1-2.

© 1994 International Bureau of Fiscal Documentation

The purpose of the Act as set forth in Section 1 is "to allow the Commissioner to issue public and private rulings which bind the Commissioner on the interpretation of taxation law so as to:

(a) provide taxpayers with certainty about the way the Commissioner will apply those laws to their arrangements; and
(b) help taxpayers to meet their obligations under those laws, – while recognizing the importance of collecting the taxes imposed by Parliament and the need for full and accurate disclosure by taxpayers". This succinctly stated purpose section will form the basis for judicial review of the Commissioner's actions and should be the underlying principle in considering policy developments regarding binding rulings.

B. Implications for the Commissioner

The Commissioner is granted power to make two types of rulings, public rulings and private rulings. Each ruling must apply to all taxpayers that fall within the ambit of the regime, even if the Commissioner subsequently determines that the ruling contains an incorrect interpretation of the law. The idea that the ruling binds the Commissioner is that the Commissioner must assess taxpayers that are permitted to rely on the ruling in accordance with that ruling.

1. Public rulings

Public rulings are initiated by the Commissioner and may be based on a suggestion made to the Commissioner that a ruling on the matter would be useful. The resulting ruling binds the Commissioner where taxpayers calculate their tax liability in accordance with the ruling.[12] The ruling may address one or more provisions of tax law rather than a comprehensive coverage of a particular transaction (which private rulings will cover). The ruling will only apply to the particular facts outlined in the ruling. Disputes as to whether a particular transaction comes within the ambit of the public ruling will ultimately be determined by the courts when a taxpayer's objection to the Commissioner's assessment is heard.

The Commissioner is permitted to continue to issue general non-binding interpretations of the law in Tax Information Bulletins and other publications. Therefore not all general rulings will be public rulings.

2. Private rulings

Taxpayers will be able to apply for a private ruling which covers specific transactions or arrangements.[13] Private rulings will only bind the Commissioner in relation to the taxpayer (or taxpayers in the case of joint applications) that applied for the ruling. In addition, the ruling must remain in force and the taxpayer must rely on it for the Commissioner to be bound by the ruling. The strict requirements that accompany a request for a private ruling reduce the situations in which the ruling applies.

3. Duration of public or private rulings

A public ruling will only bind the Commissioner for the income year or years specified in the ruling,[14] but the Commissioner may withdraw the ruling with prospective effect before it expires[15] or the ruling may be terminated by a change in the law.[16] The withdrawal procedures are consistent with the situation in Australia, Canada and the United States. Transactions entered into before to the proposed withdrawal will be assessed in accordance with the binding ruling. A notice specifying withdrawal of a private ruling must be provided to the recipient of that private ruling,[17] but with public rulings the Commissioner must either issue a notice of withdrawal or issue a new public ruling which states that the old ruling has been withdrawn.[18]

Changes in the law will cause a ruling to be terminated on the date that the amendment to the law takes effect, reflecting the practice in overseas jurisdictions.[19] The Commissioner is also required to provide a service to taxpayers through a non-exhaustive list of rulings that he considers to be withdrawn following a change in the legislation, although this is not specifically stated in the draft binding rulings legislation.

When a change in interpretation of the law occurs through the judicial process, the Commissioner is not required to immediately withdraw a ruling which is contrary to the court's interpretation. Once a court hearing is final or an appeal covering a matter addressed by a ruling is resolved, the Commissioner will withdraw the ruling when it is contrary to the finding of law.

C. Implications for taxpayers

The Commissioner's interpretation of the law issued by way of a ruling will not bind the taxpayer. Instead, the taxpayer must notify the Commissioner if he received a private ruling and whether or not he followed it.[20] This differs from the Canadian approach where rulings are purely an administrative function, and the US system of rulings where obligations on taxpayers are noticeably stricter than those proposed for New Zealand. Australian taxpayers must follow an applicable private ruling in filing their returns, but they may appeal directly against the ruling. The discussion document proposes that binding rulings in New Zealand will not have the status of law.

Strict disclosure requirements for ruling applications are included, and these requirements are accompanied by the obligation to disclose the existence of a private ruling and whether or not the disclosed ruling has been followed in tax

12. Binding Rulings Act 1994 ("BRA") Sec. 6.
13. These are made under BRA Sec. 12.
14. BRA Sec. 8.
15. BRA Sec. 10.
16. BRA Sec. 11.
17. BRA Sec. 22.
18. BRA Sec. 10.
19. For public rulings, BRA Sec. 10; and for private rulings, Sec. 23.
20. BRA Sec. 26.

© 1994 International Bureau of Fiscal Documentation

returns.[21] Failure to satisfy the disclosure requirements in tax returns will cause the ruling to be inapplicable and open the taxpayer to the existing penalties for false disclosure or negligent disclosure.

The proposed penalties for offences include:[22]

- For negligent failure to comply with disclosure requirements, and negligent failure to disclose material differences upon application for a ruling, a fine of $NZ 2,000 (maximum) for the first offence, $NZ 4,000 (maximum) for the second and $6,000 (maximum) for each subsequent offence.
- For giving false information, misleading or attempting to mislead the Commissioner in any manner connected with a ruling, a fine of $NZ 15,000 (maximum) for the first offence, and $NZ 25,000 (maximum) for each subsequent offence.
- For aiding and abetting, or inciting another to commit an offence, the same penalties are applicable depending upon the principal offence committed.

There are two major shortcomings in the regime regarding the disclosure requirements. Most importantly there is no guidance or definition as to what a material difference is, which if left as it currently stands, may potentially cause many taxpayers to face penalties for non-disclosure of a material change in the transaction to that set out in the ruling. Secondly, the boundaries of negligent conduct have moved in a number of surprising directions in the judicial arena in New Zealand. Judicial policy considerations in New Zealand with respect to negligence is noticeably different to policy considerations in many other countries, such as the United Kingdom and Australia. The binding rulings regime is an opportunity to provide guidance as to what is deemed to be negligent conduct with respect to applications for and reliance on binding rulings.

The proposed regime envisages that on occasion there will be conflicting rulings. With respect to two conflicting public rulings, the taxpayer may determine which one to rely on until the Commissioner withdraws one of them.[23] This is an improvement over the more restrictive Australian situation where a later ruling will override any conflicting ruling with prospective effect. Where there is a conflict between a public ruling and an applicable private ruling, the taxpayer may choose which one to rely on.[24] In Australia, this scenario creates confusion in that a private ruling is deemed to be withdrawn to the extent that it is inconsistent with a later public ruling. In the rare situation of two conflicting private rulings, the taxpayer may also choose which to rely on.[25]

D. Application of rulings

1. Public rulings

Public rulings will apply on an income year basis rather than deemed to apply until withdrawn as is the approach in Australia. Since the public ruling reflects the Commissioner's interpretation of the law, provided there has been no change in the law, the ruling will have value as non-binding advice for transactions entered into in income years before the public ruling was issued.

2. Private rulings

Priority is to be given to private rulings on proposed transactions initially, that is from 1 April 1995 when the regime is intended to commence, and will extend to completed transactions a year later once resource constraints are relieved.[26] With a forthcoming discussion document on increased penalties for non-compliance and associated obligations, the increased compliance certainty associated with a binding private ruling should positively assist taxpayers in satisfying their stricter compliance obligations.

E. Ambit of the regime

While the regime is proposed to cover all of the five major revenue statutes,[27] the Commissioner will not be permitted to rule on certain issues and will be granted discretion to issue binding rulings in other areas. The Commissioner will have no power to rule on:

- the exercise of any right or obligation of the Commissioner to exercise penal or investigative powers, or prosecute or recover from any person;[28]
- the law concerned with the administration of the tax system;[29]
- applications for rulings on matters which fall within the Commissioner's powers to make formally binding determinations regarding financial arrangements, accrual expenditure, depreciation, the livestock valuation regime, petroleum mining operations and withholding payment regulations;[30]
- "gaps" in the legislation.

There is provision to consider integrating other formal binding determination regimes with the binding rulings regime[31] over the next 12 months, although there is no firm resolution to move in this direction; the issue is merely open to discussion.

The Commissioner has the power to decline to issue private rulings in a number of situations, although this power will be open to review by the courts in certain circumstances.[32] The broad areas where the Commissioner may decline to issue a ruling include:

- applications relating to questions of fact;

21. *Id.*
22. BRA Secs. 27 (offences) and 28 (penalties).
23. BRA Sec. 7(2).
24. No statutory reference is provided in the BRA for this eventuality.
25. BRA Sec. 13(2).
26. BRA Sec. 2 provides for this staggered introduction.
27. Estate and Gift Duties Act 1968, Gaming Duties Act 1971, Goods and Services Tax Act 1985, Income Tax Act 1976, and Stamp and Cheque Duties Act 1971 will be covered by the regime – see BRA Sec. 3 (interpretation).
28. See BRA Sec. 3 on interpretation of the term "taxation law".
29. *Id.*
30. See BRA Sec. 3 on interpretation of the term "determination rules".
31. The other regimes include the depreciation determination and accrual determination regimes.
32. BRA Sec. 19.

© 1994 International Bureau of Fiscal Documentation

- applications containing insufficient information;
- transactions or arrangements which are not seriously contemplated;
- applications raising frivolous or vexatious issues;
- questions raised in the ruling that are currently before the courts;
- where there is already a private ruling on the arrangement for which the application is made;
- transactions or arrangements which have been assessed;
- transactions which are subject to an audit;
- applications relating to a tax, duty or levy that is due and payable;
- situations where the Commissioner wishes to consult with another competent authority;[33]
- unusual resource constraints and related issues.

Several areas raise concern, including situations where the Commissioner contends that the application has insufficient information and where there are unusual resource constraints. Before a transaction is completed it may be difficult to ascertain all of the necessary information to satisfy the Commissioner and consequently many proposed transactions may not qualify for a ruling. It may not be until the transaction is complete that all of the requested information is available and in many instances there will be no material difference between the proposed and actual transaction. It should be remembered that if there is a material difference between the actual transaction and that specified in the ruling, the ruling is not applicable.[34]

Where the Commissioner claims that there is an existing private ruling on the subject matter, the ruling may be inapplicable if the material facts have changed or differ, rendering the earlier ruling inoperative.

The unusual resource constraints area should rarely be invoked by the Commissioner to maintain credibility and integrity in the regime. To avoid frequent use of this discretion adequate funding must be provided for effective operation of the Rulings Unit and to secure the availability of qualified expert staff and consultants.[35]

The discussion document provides for several instances when the Commissioner may not decline to make a ruling *per se*, including where the circumstances involve:[36]

- new legislation;
- an existing public ruling or where one is imminent;
- consideration of ITA Section 99 (the general anti-avoidance section), although the government recognizes that this will need to be reconsidered if it is used for the purposes of tax avoidance;
- alternative transactions, so long as each is made by way of a separate application;
- any specific provisions (such as the revenue capital distinction) unless otherwise specifically provided for.

Separate applications for alternative transactions (alternative arrangements) may unduly add to taxpayers' compliance costs unless one application is essentially a reproduction of the other and the applications are considered together to reduce duplication of effort and costs by the Commissioner. The Commissioner is permitted to make particular assumptions where the taxpayer cannot provide information on a future event and where assumptions are made, they will appear in the ruling.[37] If any assumption is found to be incorrect the ruling will not bind the Commissioner.[38]

F. Implications for the courts

The courts will assume a new role with the proposed binding rulings regime, a role which will involve three major issues for determination, i.e. at what stage a taxpayer may appeal a ruling, does the taxpayer have a right to appeal a decision of the Commissioner not to issue a ruling and what is the effect of a judicial decision on public and private rulings?

1. Appeals on a private ruling

Appeals could arise in relation to rulings on proposed transactions only (once these rulings are available), since rulings on completed transactions may be appealed through the objection procedures consequent to assessment. While there are advantages to permitting appeals on proposed transactions following the issue of a ruling (such as providing certainty about application of the tax law to the proposed transaction and providing the courts with an opportunity to clarify "grey areas" of the law), the private ruling does not bind the taxpayer and therefore the government proposes that the taxpayer should not be permitted to appeal the ruling at this stage. This is consistent with the US and Canadian positions, but differs from Australia (where the taxpayer is bound by the ruling).

Administrative issues exist such as the degree of litigation, associated expenses and the priority of ruling status cases over other tax related matters. The Government remains open to a discussion from interested parties concerning these matters so this may not be firm policy as yet.

Public rulings do not impose an obligation on taxpayers to comply with them so there is no corresponding right to appeal the ruling until after an assessment utilizing the ruling is issued.

2. Appeal against a decision not to issue a private ruling

Where the taxpayer is dissatisfied with the Commissioner's exercise of his discretion not to issue a private ruling, the decision is open to judicial review.[39] It is long established in New Zealand administrative law that judicial review only ascertains whether the correct procedures have been followed

33. A competent authority means a person designated as a competent authority under a Double Taxation Agreement (an agreement given effect under Sec. 294 of the Income Tax Act 1976) – see BRA Sec. 19(2).
34. BRA Sec. 13(2).
35. The 1994 Budget has provided a NZ$ 6 million funding allocation for the Rulings Unit for the period 1 July 1994 to 30 June 1995. This has been a reallocation of funds from elsewhere within the IRD's vote allocation rather than additional funds.
36. These areas are not included in Sec. 19 of the draft BRA.
37. BRA Sec. 18.
38. BRA Sec. 13(3)(b).
39. The BRA does not prohibit the judicial review forum for reviewing the exercise of discretion by the Commissioner.

© 1994 International Bureau of Fiscal Documentation

in the exercise of administrative discretion.[40] In the binding rulings environment, the subjects for review include whether the Commissioner followed the correct procedures or utilized the legal avenues available to him when he refused to issue a ruling, and whether he followed the rules of natural justice. The merits of this decision are beyond the scope of judicial review. It is contended that judicial review of the Commissioner's exercise of discretion would need to consider the purpose of the regime (i.e. to provide more certainty for taxpayers by issuing of binding rulings) which the Commissioner must take into account in exercising his discretion. Two matters of contention with respect to when the Commissioner may refuse to issue a ruling, it is suggested, are the failure by the applicant to provide all necessary information and the unusual lack of resources constraint on the Commissioner.

3. Effect of a court decision on a binding ruling

The courts are the ultimate arbiter of Parliament's tax legislation, and should a ruling be found to be wrong at law, then the Commissioner should assess the taxpayer in accordance with the court's decision. The discussion document provides that the Commissioner will be required to withdraw a ruling prospectively if the court decision is final and there is no dispute over application of the ruling to the scenario before the courts. However, where an assessment is based on a ruling under appeal, the Commissioner need not withdraw the ruling until the appeal is concluded and the final decision is contrary to the ruling. Consequently a ruling may be in a state of flux consequent to an assessment and pending the conclusion of the final appeal on the assessment.

G. Source of rulings

The Commissioner will have the power to issue rulings, which is equivalent to the situation in Australia, Canada and the United States. The IRD in New Zealand is experienced at issuing non-binding rulings and has access to resources to issue binding rulings. This observation is strengthened by the fact that binding rulings are the Commissioner's interpretation of the law and not necessarily that intended by Parliament, and interpreted by the courts as the judicial arm of the legal process. It may be argued that the rulings have the status of de facto law, but this point is one for constitutional and legal purists to argue. Rulings will be issued centrally from the IRD's Head Office, which is the legislative position in other jurisdictions, although the practice in Australia is to devolve some of this authority to regional offices.

H. Procedural aspects

Perhaps the most controversial or at least the more incompletely specified issues are set out in the procedural aspects section of the discussion document.

1. Application for a public ruling

The procedure for a public ruling is straightforward. Taxpayers may suggest issues for which they contend a public ruling would be appropriate,[41] but they cannot request a public ruling. The Commissioner will only issue public rulings in response to a suggestion from taxpayers, on his own behalf, or as a response to an issue raised in a private ruling.

2. Application for a private ruling

The taxpayer or his agent may formally apply for a private ruling.[42] The applications must include all of the following items,[43] although the Commissioner may waive the obligation to comply with any of the technical disclosure requirements where he considers it to be unreasonable to expect the applicant to comply with all of the requirements (such as a straightforward application including all necessary information to make a ruling):[44]

- the identity and IRD number of the taxpayer(s) to whom the ruling will apply;
- a delegation of authority if the application is made on behalf of the taxpayer;
- the period for which the ruling is to apply;
- complete disclosure of the facts and relevant documents;
- specific legislative provisions in respect of which the ruling is sought;
- the propositions of law which are relevant to the issues raised in the application;
- a draft ruling.

The areas that may potentially raise difficulties for taxpayers and impose sizeable compliance costs specifically include the requirements to provide complete disclosure of the facts and relevant documents, a succinct statement of the propositions of law relevant to the issues raised in the application and a draft ruling. These represent a large portion of the ground work effectively completed on the Commissioner's behalf at the taxpayer's expense, although it should be recognized that these requirements are largely reflective of the common law situation.[45] Additionally, delays may be experienced where the Commissioner requests further relevant information.[46]

3. Consultation

There is no provision for the taxpayer to have any involvement in the ruling issued by the Commissioner beyond initially providing sufficient information to the satisfaction of the Commissioner,[47] although consultation is permitted in undertaking the depreciation determination regulation process. The absence of a specific right to consultation places the onus on the Commissioner to recognize the mutual advant-

40. Discussion continues over whether there may be judicial review for unfairness arising from a legitimate expectation. See for example, A.J. Sawyer, *supra* note 3.
41. This facility for taxpayers is not directly specified as available in the BRA.
42. BRA Sec. 15 where a prescribed form is required.
43. BRA Sec. 16.
44. BRA Sec. 16(2). However, the Commissioner may not dispense with the first four items referred to.
45. For example, see *R v. Inland Revenue Commissioners, ex parte Matrix-Securities Ltd* [1993] STC 774.
46. BRA Sec. 17.
47. BRA Sec. 20.

© 1994 International Bureau of Fiscal Documentation

ages from consulting prior to issuing the final version of the ruling.

Consultation should provide confidence in the system and enable a higher quality ruling to emerge, which in turn, minimizes the reasons for future litigation. On the other hand, an extensive consultation with taxpayers generally on proposed public rulings is intended in most instances, except for example where the ruling is to replace an earlier erroneous ruling.[48]

4. Time limit for delivery of private rulings

The discussion document provides no statutory time limit for delivery of private rulings. Rather it seeks to encourage a mutually agreeable timetable between the taxpayer and the Commissioner on a case by case basis. This is contrary to the position in Australia where a time limit is provided (three months) and the Australian Tax Office ("ATO") sets as a performance objective answering and issuing rulings within that time frame. The New Zealand Commissioner could do well to work to a performance measure similar to that in Australia where only the most complex ruling takes more than three months to prepare. Without a guiding time frame, the objective of providing certainty will be severely frustrated.

In its 1994 Corporate Plan the IRD has indicated that it intends to answer 80 percent of the requests for rulings and determinations within 21 working days after receipt of all necessary information and the remainder within an agreed time frame with the client. This is a most desirable time frame for the efficient provision of rulings from the taxpayer's perspective, provided that in a concentrated effort to achieve output goals, the quality of the rulings does not suffer. The ATO has managed to provide 54 percent of rulings within seven weeks and 78 percent within 12 weeks. This can be compared to the objective of answering 70 percent of requests within seven weeks (35 working days) and the remainder within 12 weeks (60 working days). The ATO's performance indicates the difficulty in maintaining a fast turnaround from request to issue of a ruling. Nevertheless, it is a matter of balancing the virtues and drawbacks of a "fast food style" response time to that of a "high quality restaurant experience".

5. Charging for private rulings

The most controversial feature of the proposed regime is the New Zealand Government's choice to charge for private rulings. Public rulings will be funded from the IRD's expenditure vote provided annually by Parliament. In New Zealand's current drive for "user pays" and persistence in ensuring that those receiving a private benefit are not unduly subsidized by taxpayers generally, it is not surprising that there will be a charge for private rulings. Indeed, there are sound arguments for charging for private rulings. Nevertheless, the charge-out rates must be reasonable so as not to defeat the intentions of the regime.

The discussion document is short on specifics other than proposing a non-refundable application fee of $NZ 100 and an hourly rate of $NZ 105 (including GST), which is suggested to represent "full-cost recovery". Full cost recovery is not defined in the draft legislation, nor is there any reference to the recovery of overhead costs, although the application and hourly rate figures provided in the commentary are similar to applications for determinations under the accrual provisions of the ITA.[49] Charging for rulings occurs in Canada and the United States, but not in Australia. Charging should ensure the ability to generate rulings in a shorter time frame with more comprehensive coverage of the issues compared to the situation where no fees are charged; conversely taxpayers will insist on value for money or they will not seek private rulings.

There is no recognition of the level of ground work provided by the taxpayer such as a fee discount (although this will be partially reflected in a lower number of IRD hours in preparing the ruling), nor is any maximum fee provided for. Clearly taxpayers should be able to terminate their application at some stage,[50] but they remain liable for all costs incurred. It is unclear whether job costing, process costing, activity-based costing or some other costing method will be applied. The discussion document does not recognize whether fees should vary according to the urgency of the request, or the level of IRD and outside consultant expertise utilized in preparing the ruling.

There is minimal recognition that charging creates a contractual relationship between the IRD and the taxpayer. There is no reference in the discussion document as to whether the taxpayer has all of the private law remedies that would be available against advice received from a practitioner in the private sector. Furthermore, there is no direction given in the discussion document as to how the payment of fees will be enforced by the IRD or whether the fees are intended to be more than an unsecured debt.

There is no provision for an estimate of the cost of producing the ruling before the taxpayer agrees to permit the Commissioner to provide a private ruling, nor is there provision to request an update on progress towards issuing the ruling, apart from an option to terminate the process at any stage through written notice.[51]

Consideration should also be given to including a ceiling on costs and providing bands of fees to ensure that private rulings are not restricted to wealthy taxpayers. Taxpayers with minimal funds should not be forced to be content with non-binding advance rulings. On a positive note, perhaps some taxpayers may be fortunate enough to have a public ruling issued on the transaction and be saved the cost of a private ruling!

6. Class rulings

The discussion document also raises the possibility of class rulings where a number of taxpayers are not identified in the application (the example provided is that of a life insurance

48. This is not specifically provided for in the draft BRA.
49. Specific charge out rates will no doubt be left to subsequent regulations and Orders-in Council.
50. BRA Sec. 14(3) permits this course of action.
51. BRA Sec. 14(3).

© 1994 International Bureau of Fiscal Documentation

company seeking a private ruling on the tax treatment of an insurance scheme it is promoting). This issue is open to submissions, but if class rulings were provided, then any taxpayer relying on the class ruling would need to disclose this reliance in his tax return after first being aware that there was a ruling on the matter.

I. Duration of rulings

Binding rulings will exist only for a specified period of time rather than being deemed to apply until withdrawn, as is the case in Australia.

1. Public rulings

The duration of these rulings will be on a case by case basis, applying normally for three income years in which each year the ruling applies the Commissioner must assess taxpayers in accordance with the ruling.[52] The Commissioner is permitted to utilize his power to extend the life of the public ruling beyond three years.[53]

2. Private rulings

Private rulings will commence from the date specified in the ruling[54] and should be issued on an income year basis.[55] This period may be extended where the transaction spans two or more income years, or where the relevant tax legislation does not apply on the basis of income years.[56]

J. Publication of rulings

1. Public rulings

Public rulings will be published in full by the IRD so that all interested taxpayers have access to them.[57] The method of publication has not been finalized, but a separate section or appendix to the current Tax Information Bulletins in which non-binding rulings are published appears to be a satisfactory outlet.

2. Private rulings

The discussion document appraises the arguments for and against the publication of private rulings. Overseas treatment of the publication of private rulings covers the full spectrum of alternatives. Arguments against publication include the confidentiality of taxpayers affairs, how to sanitize a ruling to remove the identity of a taxpayer in a country as small as New Zealand and the associated reluctance to seek private rulings that publication may impose on taxpayers. On the other hand, allegations of "secret law" developing between those "in the know", such as a market for exchanging rulings by practitioners (a situation that has developed in Australia and Canada), is not a desirable state of affairs. Publication will enable a degree of public scrutiny but will require a change to the current secrecy provisions of the Inland Revenue Department Act 1974 ("IRD Act").

The result of the discussion is a proposal to publish all private rulings in "summary form", although this term is not clearly defined.[58] A delay in publication will be permitted where the ruling is commercially sensitive. Private ruling issues may become the subject of a public ruling where the ruling covers issues of public importance.

The discussion document concludes by setting out draft legislation in a form conducive to assisting the new "Plain English" style of drafting, promoted by the Valabh Committee (amongst others) in its report on the Reorganization of the Income Tax Act 1976.[59]

IV. CONCLUSION

The release of the discussion document on binding rulings represents a positive step forward in the development of taxpayer certainty regarding the tax implications of proposed and completed transactions, and the associated compliance obligations. Provision of a binding rulings facility is vital if taxpayers are to be able to avoid the expected higher penalties and compliance obligations, part of the contents of a recently released discussion document.[60] It also offers the Commissioner the opportunity to be more informed and cognizant of contemporary business practice and the potential for reduced litigation.

Indirectly, there is opportunity for the Commissioner to operate a "provider-customer" type relationship with this binding rulings regime, a move which has been foreshadowed in the recently released document on the reorganization of the IRD.[61]

The discussion document approach presents the arguments considered by the New Zealand Government and the IRD in arriving at the regime, and is an example of effective use of the consultation process. The draft legislation is constructed in the "Plain English" style that has been recommended for all alterations to legislation in New Zealand, a development which should assist taxpayers and the Commissioner.

The proposed regime is not without its shortcomings, as summarized below:

- no clear statement of what is a "material difference" with respect to an application, the resulting ruling and disclosure of the actual transaction;
- an absence of any specification of the situations that will give rise to unusual resource constraints and when there is insufficient information;

52. BRA Sec. 8(1).
53. BRA Sec. 8(2).
54. BRA Sec. 20(2).
55. BRA Sec. 21.
56. This is not specifically provided for in the draft legislation.
57. BRA Sec. 9.
58. BRA Sec. 25.
59. Valabh Committee, "Reorganization of the Income Tax Act 1976" (Wellington, 1992).
60. New Zealand Government, "Taxpayer Compliance, standards and penalties, a discussion document" (Wellington, 4 August 1994).
61. Organizational Review Committee, "Organizational Review of the Inland Revenue Department" (Wellington, April 1994). This committee is chaired by Sir Ivor Richardson, a judge in the New Zealand Court of Appeal.

© 1994 International Bureau of Fiscal Documentation

- no clear statement that the appeal against use of the discretion not to issue a private ruling is judicial review, nor is there any discussion of the scope of such a review;
- no statutory provision for the taxpayer to be involved in preparing the ruling (via a consultation process) although the taxpayer must pay for the ruling;
- no discussion of the specifics of how rulings will be costed and charged for;
- failure to specify delivery times and to include this as a performance statistic for the Commissioner;
- lack of any detailed discussion of class rulings; and
- no guidelines on the nature and form of a published private ruling.

It is anticipated that a significant number of these shortcomings can be resolved through the consultation process as submissions are received, appraised in an unbiased manner and included in the Bill which should be introduced to the New Zealand Parliament later this year. When the Bill is introduced to Parliament there will be a further opportunity for submissions before binding rulings are a reality for New Zealand taxpayers.

With the progressive introduction of a binding rulings regime, taxpayers will need to educate themselves with respect to the implications of the regime for their business and employment activities, its influence on their compliance obligations and how they can make the regime "work for them".

IBFD INTERNATIONAL TAX ACADEMY is pleased to announce...

WINTER COURSES FOR YOUR DIARY

Holding Companies

Amsterdam, 8 & 9 December 1994. Topics to be covered will include:

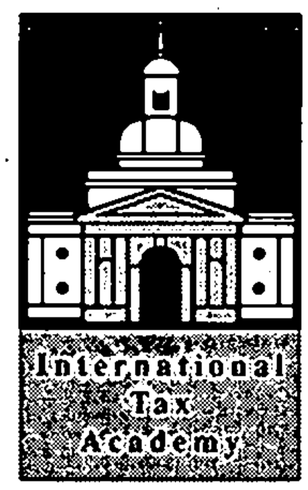
- The role of holding companies in minimizing tax on global profits
- Ideal holding company attributes and locations
- Restrictions on the use of holding companies
- Transfer pricing: recharging holding company costs in a multinational group
- The impact of the EC (EU) Parent Subsidiary Directive
- The UK's new FID/HQ scheme for foreign dividends
- The HQ company exception in the new US-NL treaty
- Holding companies v. direct investment

Principles of International Taxation

Amsterdam, 23-27 January 1995. Topics to be covered will include:

- Forms of doing business
- Residence and non-residence
- Economic double taxation
- Juridical double taxation
- OECD Model treaty and other models
- Interpretation of tax treaties
- Anti-avoidance rules
- Transfer pricing

For further information please contact: Ms Anselien School
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam
The Netherlands – Tel.: +31 20 626 7726, Fax: +31 20 620 9397



© 1994 International Bureau of Fiscal Documentation

PAKISTAN

1994-95 BUDGET[1]

Ahmad Khan

Chief (direct tax policy) Central Board of Revenue, Pakistan.

I. INTRODUCTION

Along with the usual tax measures, the 1994-95 budget seeks to introduce structural reforms in the tax system, in particular by taking measures to broaden the tax base and through administrative reforms.

No changes are proposed to the main rates of tax for companies and individuals.[2] Most of the changes in the current proposals relate to the withholding tax regime and improvements in administration and collection.

II. INCOME TAX

A. Non-resident Pakistanis

Non-resident taxpayers have been taxed at a flat rate of 30 percent as compared to the graduated rates applicable to residents. This provision placed Pakistanis temporarily residing abroad at a major disadvantage. It has therefore been decided that a Pakistani national resident abroad will be taxed on his Pakistan-source income at graduated rates applicable to residents if he did not earn any income abroad in that year.[3]

B. Non-resident contractors and consultants

The withholding tax of 3 percent on non-resident contractors has been increased to 5 percent for civil works contracts and 7 percent for turnkey projects.[4] Persons subject to these provisions will also be able to elect to be taxed under the normal tax regime.

Fees for technical services payable to non-resident consultants were previously taxed at the rate of 20 percent of gross receipts, which encouraged such recipients to disguise the payments as business profits which are subject to a concessional tax regime, particularly under tax treaties. This withholding tax on non-residents providing technical services has been reduced to 15 percent.

C. Wealth tax no longer deductible for income tax purposes

Wealth tax will no longer be deductible in computing the total liability to income tax from 1994-95, but deduction will be allowed in computing income from immovable property.

D. Withholding tax on bank transactions

Financial transactions carried out under fictitious names are increasingly contributing towards tax evasion, particularly in the unorganized business sector. In order to discourage such transactions and derive revenue from the parallel economy, a new withholding tax of 0.2 percent has been introduced for specified banking services, such as demand drafts, pay orders, etc. The tax withheld will be adjustable/refundable.

However, the new withholding tax does not apply where the payer is a Federal or Provincial Government department, a statutory body, a university, an approved charitable institution, an industrial undertaking or an institution exempt under the Second Schedule to the ITO, a listed public limited company, a diplomat or a diplomatic mission. Similarly, no tax collection will be made in respect of intracompany financial transactions.

E. Withholding tax on issuance of foreign exchange

The withholding tax of 5 percent on foreign exchange transfers has been withdrawn.

F. Minimum tax rate

The minimum rate for non-resident taxpayers has been reduced from 30 percent to 20 percent in order to create a more equitable tax regime for foreign investors.

G. Tax rebates

To promote the Government's socio-economic objectives of providing adequate dispensation to senior citizens, relief to working women and promoting human resource develop-

1. The Finance Bill 1994 presented to the National Assembly on 9 June 1994 was approved on 27 June 1994 with several modifications. These changes are included in this article.
2. In 1993 Pakistan set income tax rates for companies for all years up to 1998-99; and for individuals the rates set in the Finance Act 1993 will apply for 1994-95.
3. A certificate of residence must be obtained from the tax authorities of the country of residence in order to claim this concession.
4. A 4% rate will apply to contractors/subcontractors who are involved in the construction of power generation projects as against 5% and 7% applicable to non-resident contractors involved in other projects.

© 1994 International Bureau of Fiscal Documentation

ment, the Government has extended the following concessions:

- a special tax rebate of 25 percent of tax payable for senior citizens (i.e. those aged 65 and over) earning income up to Rs. 100,000;
- the basic exemption limit of Rs. 40,000 has been increased to Rs. 45,000 for working women (with certain exceptions); and
- a new deduction of up to Rs. 50,000 will be available to individuals for repayment of educational loans taken to finance specialized higher education in certain areas.

H. Five-year tax-holiday to selective industries

To encourage investment in industries with export potential, a five-year tax exemption will be available in respect of income of fruit processing undertakings and industrial units making soft and stuffed toys set up in Pakistan by 30 June 1997.

I. Administrative changes

1. Discretionary powers of the Federal Government

Under various provisions of the ITO (e.g. Sections 14, 50 and Third Schedule) the Federal Government was empowered to grant income tax exemptions/reductions in tax rates to any class of income or persons, and to specify depreciation rates, etc. without consulting the National Assembly. To prevent abuse of powers, these powers have been eliminated in favour of the National Assembly.

2. Tax hearings

To expedite the assessment procedure and relieve taxpayers from prolonged hearings, administrative instructions have been issued whereby assessing officers have been directed to restrict hearings to a maximum of two hearings except where necessary documents have not been submitted by the taxpayer.

3. Appeal fees

The cost of appeal fees has also been increased.

4. Increase in default penalties

The penalties for late or non-submission of income tax (and wealth tax) returns and statements have been increased.

III. WEALTH TAX

A. Rates

With a view to reduce the burden of wealth tax, the rate bands have been modified.

B. Basis of valuation

Changes have been made to the basis of valuation for the purposes of net wealth calculation. These include the valuation of rented immovable property, government allotted plots and unlet commercial properties. The exemption of certain agricultural assets from wealth tax has been increased.

C. Method of collection

To abolish complicated procedures in the collection of advance tax on rented property, advance wealth tax on rented property will be collected with provincial property tax collected by provincial excise departments.

D. Wealth tax returns

Filing of wealth tax returns will be mandatory for all income taxpayers, including those subject to the presumptive tax regime. Failure to submit the wealth tax return will render the income tax returns invalid, and there will be increases in the penalties for concealment or misdeclaration of wealth.

© 1994 International Bureau of Fiscal Documentation

ASEAN

A Primer on the ASEAN Free Trade Area

Victor T. Chew

M.C.L., LL M, LL B, Research Associate, IBFD. The author wishes to thank Dr Ng Chee Yuen, Director, Bureau of Economic Cooperation of the ASEAN Secretariat in Jakarta for his kind assistance in the preparation of this article.

I. INTRODUCTION

The ASEAN Free Trade Area ("AFTA"), using the Common Effective Preferential Tariff Scheme ("CEPT")[1] as its primary mechanism, was formally established by the ASEAN Heads of Government at the 4th ASEAN Summit ("Summit") held in Singapore on 27-28 January 1992.[2] The Singapore Declaration and the Framework Agreement on Enhancing ASEAN Economic Cooperation,[3] as well as the Agreement on the CEPT Scheme for AFTA,[4] were signed.[5] The ASEAN member countries[6] agreed to reduce intra-regional tariffs on all manufactured items, and to remove non-tariff barriers. The level of tariffs with non-ASEAN countries will continue to be decided individually by each of the Countries.[7]

II. THE COMMON EFFECTIVE PREFERENTIAL TARIFF SCHEME

AFTA was officially started on 1 January 1993.[8] The CEPT Scheme, however, was implemented on 1 January 1994.[9]

A. Objectives

AFTA's main goal is to increase ASEAN's competitiveness as a production and manufacturing centre targeted towards the liberalizing global economy. It is also hoped that AFTA will increase inter-ASEAN trade and contribute to the openness of the ASEAN economy, and that it will attract both ASEAN and non-ASEAN direct investment: to this end, private sector participation is vigorously promoted.

Moreover, AFTA may be viewed as setting a preparatory stage for either a more liberalized trading system in Southeast Asia or a larger economic union in the Asia Pacific region.[10] AFTA may also be considered as a reaction to increasing regionalism in trading arrangements, and perhaps more pertinently, to anticipate and counter growing concerns over the impact of the North American Free Trade Agreement and a unified European Union. Although the Countries acknowledge that further intra and extra-subregional economic arrangements could complement AFTA, extra-ASEAN economic relations with other countries, and regional and international organizations, are encouraged.

B. Important developments

On 11 September 1992, ASEAN instituted the AFTA Council to facilitate the implementation of AFTA. During the 3rd AFTA Council Meeting in Jakarta on 11 December 1992, documents which were finalized include the Operational Procedures for CEPT,[11] the Rules of Origin for CEPT[12] and the Interpretative Notes to the Agreement on the CEPT Scheme for AFTA.

The Senior Economic Officials' Meeting, held in Jakarta from 7-9 December 1992, agreed on a three-stage programme for the harmonization of ASEAN tariff nomenclature: firstly, the streamlining of the Countries' CEPT submissions by tariff lines; secondly, the isolation of problem areas; and lastly, the solution of problems and agreement on a standardized ASEAN tariff nomenclature.

In February 1993, the ASEAN Consultative Committee on Standards and Quality ("ACCSQ") was formed. The ACCSQ is charged with the harmonization of standards, testing and accreditation of laboratories, conformity assessment and technical information, as well as the removal of technical

1. The terms AFTA and CEPT and CEPT Scheme, will also be used interchangeably.
2. The initial proposal was first agreed to during the 22nd ASEAN Economic Ministers Meeting held in Bali on 29-30 October 1990.
3. Hereinafter "Framework Agreement".
4. Hereinafter "CEPT Agreement".
5. Hereinafter these three documents are collectively "Agreement".
6. Hereinafter singly and collectively "Countries". The Countries consist of Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand. All the Countries are signatories to the General Agreement on Tariffs and Trade (hereinafter "GATT").
7. Presently, there are no plans to form a customs union.
8. CEPT is to be effected within 15 years, by reducing tariffs on manufactured products to between zero and 5%, from its commencement on 1 January 1993.
9. By agreeing to implement tariff reductions on 1 January 1994, the Countries have in effect accelerated the implementation of AFTA. Originally, the Countries had the choice of framing their own programme of tariff reductions – in terms of commencement dates, frequency, and depth of tariff cuts – provided tariffs were reduced to no more than 5% by 1 January 2008.
10. E.g. the Asia–Pacific Economic Cooperation (hereinafter "APEC"). APEC currently has 17 members: the Countries, as well as Australia, Canada, China, Hong Kong, Japan, Mexico, New Zealand, Papua New Guinea, South Korea, Taiwan and the United States. Chile will be admitted as a member in late 1994.
11. Hereinafter "Operational Procedures".
12. Hereinafter "Rules of Origin".

© 1994 International Bureau of Fiscal Documentation

barriers. Work in these areas has commenced.[13] In addition, the 1st Consultative Forum on Foreign Direct Investment in ASEAN Countries was also convened in February 1993. The Forum will meet regularly to exchange views and consult on measures to enhance the investment climate for foreign direct investment in ASEAN.

A consolidated list of the products and tariff reduction programmes under the CEPT Scheme was published on 1 November 1993. The CEPT Product Lists for AFTA[14] covers more than 41,000 confirmed items, divided into 98 chapters, of products to which CEPT concessions apply.[15]

C. Inclusions

All manufactured products, including capital goods and processed agricultural products, as well as agricultural products not otherwise excluded, are included in the CEPT Scheme. Identification of products to be included in the CEPT Scheme is on a sectoral basis, i.e. at the HS-6 digit level.

To be eligible for concessions under CEPT, several conditions must be satisfied.[16] Firstly, the product has to be included in the Inclusion List of the exporting and importing countries, and must have a tariff of 20 percent or less.[17] Secondly, the programme of tariff reduction must be approved by the AFTA Council. Lastly, the product must be an ASEAN product, i.e. it must satisfy the local content requirement of 40 percent.[18]

D. Exclusions

There are three instances when a product may be excluded from the CEPT Scheme.

1. General exceptions

The Countries may exclude a product which it considers necessary for the protection of its national security, public morals, human, animal, or plant life and health, or articles of artistic, historic or archaeological value.[19] This category accounts for a relatively inconsequential fraction of the Countries' tariff lines.[20]

2. Temporary exclusions

Any of the Countries which is momentarily unable to include certain "sensitive" products, may exclude such products on a temporary basis.[21] Products in the Exclusion List are of course ineligible for CEPT concessions from the other Countries. The Exclusion List will be reviewed in the 8th year of the CEPT, i.e. 2003. At the review, efforts will be made to remove products from the Exclusion List, and to subject them to a schedule of tariff reduction, to between zero and 5 percent, within the remaining seven years.

3. Agricultural products

Agricultural products are excluded. Nevertheless, the Countries have *unilaterally* offered a large number of agricultural products to be included although they are not obliged to do so by the Agreement. Agricultural products are defined as either agricultural raw materials and unprocessed products covered under Chapters 1 to 24 of the HS,[22] or products which have undergone simple processing with minimal change in form from the original products.

E. Programmes of tariff reductions

The two programmes for tariff reductions are merely suggested guidelines. The Countries are not in any way precluded from a different pace of tariff reduction for each tariff line within a specified time frame. Generally, products which reach, or which are at tariff rates of 20 percent or less, will automatically enjoy CEPT concessions.

The Countries are obliged to maintain the CEPT concessions. However, emergency measures may be adopted to suspend these concessions if they should threaten the sector of the importing nation producing like or directly competitive products.

1. Fast track programme ("FTP")

The FTP covers the 15 product groups[23] identified for accelerated tariff reduction[24] at the Summit. Tariffs above 20 per-

13. E.g. products at 7, 8 and 9 digit levels of the Harmonized System Code (hereinafter "HS") have been reviewed to ensure a standardized tariff nomenclature.
14. Hereinafter "CEPT List". The CEPT List consists of products covered by the two tariff reduction programmes. See *infra* II.E. and Appendix. It has been distributed to GATT, non-ASEAN countries and the private sector.
15. Hereinafter singly and collectively "CEPT Product".
16. Products with tariff rates of between zero to 5% will be deemed to have satisfied these conditions under the Agreement. Art. 2, para. 7 of the CEPT Agreement.
17. Products with tariff rates of 20% or less which are reduced to between zero to 5%, even though granted under a most-favoured-nation basis, will nevertheless still enjoy CEPT concessions. Art. 2, para. 7 of the CEPT Agreement.
18. At least 40% of the product's contents must originate from the Countries, either singly or cumulatively. Art. 2, para. 4 of the CEPT Agreement and Rule 4 of the Rules of Origin. The formula to determine this requirement is specified by Rule 3(b) of the Rules of Origin as follows:

$$\frac{[A + B]}{C} \times 100\% \leq 60\%$$

where:
A = value of imported non-ASEAN materials, parts or produce
B = value of materials, parts or produce of undetermined origin
C = FOB price

The exporter must apply for a Certificate of Origin pursuant to the guidelines prescribed by the Operational Procedures. The certificate will only be issued if the requirements of the Rules of Origin are satisfied.
19. Art. 9 of the Agreement. This provision is consistent with Art. X of GATT.
20. This category includes principally animals and plants, alcoholic beverages and armaments.
21. These products must be at the HS-8 or 9 digit levels. Art. 2, para. 3 of the CEPT Agreement. Furthermore, they do not in any way relate to the products covered under the General Exceptions provision. See *supra* II.D.1. Motor vehicles and fuel are the most common products which are temporarily excluded.
22. This includes similar agricultural raw materials and unprocessed products in other related HS headings.
23. I.e. vegetable oils, cement, chemicals, pharmaceuticals, fertilizer, plastics, rubber products, leather products, pulp and paper, textiles, wooden and rattan furniture, ceramics and glass products, gems and jewelry products, copper cathodes and electronics.
24. Accelerated tariff reduction is encouraged. Art. 4, para. 3 of the CEPT Agreement.

© 1994 International Bureau of Fiscal Documentation

cent will be reduced to between zero and 5 percent within ten years, i.e. by 1 January 2003. However, the time frame for existing tariffs of 20 percent and below is seven years, i.e. by 1 January 2000.[25]

2. Normal track programme ("NTP")

The NTP embodies mainly machinery and electrical equipment, and iron and steel. Tariffs above 20 percent will be reduced in two stages: initially, to 20 percent within five to eight years, i.e. by 1 January 2001;[26] and subsequently, to between zero and 5 percent in seven years pursuant to an agreed schedule ending on 1 January 2008.[27] Tariffs of 20 percent and below will be reduced to between zero and 5 percent within ten years, i.e. by 1 January 2003.[28]

F. Other measures and areas of cooperation

In addition to tariff reductions, the CEPT Scheme also provides for measures which are envisaged to further promote the liberalization of trade within ASEAN. These steps include the elimination of quantitative restrictions[29] on CEPT Product upon the enjoyment of CEPT concessions, and the removal of non-tariff barriers on CEPT Product on a gradual basis of five years after the enjoyment of CEPT concessions. The Countries must also make exceptions to their foreign exchange restrictions relating to payments, as well as repatriation of such payments, on CEPT Product but without prejudice to their rights under Article XVIII of GATT and the relevant provisions of the Articles of Agreement of the IMF. Other areas of border and non-border cooperation include the harmonization of standards, the reciprocal recognition of tests and certification of products, the removal of restrictions on foreign investments, macroeconomic consultations, agreement on the rules of fair competition and the promotion of venture capital.

G. Status of other ASEAN programmes

1. ASEAN Preferential Tariff Arrangements ("APTA")

The APTA was established by the Agreement on ASEAN Preferential Trading Arrangements dated 24 February 1977. It is the forerunner to the AFTA – the latter is of course much more comprehensive than the former. Products included in the APTA may be transferred to the CEPT provided the Countries give due regard to the existing Margin of Preferences ("MOP") and the resulting tariffs under the APTA, i.e. the CEPT concessions should be at least as favourable as the APTA concessions as of 31 December 1992. All products under the APTA which are not transferred to the CEPT will continue to enjoy the MOP existing as of December 1992.[30]

2. ASEAN Industrial Joint Venture ("AIJV")

The AIJV is governed by the Revised Basic Agreement on ASEAN Industrial Joint Ventures dated 15 December 1987. Generally, products processed or manufactured by an AIJV, which must have a minimum of 51 percent ASEAN equity, enjoy preferential tariffs among the participating Countries. The CEPT takes precedence over the AIJV, but existing AIJVs will be honoured, while pending AIJV applications will be shelved. If the products covered by the AIJV are also included under the CEPT Scheme, the tariffs will be reduced pursuant to the schedule for CEPT while the main benefit of the AIJV[31] will be simultaneously decreased.[32]

III. CONCLUSION

Hopefully, AFTA will result in an increased market and synergistic trade linkages as expected. ASEAN industries should then be able to enjoy economies of scale in production and distribution. Businesses that plan to commandeer a fast track route to rapid export growth should seriously evaluate strategic alliances with other ASEAN businesses. Smaller concerns, which usually pursue less ambitious policies, may wish to cultivate supplier relationships with key exporters from other Countries. These relationships should ultimately metamorphosize into direct export activities.

ASEAN consumers can acquire imported products at lower prices from more efficient producers of other Countries. The ensuing integrated ASEAN market will also stimulate intra- and extra-sources of foreign investments through networking and complementation activities.

25. Two or more of the Countries may agree to reduce tariffs on specific products to between zero and 5% at an accelerated pace as announced at the commencement of the programme. Art. 4, para. 1(c) of the CEPT Agreement.

26. The pace of reduction of tariff rates will be determined by each of the Countries, and further, the Countries may – and, as a matter of fact, *did* – begin tariff reduction at a date later than 1 January 1993. The only binding requirement is that the CEPT rate is cut to not more than 20% by 1 January 2001. However, Art. 4, para. 1(a) of the CEPT Agreement encourages an annual reduction rate which is computed as follows:

$$\frac{[X-20]\%}{N}$$

where:
X = existing tariff rate
N = between 5 to 8 years

27. However, Art. 4 Para. 1(b) of the CEPT Agreement encourages a minimum reduction rate of 5% quantum per annum.

28. In order to promote commonality of tariff rates, the Countries have agreed to reduce tariff rates as follows:

Target date	*Tariff rate (%)*
1 January 2003	15
1 January 2005	10
1 January 2007	0-5

29. E.g. quotas and licences. The Countries have submitted their lists of Quantitative Restrictions to the ASEAN Secretariat.

30. Art. 2, para. 6 of the CEPT Agreement. In the case of Indonesia and the Philippines, the CEPT concessions must be in line with the 50% MOP target within seven years.

31. I.e. 90% MOP.

32. All these matters were decided during the 4th AFTA Council Meeting in Singapore on 4 October 1993.

© 1994 International Bureau of Fiscal Documentation

APPENDIX I

Summary of CEPT Product List
(effective 1 January 1994)

Country	HS Digit Level	Inclusion				Exclusion			Total
		Fast Track Programme	Normal Track Programme	Sub Total	%	Temporary	General Exception	Agricultural Products[1]	
Brunei	9	2,420	3,659	6,079	92.89%	206	201	56	6,544
Darussalam	6	1,975	2,604	4,579	–	–	–	–	–
Indonesia	9	2,816	4,539	7,355	78.39%	1,654	50	324	9,383
	6	1,445	2,734	4,179	80.07%	834	30	176	5,219
Malaysia	9	3,166	5,611	8,777	87.57%	627	96	541	10,023
	6	1,725	2,419	4,144	85.50%	273	96	332	4,847
Philippines	8	1,033	3,418	4,451	79.61%	714	28	398	5,591
	6	974	3,079	4,053	–	–	–	–	–
Singapore	9	2,205	3,517	5,722	97.95%	Nil	120	Nil	5,842
	6	1,896	3,078	4,976	–	Nil	–	Nil	–
Thailand	Tariff Line	3,509	5,254	8,763	94.00%	118*	26	415	9,322
	6	1,736	2,777	4,513	–	–	26	390	–

1 The figures exclude the agricultural products which have been unilaterally offered to be included.

* At HS-10 digit level

Source: 1 ASEAN Econ. InfoView 2, at 7 (December 1993).

BIBLIOGRAPHY

- Ann. Rep. of the ASEAN Standing Comm. (1992-1993).
- 1 ASEAN Econ. InfoView 1 (September 1993).
- 1 ASEAN Econ. InfoView 2 (December 1993).
- ASEAN Update (November 1993).
- ASEAN Update (January 1994).

© 1994 International Bureau of Fiscal Documentation

IFA NEWS

SOME HIGHLIGHTS FROM THE SECRETARY GENERAL'S 1993/1994 GENERAL REPORT

J. Frans Spierdijk

INTRODUCTION

The General Assembly held in Florence on 7 October 1993 unanimously appointed Prof. Avv. P. Adonnino as President of the Association. We wholeheartedly welcome this well-known IFA personality at the helm of our Organization. Mr Karl Beusch, who was IFA's President from 1989-1993, received the title of Honorary President in recognition of his special services to the Association. We thank him for his leadership and, on a personal note, I would express my sincere appreciation for the understanding and friendship experienced during a four year period of excellent cooperation.

Shortly after the Florence Congress we received the sad news of Mr J. Basanta de la Peña's death on 24 October 1993. He was a prominent member of the Spanish IFA Branch and our Permanent Scientific Committee.

With the Florence Congress held in October 1993 and the Toronto Congress scheduled to begin in August 1994, the General Secretariat experiences a shorter than normal "year" to get its work done but I think that everything is in good shape and that we are fully prepared and ready to celebrate our 48th Congress in Canada.

FLORENCE CONGRESS

The fourth IFA Congress in Italy – the previous ones were in Rome in 1948 and 1956 and in Venice in 1983 – was again a great success and very enjoyable. The themes of the two main Subjects and of the Seminars were particularly interesting. An early time schedule was observed, as we started to do in Cancun in 1992, resulting in maximum attendance at the Working Sessions and ample remaining time to sample the magnificent cultural beauty of Florence and its surroundings.

The Congress was attended by 1,397 participants and 824 accompanying persons and its organization well deserves our compliments. Our special gratitude goes to Prof. Avv. P. Adonnino, President of the Congress, Prof. Avv. Piera Filippi, Chair of the Organizing Committee and Prof. Avv. A. Fantozzi, Chairman of the Permanent Scientific Committee. The excellent services of Strumenti S.R.L., the professional Congress organizer, are also gratefully acknowledged.

Prof. Dr Klaus Vogel (Germany) and Dr R. Prokisch were General Reporters for Subject I, "Interpretation of double taxation conventions". 26 National Reports appear in the 1993 *Cahiers*. Mr D.A. Ward (Canada) took on the heavy task of Discussion Leader and chaired the Panel, which consisted of Prof. H.J. Ault (USA), Mr M. Edwardes Ker (UK), Prof. G. Gest (France), Mr P. Sundgren (Sweden) and Prof. J.C. Vicchi (Argentina). Chairman of the Session was Prof. Avv. V. Uckmar (Italy) and Dr M. Agostini (Italy) was Secretary. Under the new discussion model no Résumé Committee was required. Subject II, "Non-discrimination rules in international taxation", was treated by Prof. Avv. P. Adonnino as General Reporter. 26 National Reports for this Subject also are published in the *Cahier* concerned. For this Subject Dr J.F. Avery Jones (UK) acted as Discussion Leader. On his Panel were Mr S.H. Goldberg (USA), Mr B. Gouthière (France), Prof. Dr B. Knobbe-Keuk (Germany), Prof. C. van Raad (Netherlands) and Mr J.S. Wilkie (Canada). Secretary was Mr S. Fiorito (Italy) and Prof. J. van Hoorn Jr. (Netherlands) chaired the Working Session.

Dr J.B. Bracewell-Milnes has again produced the Reports of Proceedings on Subjects I and II, which can be found in the IFA Yearbook 1993. Also the Resolutions and the Explanatory Notes to the Resolutions by the Discussion Leaders of the two Subjects are published there.

The Seminars were the following. Seminar A, "Harmonization of corporate taxes in the EC", took place under the Chairmanship of Prof. H.M.A.L. Hamaekers (Netherlands), with Mr J. van der Bijl (Netherlands), Mr R. Goergen (Belgium), Mr A. Manganelli (Italy), Prof. Dr A.J. Rädler (Germany), Mr H.P. Shannon III (USA) and Mr I.R. Spence (UK) as Panellists. Mr Manganelli acted also as Secretary. Prof. R. Krever (Australia) chaired Seminar B, "Taxation of employee fringe benefits", and had Avv. C. D'Andria (Italy), Mr M. McLellan (UK), Mr R.B. Stanger (USA), Dr A. T. Tavolaro (Brazil), Mr O.P. Vaish (India) and Prof. F. Zimmer (Norway) as Panellists and Mr R. Sommerhalder (Netherlands) as Secretary. Seminar C's topic was "Environmental taxes and charges". Prof. S.O. Lodin (Sweden) chaired the Panel consisting of Prof. M. Burgio (EC – Italy), Prof. Dr H. Kogels (Netherlands), Dr X. Oberson (Switzerland), Dr M. Rodi (Germany) and Mr S. Smith (UK). Dr Rodi also acted as Secretary. Seminar D dealt with "Corporate tax on distributions (equalization tax)", and was chaired by Dr M. Pagani (Italy), who led the Panel of Mr J.F. Chown (UK), Mr G.S. Cooper (Australia), Mr P. de Fréminet (France) and Dr B. Runge (Germany) and Secretary Mr R. Hütteman (Germany). Prof. G. Lindencrona (Sweden) chaired Seminar E, "Resolution of tax treaty conflicts by arbitration", with a Panel consisting of Dr A.E. Burckhardt (Switzerland), Prof. M. Burgio (Italy – EC), Prof. L. Hinnekens (Belgium), Prof. W.W. Park (USA) and Prof. W. Ritter (Germany). Secretary was Dr G. Marino (Italy). Prof. Avv. G. Tremonti (Italy) chaired Seminar F, "Italian tax treatment of new financial instruments", with a Panel consisting of Mr N. Davis (Australia), Dr F.M. Giuliani (Italy), Dr E. Vatali (Italy), Dr M. Minotti (Italy) and Dr L. Piccardi (Italy) as Secretary.

Mr D. Lüthi (Switzerland) and Mr J. Sasseville (Canada) were found prepared to present the proposed changes on the

© 1994 International Bureau of Fiscal Documentation

1994 Supplement to the OECD Model Treaty. We are glad to see the relation between OECD's Committee on Fiscal Affairs and IFA gradually becoming closer again.

On behalf of IFA I would like to express our deep gratitude to all the people mentioned above and to all who have actively participated in the Working Sessions of both the Main Subjects and the Seminars or have otherwise made the Florence Congress such a success.

It is worth mentioning here that we are hopeful to be able to publish the proceedings of five of the Florence Seminars in the "IFA Congress Seminar Series". Some of these publications will already be available by the time of the 1994 Congress. Details on where these booklets may be purchased are given in the IFA Yearbook.

PERMANENT SCIENTIFIC COMMITTEE ("PSC")

The PSC met early February in Munich upon the invitation of the Canadian Branch which had secured the cooperation of the German IFA Branch for a perfect organization. Messrs. Atchabahian (Argentina), Malherbe (Belgium), Marin Arias (Spain) and Spence (UK) attended the meeting for the first time as members. At this place I take the opportunity of thanking Messrs Bracewell-Milnes (UK), Claeys Bouuaert (Belgium) and Reig (Argentina) very much indeed for their many years of service to IFA as PSC members. We hope to see and involve them regularly during future IFA Congresses.

The new procedures for the Working Sessions were reviewed at length, based on the Florence experience, and were generally considered a definite improvement, leading to livelier and more effective discussions. A number of changes, such as submitting the draft resolutions to registered participants three weeks before the Congress, were agreed upon. It was decided to implement the early timetable, with only a short snack break instead of a luncheon, also for the Toronto Congress.

Ms Lynette Eastmond (Barbados), 1993 research associate, did an excellent job, and thereby proved to be of great help to the PSC. As many as 16 applicants from Argentina, Belgium, Brazil, Germany, Greece, Portugal, Uganda and the USA applied for the 1994 research associate function. Upon the recommendation of the Research Subcommittee, the PSC decided to engage Dr E.A. Schnieder (Germany) for the 1994 position. Some of the candidates were encouraged to reapply for 1995.

The Poster programme, where young and promising people are given the opportunity to present to the Congress participants the outline of the doctoral thesis they are working on, which was held in Florence for the first time, was regarded a success and will be repeated in Toronto. PSC Chairman Prof. Avv. A. Fantozzi has contacted a number of Universities for candidates.

It was noted with great satisfaction that the contacts between IFA and OECD's Committee on Fiscal Affairs may develop into a closer cooperation. We are looking forward with anticipation to the Toronto Seminar E, "The OECD Model Treaty – 1994 and beyond", chaired by Prof. Dr Klaus Vogel and to the discussions we will have with OECD officials on the format of possible future Seminars. Also new in a way will be the Toronto Seminar, "Recent international transactions of interest" (Seminar D), wherein the major tax aspects of some important international transactions will be analysed on the basis of published documents. This will provide the material for Co-Chairmen David Tillinghast (USA) and David Oliver (UK) to raise a number of issues which we hope and trust will be of interest and benefit to many professionals who may be faced with transactions like this in actual practice. Whether this Seminar will be a recurrent phenomenon at future Congresses will be reviewed afterwards by the PSC.

The other Seminars in Toronto will be:

A: Harmonization of tax under the North American Free Trade Agreement
Chairman: Mr W.G. Williamson (Canada)

B: Secondary adjustments and related aspects of transfer pricing corrections
Chair: Mrs S. Peterson (USA)

C: How domestic anti-avoidance rules affect double taxation conventions
Chairman: Mr D.A. Ward (Canada)

The preparations of Seminars and Main Subjects for Toronto were found to be proceeding satisfactorily. Subject I, "Deductibility of interest and other financing charges in computing income", with Prof. Brian Arnold (Canada) as General Reporter, appears in the *Cahiers* with 29 National Reports. Prof. Albert Rädler (Germany), General Reporter for Subject II, "National and international tax consequences of demergers", received 28 National Reports in time for publication. Needless to say that IFA is greatly indebted to the General and National Reporters for their contributions.

The two Main Subjects for the 1995 Cannes Congress will be I, "International income tax problems of partnerships", General Reporter Prof. J.P. le Gall (France), and II, "Tax aspects of derivative financial instruments", with Messrs H.D. Rosenbloom (USA), Ch.T. Plambeck (USA) as General Reporters, and Mrs D.M. Ring as Assistant General Reporter. For 1996 in Geneva the two Main Subjects were definitely fixed, i.e. I, "Principles for the determination of the income of permanent establishments and their application to banks and insurance companies", with Dr P. Athanas (Switzerland) as General Reporter; and II, "International aspects of thin capitalization", with Prof. Dr D. Piltz (Germany) acting as General Reporter.

Initial discussions were held regarding the scientific programme for New Delhi in 1997. Our researcher will be working on the development of topics for this Congress as to be determined by the PSC, in consultation with the India Branch.

It is hoped that apart from our regular participants, the Congress will attract many members from India and also from other countries in that part of the world. In this connection, Prof. Fantozzi and I intend to travel to India and some other countries to promote IFA later this year.

© 1994 International Bureau of Fiscal Documentation

EXECUTIVE COMMITTEE

Hosted by the Canadian Branch, the Executive Committee convened on 1 May 1994 at the Westin Harbour Castle Hotel, the venue of the 48th IFA Congress in Toronto. It provided a good opportunity to all Executive Committee members to acquaint themselves with the Congress facilities. Chairing the Executive Committee for the first time, Prof. Adonnino welcomed Messrs. A. Willemsen (Germany) and F. Zimmer (Norway) as new members and Mr T. Miyatake (Japan) as candidate for membership. At the last Executive Committee meeting during the Toronto Congress we shall have to say goodbye to Messrs J.F. Avery Jones (UK), A. Overbosch (Netherlands) and K. Stocker (Switzerland), since their final term under our Articles has come to an end. New candidates for Executive Committee membership will be submitted to the General Council in Toronto.

A long list of household matters was discussed and decided upon. Financial matters were reviewed and approved on the basis of reports presented by the General Treasurer, Mr J.W.B. Westerburgen. The Executive Committee discussed at length the present format of our Congresses, the new discussion model, the early timetable and the Seminar programme. The general feeling was that we seem to be on the right track, that there is still room for improvement here and there but that no major changes are called for. Despite a well-written press release issued after the Florence Congress and forwarded through the proper channels to leading international newspapers, the conclusion had to be drawn that the news value of our Congress proceedings to the general public is considered to be minimal. Therefore it was decided that we shall make an effort to seek wider publication of what goes on during our Congresses by directing our communications to the leading tax periodicals in various countries rather than to the general press.

Other matters reviewed and discussed by the Executive Committee are mentioned under the headings hereunder.

THINK TANK COMMITTEE

Formed as a Special Committee, under the Chairmanship of Dr J.F. Avery Jones, for a period of two years commencing October 1992, the Think Tank Committee will present its report during the Toronto Congress. After the original deadline of 1 September 1993 was extended until the end of 1993, the Think Tank Committee has received a total number of 17 responses to their Questionnaire by which all National Branches were invited to give their comments and ideas. On behalf of the Think Tank Committee I thank the Branches concerned for their replies and suggestions. It goes without saying that all IFA Branches and all IFA members are very welcome any time to give us their comments and suggestions on any point. Please communicate them to the General Secretariat in Rotterdam and you will hear from us.

MEMBERSHIP FEES

The General Treasurer will propose to maintain the membership fees for 1995 at the level of the previous year:

NLG 105 for individual members of National Branches
NLG 115 for direct individual members
NLG 250 for corporate members, both direct and of National Branches

NATIONAL BRANCHES AND MEMBERSHIP

As many as four National Branches were recognized by the Florence meeting of the General Council, in Ireland, Panama, Poland and Russia. It is great that the Association is expanding like this, thanks to all the people who have been instrumental in achieving it. The Swedish Branch deserves our special gratitude for their financial assistance to help the Russian Branch come off the ground.

I am happy to report that our Greek Branch shows renewed vitality. Thanks to the drive of in particular its Chairman Georges N. Stathopoulos and its Treasurer Georges Samothrakis, they organized a very successful Seminar on "VAT in Europe" in Athens last March 1994. The alternate Foreign Minister for European Affairs and many high officials and practitioners were there and contributed and Mr Peter Wilmott, Director General of Indirect Taxes of the European Commission in Brussels was one of the key speakers. He and other members of the Panel gave excellent presentations and I was given the opportunity to address the audience, consisting of many non-IFA members, about our Association. I do hope and trust that we shall hear more and more from our Greek IFA friends.

Another Branch that is gradually taking shape is the one in Egypt. I was kindly invited to speak at a Conference in Cairo of the Egyptian Society of Taxation earlier this year where many IFA members and potential IFA members were present. Expectedly we shall see active participation from IFA Egypt in one of the Seminars in the 1995 Cannes Congress.

In Hamburg I attended the 11th *Hamburger Tagung zur Internationalen Besteuerung*, at the kind invitation of Prof. L. Fischer, PSC member. This annual event, which is co-sponsored by the German IFA Branch, provides an excellent opportunity to learn what goes on in the field of international taxation in Germany. Another occasion to meet with prominent tax experts from the private and the public sector in Germany was the official offering of an impressive Liber Amicorum to Mr Karl Beusch, our Honorary President, on 12 November 1993 in Munich. Not surprisingly, the book includes a number of contributions from IFA friends.

Among Karl's many merits in the field of taxation, his international stature and his role as IFA President were particularly highlighted at the ceremony, which Prof. Avv. P. Adonnino and I had the pleasure to attend.

The Swiss Branch held their annual meeting last June which showed the usual high standard of scientific content and amicable togetherness. A special reason for me to attend was

© 1994 International Bureau of Fiscal Documentation

that Messrs Burckhardt, Luescher and Stocker were retiring from the Board. Farewell and thanks to old friends and welcome to their successors!

CONTACT WITH INTERNATIONAL ORGANIZATIONS

As mentioned earlier a stronger liaison between IFA and OECD's Committee on Fiscal Affairs is gradually being established. We think this is important for both organizations since OECD plays a leading role in international taxation and IFA is the unique forum where the public and the private sector can meet and exchange views in an objective manner with understanding of each other's position. In April 1994 a Workshop was organized in Seoul between OECD and a number of dynamic non-member countries, which I was invited to attend. Our Korean IFA Branch played an active role there and also hosted a luncheon for all participants. I am grateful to Mr W.T. Kim, Secretary of the Branch, who gave me the opportunity to meet with a number of key people in Seoul and who further was the perfect host in many other respects.

In June 1994 the European Commission held a Conference in Brussels on "The Definite Value Added Tax System", organized by the Directorate General XXI of Mr Peter Wilmott, where IFA was officially invited to provide a speaker, in addition to speakers from the EC, national governments and the business community. Prof. F. Vanistendael (Belgium) gracefully accepted at short notice to represent IFA as such. I hear the Conference was a great success. Our President, Prof. Avv. P. Adonnino, was able to attend as well as a number of our Belgian IFA members. Our General Treasurer, Mr J.W.B. Westerburgen, was also present in his capacity of Head of the Fiscal Affairs Group of UNICE.

Dr Atchabahian, PSC member from Argentina, represented IFA at the annual CIAT meeting in Quito, Ecuador from 6-10 June 1994. Prof. Lodin, PSC member from Sweden, will be IFA's representative at the 50th Congress of the IIFP in Cambridge, USA, from 22-25 August 1994, where one of the subjects treated is "Public Finance, Environmental and VAT Resources". I attended the Tax Committee meeting of the ICC in Paris earlier this year.

The Ad Hoc Group of Experts on International Cooperation in Tax Matters of the UN Economic and Social Council has postponed its meeting until further notice. We keep in touch with the Secretariat.

On further contacts with international organizations, I refer to the reports of our Ambassadors as published in the 1993 IFA Yearbook.

MITCHELL B. CARROLL PRIZE 1993

The Jury decided to award the 1993 Prize to Dr Franz Hacker (Germany) for his work entitled, *Die Doppelbesteuerungsabkommen Russlands und der anderen GUS-Staaten*, a work which was accepted as a doctoral thesis by the faculty of law, University of Munich. The Prize was officially awarded during the Florence Opening Ceremony by Prof. Dr H.G. Ruppe (Austria), Chairman of the Jury.

I would like to thank Prof. Avv. P. Adonnino (Italy) and Prof. I. Claeys Bouuaert (Belgium) who retired from the Jury for their devoted services and welcome as new members: Prof. Dr J.M. Rivier (Switzerland) and Prof. Dr C. van Raad (Netherlands). The Executive Committee decided to slightly change the rules governing this Prize in that Jury members' terms of office are without time limit, since it is not easy to find members who can read the three official IFA languages.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

At the annual meeting of the IBFD on 20 May 1994 Prof. H.M.A.L. Hamaekers was able to report that his Bureau is in good shape and is looking at the future with great confidence. We congratulate the IBFD with its many achievements and we reiterate our thanks to Prof. Hamaekers and the entire staff of our sister organization for the pleasant and fruitful cooperation.

TORONTO CONGRESS, 28 AUGUST – 2 SEPTEMBER 1994

We look forward with anticipation to an interesting and enjoyable 48th Congress. At "press" time the number of participants is almost 1,500, including accompanying persons, but registrations are still coming in in rather large numbers. Our very best wishes for a successful Congress to all the people actively involved in its preparation, in particular to the efficient Organizing Committee, chaired by Bob Dart.

© 1994 International Bureau of Fiscal Documentation

RESUME FOR SUBJECT I – 48TH IFA CONGRESS, TORONTO

DEDUCTIBILITY OF INTEREST AND OTHER FINANCING CHARGES IN COMPUTING INCOME: INTERNATIONAL ASPECTS

I. INTRODUCTION

The deductibility of interest and other costs of borrowing funds for use in international transactions is an issue having great importance for both governments and taxpayers. It is surprising, therefore, that relatively few countries have specifically addressed the issue in their domestic legislation. Moreover, except in the context of non-discrimination, income tax treaties generally do not deal specifically with the subject. The following summarizes the issues that are raised in various types of debt-financed, cross-border transactions.

II. BASIC PRINCIPLES

Taxation of an international business activity should not lead to the effect, that less than all the interest will be deductible in either the country of residence, the country of source or a combination of both. Whether the country of residence applies the exemption or foreign tax credit method the allocation and the resulting non-deduction or deduction of interest should not be practised in a way that double taxation results. An important way to accomplish this result is to allocate to income from abroad only such interest which shows a direct and identifiable economic nexus with that foreign-source income and only with such income as is received in the same taxable year in which the interest is paid.

III. OUTBOUND TRANSACTIONS: BRANCH OPERATIONS

A. Treating interest expense incurred on debt used to produce exempt foreign source income as fully deductible against domestic source income will have the effect of a financial incentive to encourage persons from the residence country to invest abroad. A similar effect holds true if an FTC country permits interest to be allocated entirely to offset the residence country income in computing the allowable foreign tax credit.

B. If a country decides to impose a limit on interest deductibility, it may use a tracing method or an allocation method to determine the amount of interest deductible against domestic and foreign-source income.

1. A tracing method may be employed under the view that investment decisions are made at the margin and if it is administratively feasible for a given country. Use of different tracing methods by the countries in which a debt-financed transaction takes place can result in over or under deduction of the interest expense. A coordinated approach by the countries involved therefore benefits both taxpayers and governments.

2. Countries may conclude that a method for allocating the interest deduction arising from debt used in cross-border transactions is preferable to tracing in order to preserve the principle of deducting expenses necessary to produce the taxable income, and thus protecting their tax bases from non proper deductions. The use of different allocation techniques by the countries in which a cross-border debt-financed transaction takes place can result in over or under deduction of the interest expense. A coordinated approach by the countries involved therefore benefits both taxpayers and the governments.

IV. OUTBOUND TRANSACTIONS: FOREIGN SUBSIDIARY OPERATIONS

A. For countries employing a foreign tax credit system, interest normally is deductible currently while income of the foreign subsidiary is not taxed until repatriated. This corresponds to the cash method of income taxation on an annual basis. If, however, a country wishes to connect the income received in a given year with interest paid in years before, the timing problem can be addressed by one of several approaches in which the timing of the deduction for interest on debt related to income earned by a foreign subsidiary is deferred until there is inclusion in income of earnings generated by the subsidiary. Because money is fungible, implementation of such an approach is likely to require complex legislation and may raise significant administrative problems.

B. By the use of tax haven financing subsidiaries it may be possible to eliminate tax in both the residence and the source countries (a "double dip"). For those residence countries with controlled foreign corporation rules, it may be possible to deal with the "double dip" transaction by taxing the income of a tax haven subsidiary on a current basis rather than by attempting to devise special rules for interest deductions in such situations. However, if an exemption country permits a participation exemption for tax haven operations, it may find it appropriate to deny an interest deduction for debt associated with the tax haven operation.

V. INBOUND TRANSACTIONS

A. Branch Operations: It is appropriate for a source country to defer the deductibility of interest attributable to a branch or subsidiary to the time of imposition of a withholding tax.

© 1994 International Bureau of Fiscal Documentation

B. Subsidiary Operations: Debt-Equity and Thin Capitalization issues: There is no single conceptually correct and administratively feasible rule to limit the deduction for interest where debt is found to be excessive or where an obligation contains elements of both debt and equity. There is a need for additional research and analysis on this matter.

C. Tax Havens: Although some residence countries may have rules to deal with problems created by tax haven operations, the lack of exchange of information procedures with tax haven countries that would assure that the interest is subject to tax in the residence country and other concerns may justify the denial of deduction by the source country.

D. Discount Obligations and Withholding Taxes: In a country where withholding taxes are imposed on a cash basis, the country may place the interest deduction for discount obligations issued to non-residents on a cash basis as well.

RESOLVED: The Resume on Subject I identifies the issues faced by taxpayers and governments in determining the deductibility of interest on debt used to finance cross-border transactions, and suggests a range of appropriate responses thereto.

The 48th IFA CONGRESS,
HAVING REGARD to the National Reports and
the General Report on the
National and international tax consequences of demergers

TAKING NOTE of the discussions held during the Congress,

HAS ADOPTED THE FOLLOWING RESOLUTION.

I and II BASIC TAX ISSUES and LEGAL FRAMEWORK

1. The congress urges countries to introduce tax provisions, and to ameliorate existing tax provisions, so that they guarantee tax neutrality for domestic and international demerger operations and eliminate obstacles which may hamper economic efficiency.

THE CONGRESS RECOMMENDS

2.1. that both domestic and international tax neutrality be available:
- at all three levels of taxpayers involved (demerging companies, resulting companies, shareholders);
- for all three typical forms of demerger (spin-off, split-off or split-up), including demergers aiming at a split-up of groups of shareholders.

2.2. that an option for a different tax treatment at corporate or shareholders level should not preclude tax neutrality at the other level.

2.3. that countries organize the tax neutrality without imposing universal succession as a general requirement, but rather, where necessary, by applying in their tax laws the concept of universal or partial succession for tax purposes.

2.4. that a financial demerger plan be prepared establishing an appropriate allocation of all items of the balance sheets and their tax attributes, on which an advance ruling by the tax authorities should be possible but such a prior ruling of the tax authorities should not be a prerequisite to tax neutrality.

III. SCOPE OF TAX NEUTRALITY

3.1. The congress recommends that the rules organizing tax neutrality should cover the full range of tax provisions. These should include:

3.1.1. a deferral of taxation on capital gains or profits on any assets and liabilities, linked however to a roll-over of the tax basis of those items;

3.1.2. the transfer or retention of all tax benefits and advantages (such as the tax exempt reserves and provisions) and tax credits, including the recognition of circumstances or conditions that are specifically relevant in tax issues and which were fulfilled by the demerging company or its shareholders;

3.1.3. the deferral of recognition of losses and the transfer or carry-forward of relief for tax losses;

3.1.4. a deferral of or exemption from taxation on the distribution of shares, at the corporate level (e.g. corporate tax, compensatory taxes, etc.) and at the shareholders' level (withholding taxes, imputation systems, etc.).

3.1.5. a corresponding relief for transaction taxes.

3.2. The congress recommends, in the interest of economic efficiency, that the tax neutrality need not be imposed for all tax issues at all levels to qualify for a specific tax neutrality.

IV. REQUIREMENTS

THE CONGRESS RECOGNIZES

4. that countries impose conditions AT THE LEVEL OF THE DEMERGING AND RESULTING COMPANIES relating to:

4.1. the continuity of the business activities or business assets;

4.2. the roll-over of the tax basis of assets and liabilities, and the continuity of fiscal valuation rules;

4.3. the allocation and linkage of assets, liabilities, reserves and provisions, and relief for previous tax losses;

4.4. the *ratio legis* (the purpose) of specific tax benefits or advantages;

4.5. payment for the transfer of the business exclusively (or up to a minimum percentage) in shares (or other securities), or up to a certain limit, in cash;

© 1994 International Bureau of Fiscal Documentation

4.6. the allocation and/or carry-over and, possibly, the *pro rata* allocation for tax purposes of paid-in capital and taxed reserves;

4.7. the continuity of shareholders.

THE CONGRESS RECOGNIZES

4.8. that, for a coherent system of tax neutrality for SHAREHOLDERS, a variety of rules may be appropriate (e.g exemption of dividends or exemption or capital gains tax deferral for a liquidation distribution, the reimbursement of paid-in capital or the exchange or redemption of shares, etc.);

4.9. that with respect to the tax basis of shares, specific solutions may be necessary for a proper allocation of value at the shareholders level of any "deferred" gains on shares;

4.10. that also at the corporate level, appropriate rules may be necessary to determine the paid-in capital for tax purposes, particularly so as to guarantee ultimate withholding tax claims or capital gains tax claims upon a later repayment of capital or on a redemption of shares;

4.11. that in countries that grant a tax credit to shareholders for corporate tax paid (imputation system), specific rules (e.g. allocation of taxed and untaxed reserves) may be necessary to guarantee that credit for tax previously paid continues to be available to the shareholders;

4.12. that a distinct treatment for corporate shareholdings (effective participation) as contrasted with portfolio shareholdings may be justified.

HOWEVER, THE CONGRESS RECOMMENDS

4.13. that there be at the level of the demerging and resulting companies,

– a specific allocation and linkage of assets, liabilities, reserves and provisions, and continuing relief for previous tax losses according to the destination of those items or the economic reasoning that justifies their specific tax treatment, and

– a *pro rata* allocation for items which cannot thus be (specifically) allocated. The *pro rata* allocation shall be in proportion to the respective share of accounting net equity transferred to each resulting company or, in case of a spin-off, the demerging company;

4.14. that countries should avoid imposing requirements at corporate level that cause economic inefficiency and are thereby counter-productive (such as general economic tests solely on the grounds of counteracting tax avoidance, which is rather to be prevented through specific anti-avoidance measures);

4.15. that any requirements for continuity of shareholders must be reasonable (carefully and well-balanced), considering the fact that the organizational purpose and status of demerged companies may vary. Continuity of a shareholders ratio by a *pro rata* requirement must be waived on a split-up of a group or a family-owned company between its owners;

4.16. that in order not to jeopardize otherwise qualifying demerger operations, the requirements imposed at both levels should rather be based on an objective approach and not be disproportionate; that requirements for pre- or post-demerger holding periods may be unreasonable for portfolio investors participating in the demerger of a listed company and for transfer of shares within a group of companies (intra-group share transfers). Holding periods exceeding three years are unacceptable;

4.17. that, for the sake of legal certainty, the rules should be specific, clear and precise;

4.18. that, whereas a requirement for the prior acceptance of the demerger transactions by the tax authorities as a general rule is disproportionate and hampers economic efficiency, tax authorities should nevertheless be free to allow deviations or exceptions to those rules if economically justified (e.g. especially with respect to the *pro rata* requirement at the shareholders level when no tax avoidance is likely to occur); and that therefore advanced ruling by the tax authorities on such issues and on deviations or exceptions be possible.

V. INTERNATIONAL ASPECTS

5.1. The congress recognizes the right of a country to impose specific conditions for tax neutrality in international demerger operations to guarantee its taxing rights within its jurisdiction (e.g. by requiring a roll-over tax basis and valuation rules, transfer of tax exemption, benefits, loss compensation etc. e.g. to a domestic entity, whether it be a company, a permanent establishment or a fiscal representative or otherwise).

THE CONGRESS HOWEVER RECOMMENDS

5.2. that countries extend those rules to jurisdictions where its taxing rights may be guaranteed through appropriate international instruments such as tax treaties or EU Tax Directives;

5.3. that countries, in issuing such rules, avoid new causes of international double taxation.

5.4. that the domestic tax neutrality rules of both direct and indirect taxes be extended to cover international demergers either through international instruments or in the absence of such instruments through domestic law unilaterally.

VI. TAX TREATIES

THE CONGRESS RECOMMENDS

6.1. that countries amend their treaties in such a way that tax neutrality be available for taxpayers of a treaty country

© 1994 International Bureau of Fiscal Documentation

involved in a tax neutral demerger in the domestic country and vice versa,

AND THEREFORE INVITES the OECD Tax Committee to intensify its work on this subject.

THE CONGRESS RECOMMENDS

6.2. as a principle for demerger operations governed by tax treaties, that the tax neutrality of the country of the demerging company be followed by the countries where the resulting companies and the shareholders are resident.

THE CONGRESS THEREFORE RECOMMENDS the countries to clarify and update their treaties in such a way

6.3. that the non-discrimination principle shall be applicable:

* to the rules providing tax neutral treatment of demergers for the companies involved, to the effect

– that the tax neutrality for domestic demergers be available for treaty demergers when countries taxing rights are guaranteed not only by resulting domestic companies, but also by domestic resulting permanent establishments or fiscal representatives within their taxing jurisdictions or in a country where their rights are guaranteed through appropriate treaty provisions;

– that domestic permanent establishments enjoy the same tax neutrality as domestic companies in general;

– that, more specifically, a transfer of a permanent establishment within the framework of a qualifying demerger enjoys the same demerger tax neutrality in the country of the permanent establishment as is available to domestic companies;

– that in home countries applying the credit method for avoidance of double taxation, either the recognition of a gain be deferred or a credit be given for taxes that would have been payable in the country of the permanent establishment had the latter country actually taxed the transfer;

– that in home countries that have allowed previous losses of the permanent establishment to be deducted from taxable profits, those losses may continue to be recaptured as if the permanent establishment had not been transferred.

* to the shareholders in treaty demerger operations to the effect that tax neutrality rules for domestic shareholdings be also available for treaty shareholdings.

6.4. that the operations in the relation to the shareholders obtain a common qualification (dividend or capital gain) with the aim of applying a coherent set of rules to avoid double taxation:

– to ensure an appropriate deferral in both jurisdictions of taxation on the distribution or exchange of shares (including corporate tax, withholding tax and capital gains tax, etc.) if the resulting company remains in the jurisdiction of the source country;

– to ensure an appropriate transfer of dividend tax credits (domestic and treaty credits).

– The Congress recognizes the right to levy a corporate tax, a withholding tax or a capital gains tax as provided by the relevant treaty provisions on the distribution or exchange of shares in a tax neutral demerger operation in which a third country asset or permanent establishment is incorporated in a third country company.

– Where the distribution is qualified as a dividend the reduction in value of shares should be recognized for future tax treatment of the shareholder with the aim of avoiding double taxation, if appropriate by an adjustment of the tax basis of the new shares.

6.5. that the exchange of information and the mutual agreement procedure be available to organize advanced international rulings to create legal certainty as to the conditions and tax consequences of international demergers, as well as to prevent tax avoidance manoeuvres (e.g. the sound business reasons);

6.6. that the co-operation of the tax authorities in the collection of taxes be extended so as to organize an appropriate guarantee that the specific conditions for international tax neutrality are met or that the deferral of taxation does not result in a definite tax loss.

VII. TAX AVOIDANCE

THE CONGRESS RECOGNIZES

7.1. the rights of countries to introduce for international demerger operations specific conditions at the level of the demerging companies, the resulting companies and the shareholders, designed to safeguard its taxing rights, provided the principles of the treaties for the avoidance of double taxation and tax evasion are respected.

THE CONGRESS RECOMMENDS

7.2. that in the interest of legal certainty, both domestic and international anti-avoidance rules be specific, clear and unambiguous and not disproportionate to the economic needs of business operations. However, they must not result in new causes for international double taxation.

An advance ruling should be available without undue delay, especially if general anti-abuse concepts may be applied or general sound business reasons are required for a demerger to qualify for tax neutral treatment. Obtaining a ruling, however, should not be a prerequisite for tax neutral treatment.

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

CHAMBAS, Gérard.
Fiscalité développement en Afrique Subsaharienne.
Paris, Editions Economica, 59, rue Héricart, 75015 Paris, France. 1994, pp. 152.
Tax policy and development in Sub-Saharan African countries. Using comprehensive analyses of different African countries (and in particular French-speaking countries), this book tries to develop an efficient tax system that would stimulate development and would be applicable in those countries. A total reorganization of the tax systems would be needed.
(B. 13.490)

Zaire

DJUNGA, Wemo.
Contrôle externe des finances publiques type latin.
Brussels, Etablissements Emile Bruylant SA. 1993, pp. 405.
Comparative study of the importance of the auditor's offices in Belgium, France and Zaire and their impact on the control of the budget implementation.
(B. 113.794)

ASIA & THE PACIFIC

INTERNATIONAL TAX AND BUSINESS Guide: Taxation in Asia and the Southwest Pacific.
New York, Deloitte Touche Tohmatsu International. 1993, pp. 165.
Information guide about the business environments in the various countries, including the forms of business available, the tax regimes and rates, investment incentives offered, and each country's double tax treaty network.
(B. 58.029)

SOCIAL COSTS OF ECONOMIC restructuring in Asia and the Pacific.
Bangkok, UN – United Nations Economic and Social Commission for Asia and the Pacific. 1994. Development Papers, No. 15, pp. 568.
(B. 58.028)

Australia

INTERNATIONAL TAX AND BUSINESS Guide: Australia.
New York, Deloitte Touche Tohmatsu International. 1992, pp. 165.
Information guide about the Australian business environment, including the factors a foreign investor should consider in deciding whether to acquire an existing Australian company or to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 58.030)

Hong Kong

HONG KONG MASTER TAX GUIDE 1994/95.
North Ryde, CCH Australia Limited. 1994, pp. 563.
This third edition of the guide examines the taxes imposed in Hong Kong under the Inland Revenue Ordinance: profits tax, salaries tax and property tax. The full spectrum of taxation issues is explored, ranging from the liability for taxes to the procedural matters of assessment, payment, objection and appeal. Legislation, case law and Inland Revenue departmental practice are examined. Special chapters are also devoted to stamp duty and estate duty.
(B. 58.032)

Korea (Rep.)

KOREAN TAXATION 1994.
Gwachun, Ministry of Finance. 1994, pp. 280.
Up-to-date information guide on the Korean tax system. This 1994 edition incorporates changes in the tax laws made in FY 1993 (1 Jan.-31 Dec. 1993) and summarizes the major provisions of the current tax laws.
(B. 58.026)

EUROPE

Belgium

BELASTINGEN 1994. FISCAAL repertorium bij de aangifte in de personen- en vennootschapsbelasting. Editors Ann Laenen and Jan Van Dyck.
Kalmthout, Biblo NV. 1994, pp. 342.
Guide to the 1994 corporate and individual income tax return, with reference to recent jurisprudence and regulations. French edition is available under the title "Impôts 1994".
(B. 113.772)

INTERNATIONAL TAX AND BUSINESS Guide: Belgium.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 101.
Information guide to the Belgian tax system, foreign investment, corporate and individual income taxes, VAT, accounting and auditing, capital gains tax and other taxes.
(B. 113.927)

CODE DES IMPOTS SUR LES REVENUS 1992. (Edition 1994.1)
Diegem, CED Samsom. 1994, pp. 703.
Consolidated text of the Income Tax Code and most relevant regulations on income taxes, updated as of 31 March 1994.
(B. 113.741)

GHEYSENS, L.; SPRUYT, E.; BOON, R. a.o.
Fiscaal praktijkboek 1993-1994. Indirecte belastingen. Editor: W. Maeckelbergh.
Deurne, Kluwer Rechtswetenschappen. 1994, pp. 374. 1850.- Bfrs.
Book containing contributions by several authors on some selected topics on VAT, succession duties and registration duties.
(B. 113.801)

DJUNGA, Wemo.
Contrôle externe des finances publiques type latin.
Brussels, Etablissements Emile Bruylant SA. 1993, pp. 405.
Comparative study of the importance of the auditor's offices in Belgium, France and Zaire and their impact on the control of the budget implementation.
(B. 113.794)

EEC

INVENTORY OF TAXES LEVIED IN the Member States of the European Communities. 15th Edition.
Luxembourg, Office for Official Publications of the European Communities. 1993, pp. 726. 77.- ECU.
Updated and revised edition of the duties and taxes in force as of 1 January 1992 in the Member States of the EC.
(B. 113.971)

© 1994 International Bureau of Fiscal Documentation

KOOP, Michael J.
Zur Gewinnbesteuerung von Körperschaften in der Europäischen Gemeinschaft.
Tübingen, J.C.B. Mohr (Paul Siebeck). 1993.
Kieler Studien, No. 259, pp. 153.
The author analyses the taxes on corporate profits in the European Community. He compares the different tax systems with respect to harmonization and competition.
(B. 113.619)

EXCISE DUTY TABLES. SITUATION AT 1.1.1993 plus evolution up to 1.7.1993.
Luxembourg, Office for Official Publications of the European Communities. 1993, pp. 55.
Information on Member States' main excise duty rates as they apply to typical products.
(B. 113.917)

POHL, Wolfgang.
Innovative Finanzinstrumente im gemeinsamen Europäischen Bankenmarkt.
Baden-Baden, Nomos Verlagsgesellschaft. 1994. Studien zum Bank- und Börsenrecht, No. 29, pp. 157. 48.- DM.
Innovative financial instruments in the Single European Market. The author discusses the interaction between the increase in competition among banks caused by the deregulation of the EC bank market and the innovation of new financial instruments and derivates. In a second step, he analyses the consequences with regard to a European law on the supervision of banks.
(B. 113.854)

Finland

KANSAINVÄLISEN VEROTUKSEN
Käsikirja. Verohallituksen julkaisu 621.
Helsinki, Painatuskestus. 1994.
Handbook on international taxation in Finland. Loose-leaf service in one volume (supplemented irregularly), published by The National Tax Board. Topics include taxable persons, limited and unlimited tax liability, taxation of income, net wealth/worth tax, social security contributions and tax treaties. Samples of official forms and a Finnish-English vocabulary are appended.
(B. 113.866)

HENKILÖVEROTUKSEN KÄSIKIRJA.
Verohallituksen julkaisu 618.
Helsinki, Painatuskestus. 1994.
Handbook on taxation of income and capital of individuals in Finland. Loose-leaf service in one volume, (supplemented irregularly), published by The National Tax Board. Topics include taxable persons, limited and unlimited tax liability, earned income, pensions, investment income, income from forestry, business income, capital gains, exempt income, losses, net wealth tax and assessment procedures.
(B. 113.867)

HANDBOK FÖR MERVÄRDESSKATT
skyldiga.
Helsinki, Tryckericentralen Ab. 1994, pp. 72.
VAT handbook for taxable persons.
(B. 113.942)

France

DJUNGA, Wemo.
Contrôle externe des finances publiques type latin.
Brussels, Etablissements Emile Bruylant SA. 1993, pp. 405.
Comparative study of the importance of the auditor's offices in Belgium, France and Zaire and their impact on the control of the budget implementation.
(B. 113.794)

Germany

AO/FGO-HANDAUSGABE 1994.
Allgemeines steuerliches Verfahrens- und Verwaltungsrecht. Abgabenordnung, Finanzgerichtsordnung, Nebengesetze, Rechtsprechung, amtliche Texte. 4. Auflage. Bearbeitet von Ute Hermanns.
Bonn, Stollfuss Verlag. 1994, pp. 2080. 120.- DM.
General Fiscal Code, Fiscal Court Proceedings Code, implementation provisions, administrative guidelines, administrative directives, case law.
(B. 113.798)

HANDBUCH DER
Steuerveranlagungen. Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer 1993.
Munich, Verlag C.H. Beck. 1994, pp. 2850. 154.- DM.
Annual updated guide for filing 1993 returns for individual income tax, corporate income tax, business income tax and turnover taxes.
(B. 113.948)

SCHMIDT, Ludwig; MÜLLER, Thomas; STÖCKER, Ernst E.
Die Organschaft im Körperschaftsteuer-, Gewerbesteuer- und Umsatzsteuerrecht. 4. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1993, pp. 393. 88.- DM.
The authors describe the treatment of a fiscal entity with regard to corporate income tax, business tax and VAT.
(B. 112.467)

DEUTSCHE STEUERGESETZE 1994.
Textausgabe. 6. Auflage. Stand: Februar 1994.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 1367. 45.- DM.
Sixth edition of book containing texts of German tax laws, e.g. German Tax Code, income tax, corporate income tax, business tax, net worth tax, inheritance tax, turnover tax, land tax, real property transfer tax, etc.
(B. 113.714)

STEUERRECHT. STAND: 7. FEBRUAR 1994.
Baden-Baden, Nomos Verlagsgesellschaft. 1994, pp. 1098. 24.- DM.
Collection of tax codes and additional important provisions as of 7 February 1994.
(B. 113.678)

JAHRBUCH DER FACHANWÄLTE FÜR Steuerrecht 1993/94.
Herne, Verlag Neue Wirtschafts Briefe. 1994, pp. 643. 98.- DM.
Yearbook of the Association of Attourneys specializing in tax law 1993/94. Papers from the annual conference held on 24-26 May 1993.
Subjects: taxes in the investment calculation and valuation of enterprises; permanent limitations on movement and activity of enterprises within the Single Market; recent questions on investigation of enterprises; problems of corporation law discussed in recent court decisions; developments in income taxation affecting partnerships; associations, foundations, trusts and similar legal forms as economic instruments; tax planning possibilities with regard to VAT in international business; planning possibilities with regard to succession of entrepreneurs; business losses and tax law.
(B. 113.632)

BEW/VST/ERBST-HANDAUSGABE 1993/94. Gesetze (einschl. GrStG) Durchführungsverordnungen, Richtlinien, Verwaltungsanweisungen, Rechtsprechung. 2. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 1839. 122.- DM.
Valuation Law, Net Worth Law, Real Property Law, Inheritance and Gift Tax Law, implementation provisions, administration guidelines 1993, administrative directives, case law.
(B. 113.613)

JACOBS, Otto H
Internationale Unternehmensbesteuerung. Handbuch zur Besteuerung deutscher Unternehmen mit Auslandsbeziehungen. 2. Auflage.
Munich, Verlag C.H. Beck. 1991, pp. 806.
International taxation of enterprises.
A description of German international tax law. Important issues in German international tax law are discussed in order to direct attention to the alternatives in planning for an internationally active enterprise.
(B. 112.445)

DIE VERANLAGUNG ZUR
Einkommensteuer für 1993. Einkommensteuergesetz, Einkommensteuer-Durchführungsverordnung, Einkommensteuer-Richtlinien, Rechtsprechung, Anweisungen, Anlagen. 45. Auflage. Bearbeitet von R. Wiechen, G. Schmitz und K-H. Boveleth.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 1880. 56.- DM.
Handbook to the income tax declaration 1993. It contains the Income Tax Law as needed for the 1993 assessment, the implementation guidelines, the administrative directives, case law, tax tables and several by-laws.
(B. 113.716)

EINKOMMENSTEUERGESETZ
Kommentar. 13. Auflage. Herausgegeben von Ludwig Schmidt.
Munich, Verlag C.H. Beck. 1994, pp. 2673.

© 1994 International Bureau of Fiscal Documentation

158.- DM.
Annual commentary on German Income Tax Law.
(B. 113.911)

GANSKE, Joachim.
Umwandlungsrecht.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 356. 88.- DM.
Handbook compiling the drafts on the revised reorganization law and describing the grounds for the proposed amendments.
(B. 113.797)

GERMAN LOOSE-LEAF PUBLICATIONS

ABC-FÜHRER LOHNSTEUER
Original editor Wilhelm Hartz, continued by Joseph Meessen and Niels G. Wolf.
Stuttgart, Schäffer-Poeschel Verlag, P.O. Box 103241, 70028 Stuttgart.
Supplemented: three times per year. Price basicwork: 98.- DM.
Loose-leaf publication in three volumes providing extensive information on wage taxation, with tax procedures and clarifications. Various topics, such as: taxation of foreign employees working in Germany temporarily or for a longer period, double taxation, gifts, divorces and tax exemptions. The church wage tax, the cumulation of wealth and the Child Allowance Act are also included.

ABC-FÜHRER SOZIALVERSICHERUNG
By Norbert Scheele.
Stuttgart, Schäffer-Poeschel Verlag, P.O. Box 103241, 70028 Stuttgart.
Supplemented: twice per year. Price basicwork: 64.- DM.
Loose-leaf publication containing extensive explanations to the legislation on social security. The various problems are described and discussed under subject headings. Recent updates have incorporated the changes introduced by the Pension Reform Law of 1992. Texts of the laws are included.

ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
Kommentar zur Abgabenordnung (ohne Steuerstrafrecht) und Finanzgerichtsordnung. By Klaus Tipke and Heinrich Wilhelm Kruse.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: two or three times per year. Price basicwork: 270.- DM.
Loose-leaf publication in three binders containing a commentary on the German Fiscal Code (Abgabenordnung) and the Code on Fiscal Procedures (Finanzgerichtsordnung). The Penal Tax Law is not included. Literature and court decisions are thoroughly documentated. The Missbrauchsbekämpfungs- und Steuerbereinigungsgesetz (StMBG) (Anti-abuse and Correction Tax Act) of 21.12.1993 has changed many regulations and a large part of them have already been incorporated.

AUSSENSTEUERGESETZ
By Winfried Wörhle, Pieter Schelle and Ekkehard Gross.
Stuttgart, Schäffer-Poeschel Verlag, P.O. Box 103241, 70028 Stuttgart.
Supplemented: once per year. Price basicwork: 95.- DM.
Loose-leaf publication on the German Foreign Tax Law containing the text of the law, comments thereon, the rulings and the Germany–Switzerland double taxation treaties on income and capital and succession duties. Recent topics dealt with are: changing residence to low tax countries, foreign participation by changing residence, family foundation and cooperation between tax administrations.

BBK/BUCHFÜHRUNGS-BILANZ-KOSTENRECHNUNG
Herne, Verlag Neue Wirtschafts-Briefe, P.O. Box 101849, 44621 Herne.
Supplemented: twice per month. Price basicwork: 114.- DM. Subscription per year: 216.- DM.
Loose-leaf publication arranged in various parts filed in various binders comprising survey written by various authors on bookkeeping, balance sheets drafting and cost calculation and related matters. Short news services updates and reports on the new developments in the topics are published in the fortnightly supplements.

BONNER HANDBUCH GmbH
By G. Brandmüller and P. Küffner.
Bonn, Stollfuss Verlag KG, P.O. Box 2428, 53014, Bonn.
Supplemented: three times per year. Price basicwork: 178.- DM.
Loose-leaf publication in three binders explaining the various aspects of the limited liability company in Germany.

BONNER HANDBUCH RECHNUNGSLEGUNG
Aufstellung, Prüfung und Offenlegung des Jahresabschlusses. By M.A. Hofbauer and W. Kupsch.
Bonn, Stollfuss Verlag KG, P.O. Box 2428, 53014, Bonn.
Supplemented: once or more times per year. Price basicwork: 238.- DM.
Loose-leaf service in four binders. Handbook for the tendering of accounts, based on the newly enacted Balance Sheet Directives Law. The book contains texts of relevant laws and EEC Directives and discussions of these and other related laws. Tax aspects are also dealt with.

DAS EINKOMMENSTEUERRECHT
Kommentar zum Einkommensteuergesetz. By E. Littmann, H. Bitz and P. Hellwig.
Stuttgart, Schäffer-Poeschel Verlag, P.O. Box 103241, 70028 Stuttgart.
Supplemented: regularly. Price basicwork: 295.- DM.
Loose-leaf service in three volumes providing an in-depth commentary on the German individual income tax. The present version replaces a hardcover sourcebook under the same title and by the same authors of which 14 subsequent editions were published so far.

DEUTSCHES STEUERLEXICON
By J. Schaeberle and H. Utech.
Munich, Verlag C.H. Beck, Wilhelmstrasse 9, 80801 Munich.
Supplemented: once or more times per year. Price basicwork: 98.- DM.
Due to changes in the various tax laws and especially the Tax Amendment Law of 1992 (Steueränderungsgesetz of 1992), the keywords explaining the main words of the various tax laws, including net wealth taxes and the EC-Internal Common Market Turnover Tax Law, have been extended considerably during the last years. The new directive for wage taxes has brought forward a revision and extension of the section on this topic.

DEUTSCHE STEUERPRAXIS
Nachschlagewerk praktischer Steuerfälle. Herausgegeben vom Deutschen wissenschaftlichen Steuerinstitut der Steuerberater und Steuerbevollmächtigten. Edited by Katrin L. Schulz.
Cologne, Verlag Dr. Otto Schmidt, Unter den Ulmen 96-98, 50968 Cologne.
Supplemented: six times per year. Price basicwork: 178.- DM.
The Scientific Institute studies various problems occurring daily in the practice of the tax adviser. In the course of the year hundreds of special questions arise and are worked out in this publication. They indicate their points of view on the subjects and make them available to the practisers. Topics dealt with in recent supplements are: succession duties, taking domicile abroad, transfer of company by an already existed splitting-up company, hidden profit distributions in special cases, insurance claims, etc.

DOKUMENTATION INTERNATIONALES STEUERRECHT
By R.M. Wollny.
Herne, Verlag Neue Wirtschafts-Briefe, P.O. Box 101849, 44621 Herne.
Supplemented: irregularly. Price basicwork: 256.80 DM.
Loose-leaf publication in two volumes providing an extensive documentation on German national tax law in international relations and tax law regulations contained in bilateral treaties concluded by Germany as well as in international and multilateral treaties. Relevant, national law of foreign countries will be included, as well as references to case law and administrative regulations published in Germany. The discussion is presented in dictionary form with more than 4000 terms.

DOPPELBESTEUERUNG
Sammlung der zwischen der Bundesrepublik Deutschland und dem Ausland bestehenden Abkommen über die Vermeidung der Doppelbesteuerung. By H. Debatin and R. Korn, assisted by F. Hundt and P. Hellwig.
Munich, Verlag C.H. Beck, Wilhelmstrasse 9, 80801 Munich.

© 1994 International Bureau of Fiscal Documentation

Supplemented: twice or more times per year.
Price basicwork: 380.- DM.
Loose-leaf publication in four volumes containing the text of each double taxation treaty concluded by the Federal Republic of Germany, with commentaries. The text of the OECD Draft Convention on Double Taxation on Income and Capital of 1977 is included in the German language.

EINKOMMENSTEUERGESETZ
Kommentar. By Paul Kirchhof and Hartmut Söhn.
Heidelberg, C.F. Müller Juristischer Verlag, Im Weiher 10, 69121 Heidelberg.
Supplemented: five times per year. Price basicwork: 398.- DM.
Loose-leaf publication in 12 binders containing comprehensive commentary on the German Individual Income Tax. The commentary is not restricted to the basic structures of the income tax, but also deals with special cases and explains the basic principles of every regulation in detail, and for a better understanding, groups them together and lists them in alphabetical order, making the separate regulations transparent. The supplements keep the paragraphs of the income tax law up-to-date and revise or extend the commentaries.

EINKOMMENSTEUERGESETZ UND KÖRPERSCHAFTSTEUERGESETZ
Mit Nebengesetzen. 19th Edition. By H. Hermann, G. Heuer and A. Raupach.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: four times per year. Price basicwork: 475.- DM.
Loose-leaf publication in various binders of a text handbook considered to be the most authorative commentary on the individual income tax and the corporate income tax levied in Germany. This work is simply referred to as "Hermann-Heuer" and is not only useful for the tax practitioner but also for the researcher in tax philosophy.

FORMULARBUCH DER STEUER- UND WIRTSCHAFTSPRAXIS
Vertrags- und Schriftsatzmuster zum Steuerrecht, Gesellschaftsrecht und Bürgerlichem Recht mit Darstellung der Rechtsgebiete. Original editors F.A. Schmitt and Fritz Schmitt, continued by Jürgen Hille.
Bielefeld, Erich Schmidt Verlag, Viktoriastrasse 44A, 33602 Bielefeld.
Supplemented: twice per year. Price basicwork: 98.- DM.
Second edition of handbook in loose-leaf form designed to explain the German taxation system with examples for practical purposes. One of the latest supplements contains the text of the Business Location Improvement Act of 13 September 1993, text of the act to relief the German Supreme Tax Court of 20 December 1993, the law to implement the save, consolidation and growth programme of 21 December 1993 and the act to amend the political parties law and other laws coming into force on 28 January 1994.

GERMAN TAX BUSINESS LAW GUIDE
Wiesbaden, CCH Europe Inc., Parkstrasse 71-73, 6200 Wiesbaden.
Supplemented: once or more times per year.
Price basicwork: £ 320.-
Loose-leaf service in one binder containing commentaries on German business law arranged on a topic by topic base. Dealt with are taxation, company law, economic regulations as well as social and labour law. This is one of the few publications concerning Germany dealing with taxation written in English.

GmbH-HANDBUCH
Gesellschaftsrecht, Rechnungswesen, Steuerrecht, Arbeits- und Sozialversicherungsrecht, GmbH-formulare. Herausgegeben von der Centrale für GmbH Dr. Otto Schmidt. By K. Eder, P.J. Heuser, B. Tillmann and others.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: three times per year. Price basicwork: 158 DM.
Loose-leaf publication containing chapters dealing with company law, forms in connection with the limited liability company, taxation, labour legislation and social security. The book describes problems and gives many examples. The accounting chapter has been updated by incorporating the necessary changes introduced by the Balance Sheet Accounting Law which came into force in 1993 and has consequences for the fiscal and commercial balance sheet and creates more possibilities for provision for drawing losses. The labour and social security chapter includes regulations in the new Federal States of Germany.

HANDBUCH DER AKTIENGESELLSCHAFT
By Rudolf Nirk, Klaus Brezing and Hans-Ulrich Bächle.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year.
Price basicwork: 180.- DM.
In this loose-leaf guide the authors give descriptions of important topics with regard to corporations such as: the legal basis, corporation law, auditing, tax law and labour law. Now the work contains the rules governing the internal conduct of the law implementing the accounting of banks, the corporation, the extensions of the legal requirements of establishing a corporation, cash capital contributions, contributions in kind or hidden reserves. The basic work is now completed, including the necessary changes after the introduction of the Bank Balance Sheet Directive and the introduction of the Eleventh Council EC-Directive on Company Law (89/666) concerning disclosure requirements in respect of branches opened in a Member State.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBILIENKAPITALANLAGEN
By R. Dornfeld, W. Klumpe, H. Richter, K. H. Schmider and others.
Heidelberg, C.F. Müller Juristischer Verlag GmbH, Im Weiher 10, 69121 Heidelberg.
Supplemented: four or more times a year.
Price basicwork: 348.- DM.
Detailed commentary in six loose-leaf volumes on the various tax aspects gains of immovable property ownership in Germany or participation in a fund investing mainly in immovable property. Included are surveys of the development of the real estate transfer tax since 1820, net wealth tax since 1920, and valuation of land since 1960. The connected relevant court decisions are included in the commentaries.

HANDBUCH DER BESTEUERUNG DES GRUNDBESITZES
3rd Edition. By Otto Sauer, Herbert Ritzer and Helmut Schuhmann.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: two or more times a year. Price basicwork: 138.- DM.
Loose-leaf service in one volume containing commentaries to all taxes concerning the owners of land, such as individual income taxes, corporate taxes, business trade tax, wage taxes, valuation, land tax, net wealth tax, acquisition of land and value added tax.

HANDBUCH DER EINFUHR-NEBENABGABEN
Original editor P. Bollrath, continued by P. Kussner.
Aachen, Mendel Verlag, Robenssstrasse 39, 52070 Aachen.
Supplemented: three or more times a year.
Price basicwork: 136.- DM.
Loose-leaf publication in two binders containing information on all excises and taxes (other than customs duties) levied upon importation, including turnover taxes, throughout the world. Although some problems have occurred with updating the existing chapters a few years ago, every new supplement now contains various countries so that the book will be suitable for an international comparison of excise taxes on tobacco, alcohol and oil products very soon.

HANDBUCH DER RENTENBESTEUERUNG
Renten, Raten, Wiederkehrende Bezuge, Niessbrauch, Nutzungsrechte.
By Heinz Richter and Karl Heinz Boveleth.
Heidelberg, C.F. Müller Juristischer Verlag GmbH, Im Weiher 10, 69121 Heidelberg.
Supplemented: once or more times per year.
Price basicwork: 198.- DM.
Loose-leaf commentary in two binders on the taxation of old-age pensions, annuities, usufruct and users' rights, containing high court decisions and opinions of tax authorities dealing with all kind of taxes. Numerous examples give a better insight to difficult problems and help the practitioner solve problems occurring in his practice.

IWB – INTERNATIONALE WIRTSCHAFTSBRIEFE
Herne, Verlag Neue Wirtschafts-Briefe, P.O. Box 101849, 44621 Herne.

© 1994 International Bureau of Fiscal Documentation

Supplemented: weekly. Price basicwork: 434.- DM.
Loose-leaf publication arranged in various parts filed in various binders comprising surveys written by various authors on doing business, company law and taxation in each country considered. Short news services updates the material. Tax treaties are also dealt with and new developments in the topics are reported weekly in a periodical.

KOMMENTAR ZUR ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
Original editors Hübschmann/Hepp/Spitaler, continued by Hartmut Söhn, Klaus Offerhaus, Walter Schick and various other authors.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year. Price basicwork: 480.- DM.
Very extensive commentary in 10 loose-leaf volumes to the German Fiscal Code and the Code on Fiscal Procedures by judges from the Supreme Tax Court. Latest supplements deal with illegal labour, the demand for documentation, the lawfulness of entering dwelling-houses for tax purposes and the obligation to keep records. The methods of tax investigation services are discussed thoroughly.

KOMMENTAR ZUM AUSSENSTEUERRECHT
By H. Flick, F. Wassermeyer and H. Becker.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year. Price basicwork: 265.- DM.
Extensive loose-leaf publication in three volumes explaining the Foreign Tax Law which affects the taxation of Germans engaged in activities abroad, as well as a number of provisions to combat tax evasion to low-tax countries.

KOMMENTAR ZUM BEWERTUNGSGESETZ UND VERMÖGENSTEUERGESETZ
By L. Gürsching and A. Stenger.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year. Price basicwork: 225.- DM.
Commentary (with text) on the valuation law for purposes of the net worth tax law, including the regulations for the new federal states.

KOMMENTAR ZUM DOPPELBESTEUERUNGSABKOMMEN DEUTSCHLAND–SCHWEIZ
By H. Flick, F. Wassermeyer and K.D. Wingert.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year. Price basicwork: 280.- DM.
Extensive commentary on the income and net worth tax treaty as well as the inheritance tax treaty between Germany and Switzerland, including a discussion of the relevant national laws of both Germany and Switzerland, references to case law, administrative regulations, etc.

KOMMENTAR ZUM EINKOMMENSSTEUERGESETZ (EStG)
By Gerrit Frotscher and various other authors.
Freiburg, Rudolf Haufe Verlag, GmbH & Co KG, Postfach 740, 79007 Freiburg.
Supplemented: four or five times per year. Price basicwork: 185.- DM.
Loose-leaf publication in five volumes providing an extensive commentary on the German Income Tax Law, which will help the user to oppose certain opinions of the tax authorities. Not only the main opinions, but also some minor points of views have been included. An extensive keyword index and a series of special publications on important topics are included such as: usufruct, splitting-up of companies, the aspects of succession of businesses.

KOMMENTAR ZUM ERBSCHAFTSTEUERGESETZ UND SCHENKUNGSTEUERGESETZ
By R. Kapp.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: twice per year. Price basic work: 158.- DM.
Loose-leaf publication containing comments on the death duty and gift tax law. Text of statutes is appended.

KOMMENTAR ZUM GEWERBESTEUERGESETZ
8th Edition. Original editor Edgar Lenski, continued by Wilhelm Steinberg, Hans-Wilkin Stäuber and Viktor Sarrazin.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: twice per year. Price basicwork: 168.- DM.
Detailed commentary in two loose-leaf volumes on the trade tax law in the Federal Republic of Germany. Text of relevant law in connection with the subject is appended. Recent updates contain amendments related to the Anti-abuse and Corrections Tax Act of 1993 and the Business Location Improvement Act.

KOMMENTAR ZUM KÖRPERSCHAFTSTEUER
By G. Frotscher and E. Maas.
Freiburg, Rudolf Haufe Verlag, GmbH & Co KG, Postfach 740, 79007 Freiburg.
Supplemented: once or more times per year. Price basicwork: 168.- DM.
Loose-leaf publication in three volumes providing an extensive commentary on the Corporate Income Tax Law of 1977. The first part paragraph 1 till 7 discusses the tax obligation. Part 2, paragraphs 7 to 23 deal with the concept of income and part 3, the paragraphs 23 to 27 contain commentaries on the taxation of companies with income from abroad. The other parts deal with crediting procedures, origin, levying, assessing and compensation of taxes, authorization and the conversion tax law. The text of the law is published in the third binder.

KOMMENTAR ZUM UMSATZSTEUERGESETZ (MEHRWERTSTEUER)
By G. Rau, E. Dürrwächter, H. Flick and R. Geist.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: twice per year. Price basicwork: 198.- DM.
Loose-leaf publication in five binders containing text and comment on the Turnover Tax Law levied in Germany. The full text of the statute is printed and each section is followed by annotations and comments prepared by the authors with reference to case law; with cross references. Comprehensive index.

KÖRPERSCHAFTSTEUERGESETZ 1977
2nd Edition. By Kay D. Kläschen.
Bonn, Stollfuss Verlag KG., P.O. Box 2428, 53014, Bonn.
Supplemented: regularly.
Loose-leaf service containing comments on the German Corporate Income Tax Law, including the provisions of the Individual Income Tax Law and Reorganization Tax Law. The text of the Corporate Tax Law of 1991, with 1991 and 1992 amendments are included.

NWB – NEUE WIRTSCHAFTS-BRIEFE
Herne, Verlag Neue Wirtschafts-Briefe, P.O. Box 101849, 44621 Herne.
Supplemented: weekly. Price basicwork: 148.- DM. Annual subscription 344.40 DM.
Loose-leaf publication arranged in taxation and business law filed in various binders comprising text and surveys by various authors on different topics. News service reports developments in the printed matters in a periodical, published weekly.

PRAKTISCHER FÜHRER DURCH DAS STEUERRECHT
By W. Theis.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: annually. Price basicwork: 95.- DM.
Practical guide in loose-leaf form to all taxes levied in Germany. The recent supplements contain changes in the corporate tax, the land acquisition tax, motor car taxes, trade tax, valuation, net wealth and succession duties.

SOZIALVERSICHERUNGS HANDBUCH FÜR DIE BETRIEBLICHE PRAXIS
By G. Figge.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: twice per year. Price basicwork: 145.- DM.
Loose-leaf publication giving an extensive commentary on the German social security laws with reference to case law.

STEUERBERATER BRANCHENHANDBUCH
Gewerbliche und berufliche Besonderheiten zu Steuern-Wirtschaft-Recht.
Bonn, Stollfuss Verlag KG., P.O. Box 2428, 53014, Bonn.

© 1994 International Bureau of Fiscal Documentation

Supplemented: once or more times per year.
Price basicwork: 248.- DM.
Loose-leaf guide giving business information per type of industry, dealing with accounting, business economics, taxation, social security and professional education. For many industries the addresses of professional organizations and survey of professional periodicals are included.

STEUERERLASSE IN KARTEIFORM
Das Nachschlagewerk der Erlasse und Verfügungen der Finanzverwaltung. Bearbeitet in Verbindung mit dem Deutschen wissenschaftlichen Steuerinstitut der Steuerberater und Steuerbevollmächtigten e.V.
By Günther Felix and Dieter Carle.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: monthly. Price basicwork: 285.- DM.
Loose-leaf publication in various binders containing the full texts of tax rulings and decrees issued by the tax administration, with annotations after 1983. For the period 1973 to 1982 only the headlines of the tax rulings and decrees have been published.

STEUERGESETZE I
Textsammlung mit Verweisungen und Sachverzeichnis. 43rd Edition.
Munich, Verlag C.H. Beck, Wilhelmstrasse 9, 80801 Munich.
Supplemented: three times per year. Price basicwork: 46.- DM.
Loose-leaf service containing consolidated text of German tax laws with cross references.

STEUER-HANDBUCH DES RECHTSANWALTS
Typische Fall Gestaltungen und ihre Steuerfolgen in der Rechtsberatungspraxis. By Rainer Braun and Karl-Heinz Günther.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: irregularly. Price basicwork: 148.- DM.
This loose-leaf publication contains descriptions and the implications arising in practice of tax advisers. Subjects dealt with are: depreciation, companies, closed family companies, holiday houses, inflation, corporations, property, rent, etc.

STEUERRECHT DER BETRIEBLICHEN ALTERSVERSORGUNG
Mit arbeitsrechtliche Grundlegung. Original editor Ernst Heissmann, continued by Peter Ahrend, Wolfgang Förster, Norbert Rössler and others.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: once or more times per year.
Price basicwork: 250.- DM.
Loose-leaf publication providing information on taxation and pension schemes, pension funds, etc. connected with the employment conditions.

STEUERRECHTSPRECHUNG IN KARTEIFORM (StRK)
Höchstrichterliche Entscheidungen in Steuersachen. Mit Anhang StRK-Anmerkungen. Original edited by Mrozek-Hubschmann-Kaatz, continued by Eberhard Weiss and other judges.
Cologne, Verlag Dr. Otto Schmidt KG, Postfach 511026, 50946 Cologne.
Supplemented: monthly. Price basicwork: 475.- DM. Price StRK-Anmerkungen: 48.- DM.
Loose-leaf publication in 26 binders containing the full texts of all tax cases after 1959 of the Supreme Tax Court. The two binders of the "Anhang" (appendix) contain critical commentaries by Günther Felix on the decisions of the Supreme Tax Court.

STEUERRICHTLINIEN
Munich, Verlag C.H. Beck, Wilhelmstrasse 9, 80801 Munich.
Supplemented: twice per year.
Loose-leaf publication containing text of implemented regulations on tax law issued by the Federal Tax Administration, with cross references. A comprehensive index is appended.

STEUERTABELLEN
Listen, Tabellen, Übersichten für die Steuerpraxis.
Munich, Verlag C.H. Beck, Wilhelmstrasse 9, 80801 Munich.
Supplemented: two or three times per year.
Loose-leaf publication containing compilation of various tax summaries, such as depreciation tables and other practical information.

UMSATZSTEUERGESETZ
Mit Umsatzsteuer-Durchführungsverordnung, Umsatzsteuer-Richtlinien, Verwaltungs-anweisungen, Nebengesetzen, Verordnungen und den einschlägigen Internationalen Verträgen und Abkommen sowie den Umsatzsteuerrichtlinien der Europäischen Wirtschaftsgemeinschaft. Kommentar. 7th edition. Original editors A. Hartmann and M. Metzenmacher, continued by Wolfram Birkenfeld.
Bielefeld, Erich Schmidt Verlag, Viktoriastrasse 44A, 33602 Bielefeld.
Supplemented: two or more times per year.
Price basicwork: 196.- DM.
Commentary in four loose-leaf volumes on the turnover tax (value added tax) levied in the Federal Republic of Germany, including the full text of the statute, regulations and case law. The work also includes the text of relevant international agreements and conventions with respect to international agreements. The texts of the EC Value Added Tax Law together with the VAT Regulations which came into force on 1 January 1993, the full text of the Sixth EC Directive on Value Added Tax and the EC Directive on Mutual Assistance are now incorporated.
Commentaries on articles of the law are regularly revised and updated.

UMSATZSTEUERGESETZ – MEHRWERTSTEUER
Kommentar. By K. Plückebaum and H. Malitzky.
Cologne, Carl Heymanns Verlag KG., Luxemburger Strasse 449, 50939 Cologne.
Supplemented: twice per year.
Loose-leaf publication in 15 binders.
Comprehensive textbook on the Turnover Tax Law (value added tax) levied in Germany includes 1969 turnover tax system where relevant to the 1980 value added tax. The full text of the 1980 Turnover Tax Law is set out section by section, and each section is followed by comment, notes and references to all the cases which have a bearing on the section. Texts of the 1991 and 1992 Turnover Tax Laws, with commentaries, are included. The Value Added Tax Directives prepared by the EC and other sections of tax laws relevant in connection with the turnover tax system and a comprehensive index are also included.

UMWANDLUNGSRECHT
By S. Widmann and P. Mayer.
Bonn, Stollfuss Verlag KG., P.O. Box 2428, 53014, Bonn.
Supplemented: once or more times per year.
Price basicwork: 368.- DM.
Publication in five loose-leaf volumes explaining the new regime for mergers and business transformations under the Transformation Law and the law containing tax measures with respect to such legal transformations. The texts of the relevant laws are appended.

WÖRTERBUCH DES STEUERRECHTS (WdS)
By Rudolf Rössler and others.
Freiburg, Rudolf Haufe Verlag, GmbH & Co KG, Postfach 740, 79007 Freiburg.
Supplemented: three times per year. Price basicwork: 98.- DM.
This tax glossary in loose-leaf form contains a description of the main tax terms related to all taxes levied in Germany, including the source and dates of the legislation connected thereto. 2500 descriptors are published in alphabetical order in two volumes. Many related terms are mentioned and if they have a relationship with another descriptor it is referred to. The set-up of the book is very practically as the tax terms are in alphabetical order and are easy to assess.

Switzerland

SCHWÄGLER, Heinrich.
Die Besteuerung von Eigenleistungen im Geschäftsvermögen.
Bern, Verlag Paul Haupt. 1994. Schriftenreihe Finanzwirtschaft und Finanzrecht, No. 69, pp. 360. 62.- Sfrs.
Accounting and taxation of self-made assets and their tax treatment under the new VAT system and under the present sales tax.
(B. 113.843)

FUCHS, Benjamin J.
Transnationaler Verlustausgleich bei internationalen Unternehmungen und Konzernen im Steuerrecht.
Bern, Verlag Paul Haupt. 1993. Schriftenreihe Finanzwirtschaft und Finanzrecht, No. 70, pp. 307. 68.- Sfrs.
The book discusses the following issues: international enterprises, multinational groups,

© 1994 International Bureau of Fiscal Documentation

taxation of enterprise profits, methods of profit determination, Swiss enterprises with permanent establishments abroad, Swiss-located permanent establishments of foreign enterprises, Swiss groups with subsidiaries abroad, Swiss-located subsidiaries of foreign groups, comparison with other legal systems.
(B. 113.771)

United Kingdom

CLARKE, Giles.
Offshore tax planning. 3rd Edition.
London, Butterworths. 1994, pp. 259. £ 65.-.
The book explains how the territorial limits of UK fiscal legislation may be used to shelter income and capital from UK tax.
(B. 113.962)
CROOKS, Robert. 3
Tolley's VAT on construction, land and property. 3rd Edition.
Croydon, Tolley Publishing Company Ltd. 1994, pp. 199. £ 24.95.
Detailed practical guide to the complex VAT provisions, including commentary on the latest case law where appropriate.
(B. 113.943)

INTERNATIONAL

THE GLOBAL TAX HANDBOOK.
London, The Economist Intelligence Unit Ltd. 1993, pp. 250. £ 49.-
The book surveys the tax regimes of 21 countries. Each country chapter follows a specific outline of tax issues that are highly relevant to tax planning for overseas investment and foreign business operations.
(B. 113.896)

THE INTERNATIONAL HANDBOOK OF corporate and personal taxes. 2nd Edition. Edited by John Graham.
London, Chapman & Hall, 2-6 Boundary Row, London SE1 8HN, England. 1994, pp. 674. £ 50.-.
This reference book provides a concise guide to the rules governing the taxation of companies and individuals in each of the world's major trading nations. Each chapter covers a single country and includes information on: company tax, personal tax, other taxes and income subject to tax, withholding tax rates, dividends, interest and royalties.
(B. 113.905)

COMBATTING TAX ABUSE AND fraud. Technical papers and reports of the CIAT Technical Conference, Venice, Italy, 1-5 November 1993.
Panama, CIAT Executive Secretariat, P.O. Box 2129, Zone 9A, Panama. 1994, pp. 354.
Papers and reports delivered by various contributors on the topics: Concepts of tax avoidance and evasion and their effects on the application of the tax system; Forms of tax avoidance and evasion; Normative mechanisms for combatting tax avoidance and evasion; Administrative mechanisms for combatting tax avoidance and evasion; Methods for measuring tax evasion and for measuring taxpayer behaviour; International cooperation for combatting tax avoidance and evasion.
(B. 18.846)

INTERNATIONAL TRANSFER PRICING 1994.
New York, EIU The Economist Intelligence Unit, The Economist Building, 111 West 57th Street, New York, NY 10019, USA. 1994, pp. 224. £ 325.-.
Research report written in co-operation with Ernst & Young. Comprehensive up-to-date study of transfer pricing covering, *inter alia*, economic analysis and transfer pricing, foreign exchange risk, advance pricing agreements, sale of tangible and intangible property and the relation with customs valuation. Country information is available for: the United States, France, Italy, Germany, Japan, Korea, Australia, Mexico, Canada and the United Kingdom.
(B. 113.897)

ADVANCE RULING: PRACTICE AND legality. Proceedings of a seminar held in Cancún, Mexico, in 1992 during the 46th Congress of the IFA – International Fiscal Association.
Deventer, Kluwer Law and Taxation Publishers. 1994. IFA Congress Seminar Series, No. 17A,
pp. 65.
(B. 113.910)

KEMP, Alexander G.; ROSE, David.
Fiscal aspects of investment opportunities in the UKCS and Norway, Denmark, The Netherlands, Australia, China, Alaska (North and South) and the US outer continental shelf.
Aberdeen, University of Aberdeen, Dept. of Economics, Edward Wright Building, Dunbar Street, Aberdeen, AB9 2TV, England. 1993. North Sea Study Occasional Paper No. 43, pp. 70. £ 14.-.
(B. 113.931)

OECD

CNOSSEN, Sijbren.
Administrative and compliance costs of the VAT. A review of the evidence.
Rotterdam, Erasmus University Rotterdam. 1994. Research Memorandum No. 9402, pp. 37.
Topics covered include an introduction to VAT, administrative costs in OECD countries, the USA and a comparative evaluation, and compliance costs in OECD countries and the USA, and a comparative evaluation.
(B. 113.932)

NORTH AMERICA

Canada

CANADA TAX CASES. JUDGMENTS OF the Supreme Court of Canada, Federal Court of Canada, Tax Court of Canada and provincial courts on taxation matters reported by Canada Tax Cases from July to December 1993 inclusive. 1993, Volume 2. Editors H.H. Stikeman,
R.W. Pound, P.F. Smith and J. Wells.
Scarborough, Carswell Thomson Professional Publishing. 1994, pp. 3829.
(B. 113.920)

INTERNATIONAL TAX AND BUSINESS Guide: Canada.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 145.
Guide for foreign investors contemplating direct investments or passive investments in Canada. Basic information about the Canadian business environment, including taxation.
(B. 113.926)

SCHENK, Alan.
Goods and services tax. The Canadian approach to value-added tax.
North York, CCH Canadian Limited,
6 Garamond Court, North York, Ontario M3C 1Z5. 1993, pp. 475.
The book covers the following topics: GST registration, the supplier's obligation to collect and remit GST, the supply of goods and services, the calculation of net tax liability, input tax credits, the value of a supply, timing rules, zero-rated supplies, exemptions from GST, collection and remittance of tax, tax rebates, tax returns, administration and enforcement of the tax and the transitional rules. It includes a table of both Canadian and foreign cases, a statutory cross-reference table and an index. Proposed amendments to the GST statute and regulations released before 1 July 1993 are also included.
(B. 113.950)

USA

BURKE, Frank M.; STARCHER, Mark L.
Oil & gas taxation in nontechnical language.
Tulsa, Penn Well Publishing Company, 1421 South Sheridan, P.O. Box 1260, Tulsa, Oklahoma 74101, USA. 1993, pp. 261. $ 59.95.
The book focuses on the federal income tax treatment of the acquisition, exploration, development, production and disposition of oil and gas properties, and deals with the rules relating to the transportation, refining and marketing aspects of the industry when relevant to determining the tax consequences of producting of oil and gas.
(B. 113.949)

© 1994 International Bureau of Fiscal Documentation

Loose-leaf Services

Received between 1 and 31 August 1994

AFRICA

FIDAFRICA
release 6
Fidafrica, Paris.

FISCALITE AFRICAINE
releases 12 and 13
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIAN TAX PRACTICE
- Rulings and Guidelines
  releases 153 and 154
- Legislation
  releases 75 and 78

Butterworths, North Ryde.

AUSTRIA

DIE EINKOMMENSTEUER
- Kommentar
  release 13

Anton Orac Verlag, Vienna.

BELGIUM

COMMENTAIRE DU CODE DES IMPOTS SUR LES REVENUES
release 8
Ministry of Finance, Brussels.

CANADA

INCOME TAX REFERENCES/ REFERENCES A LA LOI DE L'IMPÔT SUR LE REVENUE
release 55
Carswell Thomson Professional Publishers, Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 900-902
Prentice-Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER

- Moms
  release 5
- Skattenyt – Kronologisk
  releases 16-18
- Skattebestemmelser – Systematisk
  release 11

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 346

Kluwer, Deventer.

FRANCE

JURIS CLASSEUR – CHIFFRE D'AFFAIRES – COMMENTAIRES
release 6161
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – CODE GENERAL DES IMPÔTS
release 74
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – COMMENTAIRES – IMPÔTS DIRECTS
release 1190
Editions Techniques, Paris.

GERMANY

ABGABENORDNUNG – FINANZGERICHTSORDNUNG
Tipke - Kruse
release 73
Verlag Dr. Otto Schmidt, Cologne.

BONNER HANDBUCH GMBH
Brandmüller - Küffner
release 29
Stollfuss Verlag, Bonn.

DEUTSCHE STEUERPRAXIS – NACHSCHLAGWERK PRAKTISCHER STEUERFÄLLE
Felix
release 157
Verlag Dr. Otto Schmidt, Cologne.

EINKOMMENSTEUERGESETZ – KOMMENTAR
Kirchhof - Sohn
release 53
C.F. Müller Juristischer Verlag, Heidelberg.

DAS EINKOMMENSTEUERRECHT. KOMMENTAR ZUM EINKOMMENSTEUERGESETZ
Littmann - Bitz - Meincke
release 20
Verlag Schäffer & Co., Stuttgart.

FORMULAR DER STEUER UND WIRTSCHAFTSPRAXIS
release 34
Erich Schmidt Verlag, Bielefeld.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBIEL-KAPITALANLAGEN
release 68
C.F. Müller Juristischer Verlag, Heidelberg.

HANDBUCH DER BESTEUERUNG DES GRUNDBESITZES
release 55
Verlag Dr. Otto Schmidt, Cologne.

HANDBUCH DER EINFUHRNEBENABGABEN
release 4
Mendel Verlag, Robenstrasse 39, 52070 Aachen.

HANDBUCH DER GMBH
Eder - Heuser - Tillmann - Gaul
release 65
Verlag Dr. Otto Schmidt, Cologne.

KOMMENTAR ZUM EINKOMMENSTEUERGESETZ
Frotscher
release 68
Rudolf Haufe Verlag, Freiburg.

STEUERERLASSE IN KARTEIFORM
releases 393 and 394
Verlag Dr. Otto Schmidt, Cologne.

STEUERGESETZE
II, release 13
Verlag C.H. Beck, Munich.

STEUERRECHTSPRECHUNG IN KARTEIFORM
releases 509-511
Verlag Dr. Otto Schmidt, Cologne.

STEUERRICHTLINIEN
release 77
Verlag C.H. Beck, Munich.

UMSATZSTEUERGESETZ (MEHRWERTSTEUER)
Hartmann - Metzenmacher
releases 2 and 3
Erich Schmidt Verlag, Bielefeld.

LUXEMBOURG

CODE DE LA LEGISLATION FISCALE
Volumes 1-7
Impremerie Saint Paul, Luxembourg.

NAMIBIA

JUTA'S TAX SERVICE – LEGISLATION SERVICE – NAMIBIA
release 8
Juta & Co., Ltd., Kenwyn.

NETHERLANDS

BELASTINGHEFFING IN LAND EN TUINBOUW
release 19
Kluwer, Deventer.

© 1994 International Bureau of Fiscal Documentation

BELASTINGWETTEN (DE BELASTINGGIDS)
releases 167 and 168
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
- Algemene wet inzake rijksbelastingen
  release 83
- Loonbelasting
  release 154

Noorduijn BV., Arnhem.

CURSUS BELASTINGRECHT
Mobach
release 218
Gouda Quint/D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Motorrijtuigenbelasting
  release 34

Kluwer, Deventer.

FISCALE WETTEN
releases 216 and 217
Fed, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Belastingheffing bij invoer
  releases 7 and 8
- Algemene wetgeving inzake douane
  release 11
- Gecombineerde nomenclatuur
  releases 92 and 93
- Tarief van invoerrechten
  release 114

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK
releases 377 and 378
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 151 and 152
Kluwer, Deventer.

KLUWERS TARIEVENBOEK
release 437
Kluwer, Deventer.

PRAKTIJKBOEK SOCIALE VERZEKERINGEN
release 10
SDU, The Hague.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  release 79
- Heffing over uitkeringen en loon
  releases 54 and 55
- AWBZ
  releases 117 and 118

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
release 300
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  release 240
- Inkomstenbelasting 1964
  releases 913-918
- Loonbelasting
  releases 585-592
- Omzetbelasting
  releases 256-260
- Vennootschapsbelasting – Jaarverslaglegging
  release 6

Kluwer, Deventer.

SWITZERLAND

DIE STEUERN DER SCHWEIZ/LES IMPÔTS DE LA SUISSE
Band I, release 90
Band II, release 82
Band III, release 80
Verlag für Recht und Gesellschaft AG, Basel.

UNITED KINGDOM

SIMON'S TAX CASES
releases 25-29
Butterworth & Co., Sevenoaks.

SIMON'S TAXES
release 202
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE
releases 29-33
Butterworth, London.

VALUE ADDED TAX – DE VOIL
release 228
Butterworth & Co., Sevenoaks.

USA

TAX TREATIES – REPORT BULLETIN
release 7
Warren, Gorham & Lamont, Boston.

TAX IDEAS – REPORT BULLETIN
release 7
Warren, Gorham & Lamont, Boston.

UNITED STATES TAX REPORTER
releases 29-32
RIA – Research Institute of America, New York.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Australia:
Ann O'Connell:
Capital Gains Tax Amendments 176

Michael Dirkis:
The Times They Are A'Changing: Tax Reform in 1993/94 492

Abe. I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Benelux:
Paul Sleurink, Hans Decleir and Veronique Sway:
Holding Companies 271

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

Canada:
Nathan Boidman:
Transfer Pricing: Current Canadian Perspective 457

Marianne Burge:
The Conduit Regulations: Canadian Investors Beware! 469

Robert Couzin:
The Ontario Fair Tax Commission: Tax reform in Action 380

Blair P. Dwyer and Katherine A. Thiessen:
The Division of Canadian Taxing Powers: A Tug of War, with Taxpayers in the Middle 392

James S. Hausman and Kathleen V. Penny:
Cross-Border Reorganizations Involving Canadian Corporations 442

Allan R. Lanthier:
Acquiring, Holding and Financing Canadian Corporations 419

Stephen S. Ruby:
Highlights of the 1994 Canadian Budget 402

Ingrid Sapona:
Taxation of Foreign Affiliates 430

Jacques Sasseville:
Interpretation of Double Taxation Conventions in Canada: An Update 374

Gary J. Webb:
Structuring International Joint Ventures: Canadian Tax Issues to Consider 448

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Implementing Regulations for the New Income Tax Law 250

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Olivier Delattre and Clotilde Fournier:
Tax Regime of Holding Corporations 281

Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Germany:
Dr Thomas Töben:
Holding Companies 285

Hong Kong:
Ian Harris:
Budget Bonanza 257

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Lynette V. Eastmond:
Public International Law Aspects of Some Transfer Pricing Issues 351

Diane Hay, Frances Horner and Jeffrey Owens:
Past and Present Work in the OECD on Transfer Pricing and Selected Issues 508

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shoma and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Vito Tanzi and Parthasarathi Shome:
A Primer on Tax Evasion 328

Israel:
Taxation of Corporations 141

Japan:
Vicki L. Beyer
1994 Tax Reforms 487

Latin America:
Ruben Diaz, Jr.:
Selected Tax Aspects of Investment 306

© 1994 International Bureau of Fiscal Documentation

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

Mexico:
Barry Larking:
International Tax Treaty Developments: The Mexican Experience 537

New Zealand:
Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Update on the Tax Implications of the New Companies Act 1993 504

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Russia:
Dr Elena Markina:
Results of Initial Implementation of Tax Reform 338

Qatar:
Finbarr Sexton:
Taxation Regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

Singapore:
Lee Fook Hong:
1994 Budget 347

Switzerland:
Dr Nico H. Burki:
Holding Companies 292

Wiliam Bush:
Low Tax Opportunities 183

United Kingdom:
Michael McGowan:
Setting up a UK International Holding Company 296

United States:
David M. Benson and Matthew M. McKenna:
Deductibility of Interest and Other Financing Charges in Computing Income 310

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Peter J. Connors and Michael F. Patton:
New Transfer Pricing Penalty Regulations Require Immediate Action to Avoid Overvaluation Penalties 529

Peter J. Connors and Robert M. Spevack:
Does The Brown Group Case Spell the Effective End of Subpart F? 534

Kenneth J. Krupsky, Esq.:
New IRS Transfer Pricing Documentation Requirements 321

Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

Worldwide Combined Reporting Ruled Constitutional as *Barclays* Loses in the US Supreme Court: What are the Options for a Foreign-Based Company? 525

James J. Tobin and William R. Seto:
Hybrid Entities 315

II. REPORTS AND DOCUMENTS

International:
Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 521

III. IFA NEWS 41, 200, 260, 269,371,545

IV. CONFERENCE DIARY 55, 81, 137, 207, 267, 327, 483,506

V. BIBLIOGRAPHY
- Books 45, 103, 150, 201, 261, 358, 476,547
- Loose-leaf services 49, 107, 154, 205, 266, 366, 480,559
- List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

CONTENTS

VOL. 48 NO. 12 DECEMBER 1994

JOINT SEMINAR OF US AND NETHERLANDS IFA BRANCHES

We are pleased to present in this issue three of the papers (Levin, North and van Weeghel) delivered during the joint seminar of the US and Netherlands branches of IFA held at Niagara-on-the-Lake, Canada, immediately preceding the annual IFA Congress. Also included in this issue is the text of the luncheon speech delivered by H. Onno Ruding.

UNITED STATES:
INTERNATIONAL TAX POLICY AT THE CROSSROADS: NEW DEVELOPMENTS AND POSSIBLE AVENUES FOR REFORM 619
H. Onno Ruding

The text of the luncheon speech delivered by Mr Ruding during the joint seminar of the US/Netherlands branches of IFA.

UNITED STATES:
A SHORT HISTORY OF THE PORTFOLIO INTEREST EXEMPTION AND US REAL ESTATE INVESTMENT BY NON-RESIDENTS AND FOREIGN CORPORATIONS: TOO MUCH OF A GOOD THING 624
Leonard D. Levin

A debate has long endured as to whether the IRC is biased in favour of debt as opposed to equity in financing investments. The IRC contains rules which effectively limit the percentage of a business' capital which can be raised in the form of debt, most notably in the case of foreign ownership of US companies. One such illustration is the recent retroactive expansion of the earnings stripping rules under IRC Section 163(j).

NETHERLANDS–UNITED STATES:
WITHHOLDING TAX ON "CONTINGENT INTEREST" UNDER THE NEW US–NETHERLANDS TREATY 630
André H. Boekhoudt and Thomas P. North

One of the significant changes brought about in the new US–Netherlands tax treaty is the exclusion of certain types of instruments from the definition of "interest". This article examines both the US and Netherlands withholding tax rules for "contingent interest". It then tries to reconcile these internal law provisions with the provisions of the new treaty. Finally, the article briefly addresses the possible impact of these new rules on withholding agents and taxpayers.

NETHERLANDS:
RECENT CASE LAW 637
Stef van Weeghel

This article looks at a number of Dutch Supreme Court decisions handed down in the last year – all of the decisions relate to application of tax treaties, or domestic rules concerning residence, permanent establishment/business profits, dividends and non-discrimination.

NETHERLANDS:
TOWARDS A GRADUAL ABOLITION OF CAPITAL TAX? 645
Arnold J. van der Smeede

This article discusses recent Supreme Court cases regarding the Dutch capital tax. Whether the Ministry of Finance will follow the steps initiated by the Supreme Court remains to be seen.

CENTRAL AND EASTERN EUROPE:
MEETING TAX OBLIGATIONS IN CENTRAL AND EASTERN EUROPE 648
Sarah Bolderson and Theodoor Huiskes

Although it is generally easy to determine the corporate tax rate in a given central European country, it is more difficult to ascertain the precise rules for determining, agreeing and paying tax liabilities. This article analyses and compares the relative merits of the tax compliance mechanisms in eight central and eastern European countries.

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND:
RAISING THE THRESHOLD FOR TAXPAYER COMPLIANCE: A NEW ERA OF COMPLIANCE STANDARDS AND PENALTIES 655
Adrian J. Sawyer
Proposals contained in a recent discussion document are directed at addressing deficiencies in the current compliance and penalties regime. The discussion document attempts to directly confront sophisticated forms of non-compliance by tightening the structure of taxpayer obligations and penalties. This article examines the proposed reforms.

INTERNATIONAL:
CONSUMPTION TAX RULES 665
Ken Messere
This article describes and analyses the international consumption tax rules and enquires in the light of the theoretical literature, and political and administrative constraints how such rules might be improved.

BIBLIOGRAPHY
– Books 682
– Loose-leaf services 686

CONFERENCE DIARY 623

CUMULATIVE INDEX 688

LIST OF AUTHORS 690

DISCLAIMER. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

© 1994
International Bureau of Fiscal Documentation,
the Netherlands

All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, recording taping, or information retrieval systems) without the written permission of the publisher.

UNITED STATES

INTERNATIONAL TAX POLICY AT THE CROSSROADS: NEW DEVELOPMENTS AND POSSIBLE AVENUES FOR REFORM

H. Onno Ruding,

Vice Chairman Citicorp/Citibank

My thanks to Robert Y. Lider, Deputy Director, Tax Regulations, and David C. Jory, Director of Federal Taxation, both of Citicorp Washington, and Denise Strain, Deputy Chief Tax Officer, Citibank, for their assistance in the preparation of this paper.

I am pleased to have been asked to speak to the US–Netherlands branches of the International Fiscal Association because I have a special interest in the topics discussed here: as a Vice Chairman of Citicorp, a taxpayer in over 90 countries; as a former Minister of Finance in the Netherlands; and as the chairperson of the Committee of Independent Experts on Company Taxation in the European Community, which submitted its report to the European Commission in March 1992. I have always regarded IFA as one of the pre-eminent organizations dedicated to advancing tax and fiscal policies throughout the world. The rapid changes in the way we do business, both domestically and in overseas markets brought about by advances in technology, have made obsolete many of the ways we structure our tax systems. Moreover, the fiscal needs of governments also continue to evolve. Meeting the needs of both the taxpayer and tax collector will present unprecedented challenges to many of you here today.

To begin, let me say that I believe taxes to be a necessary evil – something which will always add inefficiencies to business growth. However, in attempting to reach the right balance between the revenue needs of a government and the burden borne by the private sector, difficult decisions must be made as to the best method to measure income and collect taxes. It is these decisions, especially as they relate to the US system of taxing multinational corporations (both foreign and domestic), which I would like to discuss with you.

When I look at developments in the United States, I find some of the tax rules troublesome. I think we can do better in many respects. I do not like the increasing level of complexity, the suspicious opposition to international business on the part of both the Administration and Congress and the relentless search for alleged "abuse" in the tax system. But there are many good things going on which I find promising.

One such development, a topic of special interest to our manufacturing customers and of growing interest in the service sector, is the advent of Advance Pricing Agreements ("APA"). These agreements are significantly reducing audit and litigation costs – and the risk of heavy transfer pricing penalties – associated with US government inquiries into intercompany price setting. The process of getting an APA is rigorous, time consuming and expensive, but the rewards can be dramatic for some taxpayers.

Transfer pricing is a problematic area for tax authorities and taxpayers around the globe. It was the United States that developed the "arm's length method" of transfer pricing in the early 1970s, which is now rightly the international norm. However, threats to that method in the form of state unitary tax schemes or Congressional forays into formulary pricing, which the "Ruding Report" among others has condemned, must be guarded against. The recently introduced "Foreign Tax Compliance Act of 1994" is a good example of what to avoid: if arm's length pricing is abandoned in favour of a formulary approach, some taxpayers will suffer double taxation while others will escape taxation altogether, a serious problem for tax authorities. Simple solutions to complex problems caused by transnational business activities are destined to fail; it is better that they be avoided from the beginning in favour of the reasonable, case-by-case approach that is the hallmark of the arm's length method.

The APA process is a good step forward, but needs to grow from a bilateral process between the US government and a single taxpayer, to a multilateral process between the taxpayer and each of the taxing jurisdictions in which it does business. The recent announcement that a number of foreign governments are beginning consultations with the United States to start this procedure is welcome. Unfortunately, the size of the resources devoted by the US taxing authorities to this process will not soon be matched by other countries, either developed or developing. Nonetheless, expansion of the APA process is a positive step forward for the United States and many taxpayers. Foreign governments would do well to study its many positive points.

Another positive development is the US Treasury's strong commitment to the expansion of the US tax treaty network. During the past four years, the United States has concluded or renegotiated tax treaties with Mexico, the first ever within Latin America, Germany, India, Spain and the Netherlands, among others.

Citicorp has actively participated in and supported the US Treasury's tax treaty programme. Citicorp recognizes that as

© 1994 International Bureau of Fiscal Documentation

global competition grows, tax treaties are a critical component of the framework necessary for US firms to succeed overseas.

Tax treaties serve a number of vital tax policy objectives. Most importantly, they serve to harmonize the tax systems of the treaty partners and in so doing, reduce the imposition of double taxation on international transactions and investments of residents in the signatory countries. Tax treaties reduce withholding taxes that are frequently imposed at high rates on cross-border payments of dividends, interest and royalties. If US companies earning income abroad cannot obtain the benefits of reduced withholding rates, or tax credits in the United States, they are likely to suffer excessive levels of (foreign) tax, thus putting them at a competitive disadvantage relative to investors from countries that do have such benefits.

Tax treaties also prescribe internationally-agreed thresholds for imposition of tax on inbound investments. By requiring foreign tax laws to be applied in a non-discriminatory manner to US enterprises, treaties offer a significant measure of certainty to potential investors.

Another benefit available exclusively under tax treaties is the mutual agreement procedure, a bilateral administrative mechanism for avoiding double taxation. This mechanism becomes all the more critical in resolving cross-border transfer pricing disputes. The competent authority resolution of these disputes is made possible under a tax treaty's mutual agreement procedure.

A critical compliance role played by tax treaties is the exchange of taxpayer information between the signatories. US Treasury tax officials have made it abundantly clear that effective exchange of information is a key factor in guiding treaty strategy, given their very high standards for international tax compliance. Where tax treaties also override existing bank secrecy laws, US financial institutions may be protected from criminal liability.

Although I generally approve of US tax treaty policy, I believe it over-reaches on the issue of treaty shopping. The current Administration has stated its commitment to prevent abuse of the US extensive tax treaty network. Its objective in adopting tough and restrictive treaty shopping provisions is to ensure that taxpayers which are not bona fide residents of the treaty partner are precluded from taking advantage of the beneficial provisions of that treaty through artificial business dealings.

I believe that US tax policy on treaty shopping, while serving a legitimate objective, imposes undue limitations on the structuring of international business operations by US multinational firms.

You are all no doubt familiar with the most recent example of US treaty shopping policy, i.e. Article 26 of the new US-Netherlands income tax treaty, comprising 23 pages of text and accompanied by a 19-page Memorandum of Understanding. In terms of length and complexity, this treaty shopping article is without precedent in the US tax treaty network.

The net effect of the treaty shopping provision is that it significantly hurts legitimate planning opportunities. Through the use of numerous objective or subjective safe-harbour tests, taxpayers must structure their ownership of business operations and earn income in specific ways or lose tax treaty benefits.

The Dutch treaty shopping article, however, does contain some positive elements. First, it has a provision recognizing that the EU is in many respects a single market for US companies investing abroad. I consider the criterion of EU ownership of a Netherlands company a positive factor in determining eligibility for treaty benefits. A second positive aspect is the adoption of a partial derivative benefits approach to testing a resident's eligibility for benefits. As treaty shopping articles become more common, the use of derivative benefits rules as a safety valve becomes critical by helping to ensure that the treaty shopping article does not inadvertently deprive bona fide investors of treaty benefits.

A third positive provision in the article is the recognition that legitimate business reasons may prompt third-country residents to locate a headquarters company in the Netherlands, and that such companies should be eligible for treaty benefits. In prior US tax treaties, safe harbours were not extended to companies that performed only supervisory, administrative or management functions, as these activities did not constitute an active business. The US agreement to include a headquarters provision of this nature helps preserve the Netherlands as an attractive site for such a company, given all the other benefits it offers to multinational companies.

On a broader level, I am concerned about the so-called balkanization of US trade and tax policy. It became evident during Citicorp's active participation in the NAFTA debate and the negotiations on Canadian and Mexican tax treaties that there was a lack of synergy between the US Trade Representative and the US Treasury on tax and trade issues affecting the cross-border flows of capital, goods and services. It was disquieting to learn that these two agencies did not consult on trade and tax issues of mutual concern, even though the general objective of both trade agreements and tax treaties is to provide greater market access in cross-border transactions by removing the barriers to free trade. Officials at these agencies were unwilling to pool resources and to consider policy issues at any level broader than that over which they reserved complete oversight.

One of the ultimate losers in this balkanized trade and tax policy environment is the US financial services sector. For example, even though a free trade agreement, such as the one with Canada, may provide greater market access, other barriers remain unless and until the United States is able to negotiate a reduction in the rate of withholding taxes. High withholding tax rates erode many of the benefits that financial service companies otherwise derive in trade agreements.

Another troubling trend in US tax law is its ever-increasing complexity: it is difficult to understand and to comply with. Forgive me if I am preaching to the choir when I say that the complexity of the rules for taxing foreign-source income imposes enormous compliance costs on US multinationals. As you recall, the goals of the 1986 Tax Reform Act were to

© 1994 International Bureau of Fiscal Documentation

create a fairer, more efficient and simpler tax system. Certainly in the international provisions of the Code, these goals have not been met.

Coping with this excessive complexity demands resources that could otherwise be used more productively. You tax experts are smart people; you could find something else to do. In addition, compliance is undoubtedly a barrier to foreign investment for small- and medium-sized enterprises, and it creates uncertainty that disrupts long-term planning. The current trend in US tax law of ever-increasing complexity also impacts cross-border transactions. One needs only consider how the foreign tax credit and interest allocation rules have developed to understand the lengths to which US tax officials will go to curb perceived abuses in the international tax area regardless of how complex the rules are to administer.

Equally troubling is the trend towards rules so vague that practitioners have no way of knowing whether a transaction works or not. To illustrate, consider the development of the anti-conduit rules. US tax officials initially dealt with anti-conduit transactions through the issuance of rulings. These rulings were later affirmed in numerous court decisions. Congress then enacted an anti-conduit statute in last year's budget bill, and in that statute ceded complete discretionary authority to the Secretary to promulgate regulations identifying what a conduit is and what abuses will not be acceptable. It is impossible to plan and structure international operations without knowing the full extent to which these new anti-conduit rules may he applied.

None of the objections I have made today with respect to the complexity and uncertainty of US tax laws can be redressed unless there is a rethinking in US fiscal policy. There is, in my view, an over-reliance on net income taxes in US fiscal policy. This serves as a justification for US tax policy in the international tax area to curb as many perceived abuses as possible in order to prevent the loss of tax dollars to the United States. This policy does not discriminate between inbound and outbound transactions; rather, it goes after both. Whether it is an enhanced earnings stripping provision on inbound investors or a runaway plant provision that would end deferral, the net effect is the same, creating tax barriers in order to raise tax revenue.

I believe the EU has a more enlightened approach to tax and fiscal policy. Because the member countries have adopted national consumption taxes, the EU as a whole does not have to rely as much on net income taxes as a source of revenue. As a result, the EU, through the adoption of tax directives, including the parent-subsidiary and mergers directives, has eliminated many tax barriers to cross-border investment. A freer flow of capital, goods and services is now more possible within the EU. As a former finance minister of the Netherlands, I saw first-hand the benefits of taxing consumption by way of indirect taxes and thereby giving the government the means to lighten the direct tax burden on productive activity, especially savings. With a VAT or other consumption tax, governments need not devote all their resources, as does the United States, to devising a "perfect" system of taxing worldwide income; a system that tries to take its fair share of every penny, piaster or pfennig of a resident's income; a system that is complex, cumbersome and expensive for both tax collector and taxpayer.

Adoption of a consumption tax by the United States as an alternative to the present income and payroll tax systems – not simply an add-on but as a (partial) alternative – is long overdue. Neither additional layers of complexity in the current income tax nor further growth of payroll taxes are the answer to US fiscal problems.

Knowledgeable people on Capitol Hill have said that a US VAT is always five years away – it was five years away last year; it is five years away this year and it will be five years away next year. Political opposition to a consumption tax from both left and right, because of the potential for regressivity, because of the fear of a shift from state taxes to federal taxes and because of the fear of creating an additional overall tax burden, could halt further development of a new tax system in this country. However, I would argue that a confluence of events makes consumption taxes a more viable alternative today than at any time in the past.

First, the long-term results from the 1986 Act have been modest at best. Lower rates are now rising to pre-Act levels, deductions and credits lost as the base was broadened are being restored and complexity has only increased in the corporate, and as I mentioned earlier, the international provisions. The current tax system in the United States is not working.

Second, the new, bipartisan Commission on Entitlement and Tax Reform has focused Congressional and, hopefully, public attention on the unchecked growth of entitlement spending in this nation, especially in health care, and the inadequacy of existing policy options to deal with this threat. If US laws are not changed soon, entitlement spending early in the 21st century – only six years away – threatens either to consume all federal spending if taxes are not raised or to require a 50 percent hike in the federal tax burden. Neither option is economically or politically viable and so new courses of action are necessary.

Third, the consumption tax debate has progressed to a new and higher level, certainly farther than at any time since the Carter Treasury Department issued its report, "Blueprints for Basic Tax Reform", 17 years ago. This summer, Senators John Danforth and David Boren, one a Republican and the other a Democrat, and both members of the Senate Finance Committee (and both sadly retiring after this year) introduced an interesting, well thought-out proposal called the "Business Activities Tax" or BAT, which closely resembles the new Japanese consumption tax. Senators Sam Nunn and Pete Domenici likewise have introduced the "Savings Exempt Income Tax", a similarly dramatic departure from the current system. Further and of special note, the new acting Chairman of the House Ways and Means Committee, the Honourable Sam Gibbons of Florida, has introduced his own version of a value added tax, already in its eighth iteration.

Given the confluence of these events, which way should this nation turn in its examination of consumption taxes and their modern progeny?

© 1994 International Bureau of Fiscal Documentation

An invoice and credit-method VAT is the taxing vehicle of choice throughout Europe and comes highly recommended as a simple, tried-and-true alternative to the present US system. Replacing the present payroll and corporate income taxes with a VAT would greatly simplify US tax administration and international tax compliance. Alternatively, replacing the present states sales taxes with a (federal) VAT would move the US tax system closer to the European system, would offer advantages from a general economic point of view and would benefit US exporting and importing companies by improving their international competitiveness (level playing field). However, the tax proposals put forward by Senators Danforth, Boren and others move away from a VAT and towards a hybrid tax system that retains elements of both consumption and income taxes.

One reason for this move from VAT to BAT is the goal of preserving the existing distribution of the tax burden within the US economy (although the Danforth-Boren proposal results in a jiggering of the tax burden within sectors of the economy as well as a hefty $ 170 billion increase in the corporate tax burden). Only by retaining a tax which targets upper-income persons and corporate retained earnings can a new proposal meet this goal. Another of the goals is revenue-neutrality with the present system, a requirement of the present "pay-as-you-go" budget rules, which may be discarded as the demands of the looming entitlement crisis grow more pronounced. Even with these modifications, however, the new proposals contain much promise and should be welcomed by corporate and consumer advocates alike.

Unfortunately, even the most advanced and recent version of a consumption system is only an unfinished work-in-progress in one important area. I would therefore present you tax experts with a challenge that my former colleagues in the EU have not mastered with their VAT, that our friends here in Canada could not surmount when they adopted their GST and that the Japanese did not overcome with their BAT. That problem is the appropriate, simple and efficient taxation of financial services under any of these systems.

Value added taxes have at their core a fundamental shift from classical income taxes – that capital and labour are to be treated equally and that no deduction is permitted for the cost of either. Transactions in "real" goods and services are subject to VAT, but financial services generally are not. The problem arises in part due to the difficulty in measuring the "value added" by financial intermediaries. Value is certainly added, but how is it to be measured and allocated?

The problem does not arise when a bank charges a fee for a specific and separately stated service. Foreign exchange, safety deposit boxes, mergers and acquisitions, credit cards, even derivative instruments, all generate fees to which a VAT or a BAT can apply. On the other hand, dealing with interest is the problem. Interest is payment for the time value of money, but it usually incorporates other components as well, including a charge for the intermediation service a bank provides by matching a willing lender to a willing borrower. Intermediation also involves the assessment and management of a variety of risks. It is this core activity that experts have not been able to tax easily or efficiently in any consumption tax regime.

European VATs commonly exclude this element of financial service from tax. The United Kingdom and France exempt these services from tax and France provides an additional tax on capital, while Germany permits taxpayers to opt into the VAT on a transaction-by-transaction basis. The result is that the VAT on the bank's inputs is not credited and is buried in the interest cost. Consequently, it cascades through the rest of the business stream when charged to a business. Cascading taxes are to be avoided at all costs in any system where efficiency is a key goal.

One possible solution would be to include financial services in a VAT. However, including financial services in the VAT creates the problem of separating the bank's interest cost from the intermediation services it provides; further, the bank must allocate the input tax attributable to that service between depositors and borrowers.

Another potential answer is to "zero rate" financial services under the VAT, permitting the financial institution a credit or deduction for taxes paid on inputs (computers, rents, paper, etc.) and then imposing a zero rate of VAT on the borrower's interest payment. The cascading problem disappears and the economic inefficiency is avoided. Unfortunately, few members of the US Congress will be happy to hear a constituent ask: "How is it that your new proposal, Congressman, exempts banks from tax but insists on taxing their customers (widows and orphans included)?"

The Danforth-Boren BAT departs from the VAT in that they would tax cash flow and not consumption. For banks, this means that deposits coming in are included in the tax base, as is interest received; on the other side of the ledger, loans made and interest paid are deducted from the tax base. (Neither equity infusions nor dividends paid are counted in the tax base, however). The difference between cash inflow and outflow is then subjected to the proposed 14 percent nominal tax rate (which is actually 17 percent, given that state taxes are included in the tax base).

The BAT avoids both cascading tax and the politically nettlesome zero rate with an ingenious but administratively burdensome requirement that the bank notify its business customers quarterly of the value of the intermediation service imbedded in the interest charged; the customer is then able to claim a BAT deduction for that amount. Interestingly, the proposal calls upon the US Treasury to tell financial intermediaries how to allocate these input tax between borrowers and lenders. This element of the BAT has been criticized for its cumbersome result; however, the two Senators are to be commended for giving serious thought to this thorny problem.

Another goal of consumption taxes is to lift the tax burden on exports and impose it on imported goods, effectively "levelling the playing field" between domestic and foreign producers. The same rule should apply to service providers, yet the Danforth-Boren proposal leaves taxes in place on exported financial services and does not impose them on imported financial services. Whether this will have a negative impact

© 1994 International Bureau of Fiscal Documentation

on US banks should at least be a subject for further discussion.

Further, as mentioned previously, both the BAT and the Nunn-Domenici proposal are cash-flow taxes, which adds another interesting twist to the debate. For banks, measuring and taxing cash flow would be very difficult, perhaps unworkable, and would generate vast recordkeeping burdens.

Finally, I should note that my esteemed countryman and friend, Professor Sijbren Cnossen of Erasmus University, has written that he believes the German system of permitting banks to opt into the German VAT on a transactional basis to be the best solution to this problem. Certainly safeguards can be imposed to stop game-playing with such a system and perhaps Dr Cnossen's recommendation is sound and should be implemented elsewhere.

The proper treatment of banking income from lending transactions in a consumption tax is problematic and the bright young man or woman who comes up with a workable solution will justifiably be famous – at least in bank tax circles. With the services sector and financial services in particular a growing and vitally important piece of the US and international economy, solving these intractable problems in a way that both ensures adequate government revenues while minimizing the taxpayer's compliance burden is a crucial inquiry.

In conclusion, let me say that it has been a pleasure to address you today on these important and difficult issues. I look forward to hearing from you both on US international tax policy matters and how best the United States can extricate itself from its current course. Perhaps soon, this group will be meeting to discuss the international tax ramifications of implementing the US VAT.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

DECEMBER 1994

Current Issues in International Taxation, Washington D.C., 15 and 16 December 1994 (English):

George Washington University, Conferences and Institutes, GW/OMCE, 2029 K Street, N.W., Suite 700, Washington, D.C. 20006, Tel.: 1-202-973 1110, Fax: 1-202-973 1111.

JANUARY 1995

Internationales Steuerseminar, St. Moritz, Switzerland, 9-13 January 1995 (German):

Attn: Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postbach, CH-8022 Zürich, Switzerland, Tel.: 41-1-2-192399.

Leading Edge Tax Strategies for the Corporate Tax Manager, London, 10 and 11 January 1995 (English):

IIR Ltd., 8th Floor, Centre Point, 103 New Oxford Street, London WC1A 1DD, Tel.: 44-71-412 0141, Fax: 44-71-412 0145.

Course on the principles of international taxation, Amsterdam, 23-27 January 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

FEBRUARY 1995

Course providing an international taxation overview for non-tax executives, Amsterdam, 10 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Death and Taxes in Europe, Planning for Cross-Border Estates, London, 13 and 14 February 1995 (English):

Vicki Goffin or Evie Kinane, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Course on working with tax treaties, Amsterdam, 15-17 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Conference on VAT Planning in an enlarged European Union, Stockholm, 21 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

© 1994 International Bureau of Fiscal Documentation

UNITED STATES

A SHORT HISTORY OF THE PORTFOLIO INTEREST EXEMPTION AND US REAL ESTATE INVESTMENT BY NON-RESIDENTS AND FOREIGN CORPORATIONS: TOO MUCH OF A GOOD THING

Leonard D. Levin

Beller & Keller, New York

I. BACKGROUND

A. Debt v. equity

A debate has long endured as to whether the Internal Revenue Code ("IRC") is biased in favour of debt as opposed to equity in financing investments. Debt is somehow viewed as evil because interest paid to a lender is deductible in computing the taxable income of a borrower engaged in a trade or business, whereas dividends are paid to shareholders out of after-tax income. An individual investor who lends money to a business receives interest income on which tax will be paid only once, whereas, under the US tax system, dividend income is taxed twice, once when the income is earned by the business and a second time when the dividend income is received by the investor. Equality in the tax treatment of interest and dividends could be achieved by either forgiving one level of tax on dividends (an integration system as in France, Germany or the United Kingdom) or denying a corporate tax deduction for interest (through the application of debt to equity ratios). So far, neither of the two "solutions" has been capable of gaining general acceptance in the United States.[1]

If there were no limits on the percentage of capital which could be furnished as debt, a business would theoretically, absent other considerations, be able to attract more investment by offering debt rather than equity since it could afford to pay a higher rate of return on debt. Partially to reverse this bias, the IRC contains rules which effectively limit the percentage of a business' capital which can be raised in the form of debt, most notably in the case of foreign ownership of US companies. One such illustration is the recent retroactive expansion of the earnings stripping rules under IRC Section 163(j) introduced as part of the Omnibus Budget Reconciliation Act of 1993.

B. International aspects

The Internal Revenue Service ("IRS") search for situations which harbour the potential for abuse in the area of debt financing has, over the years, tended to focus on lending activity where the creditor is also a shareholder of the borrower. In the international arena the potential for abuse is thought to increase where an income tax treaty has eliminated or sharply reduced the withholding tax rate on interest paid to a non-resident lender, while retaining a 10 or 15 percent withholding tax rate on dividend distributions to foreign parent companies.

1. 30 percent withholding on FIDAP

The IRC imposes a flat 30 percent tax on certain types of income received from sources within the United States by a non-resident alien individual or a foreign corporation, provided the amount so received is not effectively connected with the conduct of a trade or business within the United States.[2] The income subject to the 30 percent tax includes "interest (other than original issue discount ['OID'] as defined in Section 1273), dividends, rents, ... and other fixed or determinable annual or periodical gains, profits, and income ['FIDAP']". The 30 percent tax applies to the gross amount of the US source interest or dividend payment, while in the case of rental income from real property, for example, the recipient may make an election to be taxed on a net basis at regular rates.[3]

A tax treaty, if applicable, may reduce the tax rate on such income or eliminate the tax completely. As noted above, the rate of withholding tax on interest paid by a US borrower to lenders in developed countries is often zero. The 30 percent tax is generally collected by means of a withholding tax remitted by the payor directly to the IRS.[4]

2. Exemptions to the 30 percent withholding

As the United States moved from a creditor to a debtor nation in the 1970s, the US Congress, partly to manage the country's balance of payments, created tax exemptions for certain types of US source interest earned by foreign persons, such as the

1. There are still no regulations, for example, governing debt-to-equity ratios under IRC Sec. 385.
2. IRC Secs. 871(a)(1) and 881(a).
3. IRC Secs. 871, 872, 881, 882, 1441, 1442, 1446.
4. IRC Secs. 1441 and 1442.

© 1994 International Bureau of Fiscal Documentation

exemption for portfolio interest, for bank interest and for short-term OID. These unilateral exemptions have been driven, therefore, by the US need to borrow rather than by tax policy considerations, unlike bilateral exemptions or reductions in withholding tax rates negotiated as part of tax treaties. As has happened with other rules designed to encourage or direct taxpayer behaviour (such as the safe harbour or tax benefit leases introduced in 1981), if the rules are too effective, it will not be long before Congress begins to cut back on what is then perceived as an over generous taxpayer benefit (the so-called "loophole").[5] One such exemption that was designed to encourage specific taxpayer behaviour and which has just recently been cut back concerns the portfolio interest exemption.

II. PORTFOLIO INTEREST EXEMPTION

A. General

The portfolio interest exemption, IRC Sections 871(h) and 881(c), introduced by the Deficit Reduction Act of 1984, allows US source interest (including OID) in respect of an obligation issued after 18 July 1984, which would be subject to tax but for Sections 871(h) and 881(c), to be paid to a non-resident alien individual or foreign corporation free of the 30 percent US withholding tax. This withholding tax exemption is available on interest payments if the underlying debt meets certain technical registration requirements or specified exemptions thereto designed to prevent the obligations from being held by US persons who, it is believed, might not report the income.

In addition to the fact that the interest (including original issue discount) not be effectively connected with the conduct of a US trade or business, the interest must have been paid on a debt instrument that satisfies certain registration requirements or exemptions from such requirements. An additional requirement is that the interest must not be received by a 10-percent owner of the issuer of the debt instrument, taking into account shares owned by attribution, or the equivalent capital or profits interest in the case of a partnership.[6]

Short-term (183 days or less) OID obligations have a separate exemption from interest withholding[7] and thus, although the interest is tax exempt as is true for portfolio interest, such short-term OID obligations do not enjoy the estate tax exemption applicable to portfolio interest obligations (see below).

B. Qualified obligations

1. In general

To qualify for portfolio interest exemption, the obligation must be issued in either bearer or registered form. Thus, obligations which are transferrable by negotiation (commercial promissory notes) do not qualify. Any bearer or registered obligation may produce exempt US portfolio interest in a private placement, including obligations of natural persons, obligations with maturities of one year or less, or obligations not of the type issued to the public provided the other statutory requirements are met.

2. Bearer form

Bearer obligations must be sold under circumstances reasonably designed to insure that the purchasers are not US persons. First, the distributors of the debt obligations covenant with the issuers not to offer or sell the obligations during a restricted period to a person who is within the United States or its possessions or to a US person and that they have procedures reasonably designed to insure that their employees or other agents who are directly engaged in selling the obligations are aware of the sale restrictions on the obligations.[8] In addition to the Treasury Regulations, SEC Regulation S also applies to the issuance of bearer obligations.

Interest on bearer obligations must be paid outside the United States and its possessions.[9] The obligation and all detachable income coupons must contain legends in accordance with specific forms set out in the regulations, that, for example, any US holder will be subject to limitations under US income tax laws.[10]

3. Registered form

Interest paid on any debt obligation in registered form is also exempt if the payor receives a statement on IRS Form W-8 from the foreign payee that the beneficial owner of the interest is not a US person. There are, effectively, additional restrictions on transferability, since the obligation has a registered owner and can only be transferred, by its terms, by surrender and cancellation of the old obligation and reissuance of a new obligation registered in the name of the new owner.[11]

III. PARTICIPATING LOANS AND PORTFOLIO INTEREST

The above rules also applied to payments made with respect to participating loans, such as loans where part of the payment depended on the extent of rental income from the underlying properties. The payments to the providers of the capital were deductible for US income tax purposes as regarded both the fixed interest component and the participation to the extent that the payment constituted interest for federal income tax purposes. The question, therefore, is whether

5. Safe harbour leases were sharply curtailed in 1982 once the country understood the impact of such leases on the US Treasury and the budget deficit.
6. IRC Secs. 871(h)(3) and 881(c)(3)(B).
7. IRC Sec. 871(g).
8. IRC Sec. 163(f)(2)(B) and Reg. § 1.163-5(c)(1)(i).
9. Reg. § 1.163-5(c)(2)(iv).
10. These rules also apply to debt issued by a controlled foreign subsidiary of a US parent corporation which guarantees such debt obligations.
11. Reg. § 5f.103-1(c)(1)(i).

© 1994 International Bureau of Fiscal Documentation

a profit-based participation is to be characterized as interest, equity income or some form of partnership participation.

Under the tax law prior to OBRA 1993, an instrument could qualify as debt for which an interest deduction was allowed even though the instrument provided the holder with significant equity participation rights, e.g. where interest is expressed in terms of a share of the payor/borrower's profits (shared appreciation mortgage – Revenue Ruling 83-51, 1983-1 C.B. 48, where contingent interest was ruled deductible interest – since interest need not be computed at a rigid, stated rate).

For example, a US corporation owning commercial real estate in the United States could raise capital overseas by issuing obligations that paid a fixed annual interest plus a "kicker" equal to a percentage of the rental income from the properties. Under the logic of Rev. Rul. 83-51, the entire amount of the annual payment on the debt would qualify as portfolio interest and the foreign investor paid no tax in the United States on his or her investment.

The availability of the rationale expressed in Rev. Rul. 83-51 was sharply limited by Revenue Procedure 93-3 § 3.01 (9),[12] which notified taxpayers that rulings will not be issued on the consequences of shared appreciation mortgage loans if the facts are not similar to those described in the Revenue Ruling.

An additional benefit to the foreign investor was available despite the provisions in the IRC introduced by the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under FIRPTA, Reg. § 1.897-1(d) provides that the right to share in the appreciation of, or the gross or net proceeds or profits generated by, US real property constitutes an interest in real property other than an interest solely as a creditor. Thus the amount received on a participating mortgage obligation which otherwise qualified as a loan carrying contingent interest could benefit from both the portfolio interest exemption and an exemption from FIRPTA since payments of principal and interest do not constitute gain.[13] If, however, the foreign holder sold the obligation prior to maturity, he or she would be subject to US tax on any gain.

The tax problems created by the creative use of participating debt were not something unknown to the IRS prior to the 1980s, as the issues had surfaced even before the case of *Farley v. Commissioner*,[14] where the US Court of Appeals implied that the participating loan feature might be split from the fixed obligation and taxed separately in accordance with its character. The Treasury ran headlong into the characterization problem when it issued proposed regulations[15] in February 1991, in an effort to deal with hedging transactions. The difficulty the Treasury faced was in trying to determine what part of the issue price should be allocated to the debt component. The proposed regulation, later withdrawn, would have bifurcated contingent debt instruments.

A related question arises with respect to the intent of the parties in a participating loan. Specifically, whether it might be argued that the debtor and the creditor could be viewed as having intended to create a partnership relationship.[16]

IV. OBRA 1993

A. Repeal of portfolio interest exemption for contingent interest

The Omnibus Budget Reconciliation Act of 1993, added new Sections 871(h)(4) and 881(c)(4) to the IRC, which effectively repealed the portfolio interest exemption from withholding tax for contingent interest payments on what is sometimes referred to as participating debt. The reason given by Congress for the change was the belief that the portfolio interest exemption provided an incentive for foreign persons to make their US investments in projects that provided equity participation rights structured in such a way that the return on the investment would be characterized as interest exempt from US income tax under the portfolio interest rules. In the view of Congress, this unanticipated application of the rules designed and intended to encourage portfolio interest to contingent interest had led to a significant erosion in the US tax base, particularly as regards the taxation of real estate owned by non-US persons.[17]

B. Contingent interest defined

Contingent interest is defined as any payments that are dependent upon factors that reflect the following attributes of the debtor or any related person: (1) receipts, sales, or other cash flow; (2) income or profits; (3) changes in the value of property; or (4) payments of interest determined by reference to any dividend, partnership distribution or similar payment made by the debtor or a related person.[18] The Treasury is also broadly authorized to deny the portfolio interest exemption for other types of contingent interest that it identifies by regulation "where a denial of the portfolio interest exemptions is necessary or appropriate to prevent avoidance of Federal income tax".[19] This ill defined ("flexible") regulatory authority is, unfortunately, consistent with other similar provisions by which the Treasury is granted authority to limit the use of conduit loan arrangements[20] and abusive partnership arrangements.[21] Until there is some history as to how the Treasury intends to apply these provisions, tax planners will have to walk through a very dark valley indeed.

The term "related person" means any person related to the borrower under the general expense disallowance rules of IRC Section 267(b) or the partnership attribution rules of IRC Section 707(b)(1), and also any party to an arrangement

12. I.R.B. 1993-1, 71.
13. Reg. § 1.897-1(h).
14. 279 F.2d 701 (2nd Cir. 1960).
15. Reg. § 1.1275-4(g).
16. See *Commissioner v. Tower*, 327 US 280 (1946), 66 S.Ct. 532 and Rev. Proc. 74-17 § 3.03, 1974-1 C.B. 438.
17. See HR Rep. No. 111, 103rd Cong., 1st Sess. 724 (1993).
18. IRC Sec. 871(h)(4)(A).
19. IRC Sec. 871(h)(4)(A)(ii).
20. IRC Sec. 7701(l).
21. Reg. § 1.701-2.

© 1994 International Bureau of Fiscal Documentation

undertaken for the purpose of avoiding the application of this provision.[22]

The net result of the statutory change is that payments that look more like returns on equity than interest will be subject to the normal US withholding tax of 30 percent (or lower if a treaty applies).

If a debt instrument provides for both contingent and non-contingent interest, the portfolio interest exemption is lost only on the portion that represents contingent interest. If an instrument provides for a minimum non-contingent interest rate, only the excess of the contingent amount over the minimum fixed interest amount is denied portfolio interest treatment.[23] For example, if the interest rate on a debt obligation is the greater of 6 percent, or 8 percent of gross profits, only the excess of the contingent amount (8 percent of gross profits), if any, over the minimum fixed amount of interest (6 percent) is disqualified from portfolio interest treatment.

C. Exceptions to the definition of contingent interest

1. In general

OBRA provides for a number of exceptions to the definition of contingent interest. Thus, interest is not contingent for purposes of the portfolio interest exemption solely by reason of the fact that (1) the timing of the interest or any principal payment is subject to a contingency; (2) the interest is paid with respect to non-recourse or limited recourse indebtedness; (3) all or substantially all of the interest is determined by reference to non-contingent interest, or the principal amount of indebtedness on which such interest is paid; (4) the interest is related to currency or interest rate hedging transactions (a possible basis for creative tax solutions); or (5) the interest is determined by reference to changes in the value of or yield on actively traded property other than US real property interest, or the index of the value or yield on such property. For this purpose the term "property" includes stock, and "actively traded" has the same meaning as in IRC Section 1092(d) relating to straddles. However, the "yield" exception does not apply if the property is a debt instrument that itself pays contingent interest or is stock or other property representing a beneficial interest in the debtor or a related person.

2. Examples involving a REMIC

An example of a financing that qualifies under the first exception involves debt which constitutes a regular interest in a REMIC (real estate mortgage investment conduit)[24] and on which fixed interest is paid at a competitive market rate. However, the period during which the debt is to remain outstanding depends on the extent to which the qualified mortgages held by the REMIC are prepaid (and on other contingencies related to the REMIC's income or expenses). The legislative history states that interest received by the REMIC would not be treated as contingent interest solely by reason of this feature.[25] (REMICs can issue regular and residual interests, but only regular interests are certain to be classified as debt. All of the examples in the legislative history that involve REMICs deal only with regular interests).

Another REMIC example involves the third exception listed above. Congress intended in this exception to cover the case of a regular interest in a REMIC "which pays annual amounts of interest equal to a percentage of the interest earned by the REMIC on qualified mortgages, where the interest earned by the REMIC is not considered contingent interest under the rules of the provision".[26]

The legislative history provides two examples of interest which come within the fifth exception listed above. First, the portfolio interest exemption would not be denied for interest on a debt instrument that is determined by reference to the value of a commodities index merely because the debtor hedges its interest rate risk by acquiring an offsetting position in commodities that produces a cash flow correlating with the interest payments. Second, portfolio interest treatment is not denied for a debt instrument that pays interest in an amount determined by reference to the value of a stock market index merely because an affiliate of the debtor holds stock that is publicly traded on that market.[27]

Finally, as noted above, OBRA grants the Secretary of the Treasury authority to issue additional regulations to supplement the statutory definition of contingent interest to address cases where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of US income tax. The Act also permits the Secretary in regulations to exempt any type of interest from denial of portfolio interest treatment.

D. Effective date

The new provision limiting the portfolio interest exemption applies to interest received after 31 December 1993. There is an exception for fixed term participating debt obligations that were issued prior to 8 April 1993, or were issued after that date under a binding written contract in effect on 7 April.

V. INTERACTION OF OBRA CHANGE AND EXISTING TREATIES

A. No treaty override intended

The committee reports indicate that the denial of portfolio interest treatment was not intended to override existing treaties that reduce or eliminate US withholding tax on interest paid to foreign persons.[28] This statement is interesting for two reasons. First, because it recognizes, by implication, that

22. IRC Sec. 871(h)(4)(B).
23. H. Rep. 103-213 at 184.
24. The "I" stands for "investment", not "interest" as mistakenly used in the legislative history.
25. HR Rep. No. 111, 103rd Cong., 1st Sess. 725 (1993).
26. HR Rep. No. 111, 103rd Cong., 1st Sess. 726 (1993).
27. HR Rep. No. 111, 103rd Cong., 1st Sess. 726-727 (1993).
28. See HR Conf. Rep. No. 213, 103rd Cong., 1st Sess. 653 (1993).

© 1994 International Bureau of Fiscal Documentation

even before the change in the statute, the United States had been successful in including in at least two new treaties, those with Germany and the Netherlands, provisions which effectively recharacterized certain contingent interest payments as dividends. The second reason is that it leaves the Treasury with an option in income tax treaty negotiations with other countries to provide exclusions on a more targeted basis.

B. Treaties with similar provisions on contingent interest

1. 1989 US–Germany treaty

Article 11 (Interest) paragraph 2 of the 1989 US–Germany treaty provides that the term "interest" does not include income dealt with in Article 10 (Dividends). Paragraph 4 of Article 10 provides that the term "dividends" as used in this Article means income from shares ... or other rights (not being debt claims) participating in profits; while paragraph 5 provides that "[N]otwithstanding ... paragraph 1 of Article 11 (Interest), 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". The use of the words "or other rights" in Article 10(4) avoids the gap which arises under the US–Netherlands treaty which does not cover or include contingent interest paid by a partnership.

2. 1994 US–Netherlands treaty

The new US–Netherlands treaty signed in 1992 is even more to the point. Article 10 (Dividends) provides in paragraph 4 that "[F]or the purposes of this paragraph, the term 'dividends' also includes, in the case of the Netherlands, income from profit sharing bonds ('winstdelende obligaties') and, in the case of the United States, income from debt obligations carrying the right to participate in profits". Article 12 (Interest) defines the term "interest" in paragraph 2 to mean "income from debt-claims of every kind, whether or not secured by mortgage, and not carrying a right to participate in the debtor's profits, ...and an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit, as well as other income that is treated as income from money lent by the taxation law of the State in which the income arises. The term does not include income dealt with in Article 10 (Dividends)".[29]

The Joint Committee on Taxation's Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Kingdom of the Netherlands (JCS-15-93, 26 October 1993), noted that, even though there is an absence of source country taxation on interest (including the branch level tax on excess interest deductions), the treaty expressly allows the United States to impose withholding tax at the dividend rate on income from any arrangement, including debt obligations, carrying the right to participate in profits, such a deductible interest paid under an "equity kicker" loan. In addition, the explanation noted that the "internal laws of both the Netherlands and the United States (under a provision added to the Code in the OBRA 1993) impose withholding tax in such cases".[30]

VI. IMPACT OF PORTFOLIO INTEREST CHANGE ON US ESTATE TAXES

OBRA also provides special rules for the estate tax treatment of contingent interest obligations. Under prior law, the US gross estate of a non-resident decedent who was not a US citizen does not include a debt obligation if any interest on the obligation would be eligible for portfolio interest treatment were the interest to be received by the decedent at the time of his or her death.[31] OBRA, as part of the modification of the portfolio interest exemption, specifically provides that if any portion of the interest would not be eligible for the portfolio interest exemption because it is treated as contingent interest, an appropriate portion of the value of the instrument is treated as US situs property and, therefore, is included in the non-resident decedent's gross estate.

Until rules are issued that provide guidance as to the proper method for determining the appropriate portion of such an instrument that is treated as situated in the United States, taxpayers are permitted to use any reasonable method for making such determination. This change is effective for decedents dying after 31 December 1993, except with respect to any obligation with a fixed term that was issued before 8 April 1993, or was issued after 7 April 1993, pursuant to a written binding contract in effect on that date.

VII. CONDUIT REGULATIONS – SECTION 7701(L)

OBRA also introduced new Section 7701(l) under which the IRS is granted authority to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among two or more of such parties where the IRS determines that such recharacterization is appropriate to prevent the avoidance of any income tax. This provision is intended to apply not only to back-to-back loans, but also to other financing transactions such as multiple-party transactions involving debt guarantees or equity investments. These regulations could thus serve as an additional basis for the taxation of interest as dividends. The regulations are also expected to establish rules for determining when a party involved in a financing transaction is to be ignored as a conduit or mere intermediary for federal income tax purposes.

29. Note, however, that contingent interest paid by a partnership is not covered by any of the recharacterization language.
30. Despite this language, the treaty terms do not include debt obligations if issued by a partnership and on which contingent interest is paid.
31. IRC Sec. 23105(b)(3).

© 1994 International Bureau of Fiscal Documentation

VIII. SWAPS AS VEHICLES TO AVOID CONTINGENT INTEREST LIMITATIONS

As indicated above, the exception for hedging transactions from the definition of contingent interest provides a possible basis for creating financial arrangements that are the equivalent of contingent interest borrowings. Suppose, for example, that a US corporation, D, borrows funds at a fixed rate from a foreign investor, NL1, and, at the same time enters into a swap with a second, unrelated foreign investor, NL2, under which D receives funds from NL2 at a fixed rate that offsets D's interest expense, but that the rate D pays to NL2 is based on the dividends that D pays to its shareholders. Viewed as two separate transactions, the interest paid to NL1 should qualify for the portfolio interest exemption, while the swap payments to NL2 should not be subject to withholding under Reg. § 1.863-7(b).

The question, which is still unanswered, is whether the IRS could or would collapse such a transaction under the conduit financing regulations[32] into a contingent interest loan not eligible for the portfolio interest exemption, despite the fact that NL1 and NL2 are unrelated to D and to each other?

IX. FASIT

At the same time that the Treasury is considering regulations on conduit financing and contingent interest, consider for a minute in light of the above discussion the fact that a bill (HR 2065) has been under consideration in the House of Representatives since May 1993, which would establish a new kind of tax vehicle to facilitate the securitization of a wide variety of financial assets. The legislation would authorize a new entity called a Financial Asset Securitization Investment Trust ("FASIT"). A FASIT would serve as a tax law securitization vehicle for many transactions that cannot now use a real estate mortgage investment conduit ("REMIC") or fixed investment trust because they would involve the holding of debt and issue securities backed by obligations other than mortgages.

One of the advantages cited for a FASIT is that it would facilitate a variety of securitization transactions by eliminating tax law considerations such as distinctions between debt and equity (no more contingent interest problems?) and between borrowings and dispositions, two topics that often hinder or render securitization transactions less efficient than other financing vehicles. This very flexibility, however, has been cited by Assistant Treasury Secretary for Tax Policy Leslie B. Samuels, as creating the potential for income to completely escape taxation.

Given this expression of government concern and given the history of the development of tax incentives in the United States, one has to wonder whether we will ever see FASITs in our future?

32. IRC Sec. 7701(l).

IBFD INTERNATIONAL TAX ACADEMY
is pleased to announce...

WINTER COURSES FOR YOUR DIARY

Principles of International Taxation
One-week winter course
23-27 January 1995

International Taxation Overview for Non-Tax Executives
One day crash course
10 February 1995

Working with Tax Treaties
15, 16 & 17 February 1995

For further information please contact: Ms Anselien School
IBFD International Tax Academy, PO Box 20237, 1000 HE Amsterdam
The Netherlands – Tel.: +31 20 626 7726, Fax: +31 20 620 9397

© 1994 International Bureau of Fiscal Documentation

NETHERLANDS–UNITED STATES

WITHHOLDING TAX ON "CONTINGENT INTEREST" UNDER THE NEW US–NETHERLANDS TREATY

André H. Boekhoudt and Thomas P. North

André Boekhoudt obtained his fiscal law degree from the University of Groningen in 1982. Until joining KPMG Meijburg & Co. in 1988, he was a tax inspector for the Netherlands Revenue Service. Mr Boekhoudt is currently in KPMG Meijburg's Amsterdam office where he specializes in international tax law. Mr Boekhoudt is a member of the IFA and the Dutch Order of Tax Advisors.

Thomas North is an American lawyer and senior US tax manager with KPMG Meijburg & Co. in Amsterdam. He obtained a BA from Loras College in 1976 and a JD from the University of Iowa College of Law in 1979. From 1979-1990, he practised international law in Germany, where he was also a faculty member of the Johannes Gutenburg Universität, Mainz. Mr North joined KPMG Meijburg in 1990, where he specializes in international taxation.

I. INTRODUCTION

One of the significant changes brought about in the 1992 Tax Treaty between the United States and the Netherlands ("the Treaty") is the exclusion from the definition of "interest" of "income from debt claims...carrying the right to participate in profits".[1] This exclusion is meant to prevent income from "contingent interest", "equity kickers", "shared appreciation debit", "participating debt" (hereafter "contingent interest") and "winstdelende obligaties" (profit-sharing bonds) from enjoying the exemption from withholding tax which is afforded "true" interest.[2] The policy of denying the exemption from US withholding tax for contingent interest is also reflected in the recent changes to the US portfolio interest rules.[3]

Unfortunately, the Treaty is not entirely clear as to which types of instruments, or to what portion of income from such instruments, the treatment as interest will be denied. In addition, the drafters apparently intended that payments not qualifying as interest would be re-classified as "dividends" so that they could be taxed accordingly under Article 10 of the Treaty. Nevertheless, the operative section of Article 10 refers to dividend withholding tax only in respect of dividends which are paid by "a company" resident in the source State.[4] This opens the question as to whether contingent interest and similar payments made by individuals or partnerships may be taxed under Article 10 (or any other article) of the Treaty. This issue is primarily, but not only, of importance to Netherlands persons which have extended loans for the financing of US real estate that provide for contingent interest which is also often referred to as an "equity kicker".

This article will first discuss the domestic US and Netherlands withholding tax rules for contingent interest. An attempt will then be made to reconcile these internal law provisions with the provisions of the new Treaty. Finally, the article will briefly address the possible impact of these rules on withholding agents and taxpayers.

II. WITHHOLDING UNDER DOMESTIC LAW

A. United States

1. General

Generally, a foreign person's US source interest income that is not effectively connected with the conduct of a US trade or business is subject to a 30 percent withholding tax at source. There is a significant statutory exception for portfolio interest (see below). Although income tax treaties generally reduce the rate of US withholding tax to zero in respect of interest, reliance on treaty provisions is not necessary if the portfolio interest exemption can be claimed.

Therefore, with respect to payments from US sources, it is first important to determine if contingent interest will qualify as portfolio interest. In addition, since the phrase "income...carrying the right to participate in profits" is not further defined in the Treaty, the phrase will likely be interpreted by US domestic law principles under the authority of Article 3(2) of the Treaty when US withholding tax is at issue. Since it is likely the United States would intend the exclusion of contingent interest from the portfolio interest exemption to match the analogous exclusion under Article 12 of the Treaty, the definition of contingent interest under the portfolio interest rules is the most logical place to seek clarification of the Treaty exclusion.

1. Art. 12(2).
2. For purposes of the following discussion, we will assume that the (interest) income in question would not otherwise be considered to be derived from an equity or from a partnership interest, *per se*. Normally, this would be the initial consideration in evaluating the tax treatment of income from instruments or investments which have characteristics of both debt and equity.
3. Sec. 13237(a)(1), Omnibus Budget Reconciliation Act of 1993, P.L. 103-66.
4. Treaty Art. 10(1) and(2).

© 1994 International Bureau of Fiscal Documentation

2. Portfolio interest exception

Under the portfolio interest rules of IRC Section 871(h), US source interest (including original issue discount) is exempt from withholding tax if (1) the instrument meets certain registration and "foreign targeting" requirements designed to ensure that the instrument is not sold to a US person, and (2) the interest is not received by a "10 percent shareholder" of the issuer of the obligation, taking into account certain attribution rules. For this purpose, a "10 percent shareholder" includes not only a corporate shareholder, but also "in the case of a partnership, any person who owns 10 percent or more of the capital or profits interest of the partnership".[5]

The Omnibus Budget Reconciliation Act of 1993 ("OBRA") repealed the portfolio interest exemption with respect to certain contingent interest.[6] For this purpose, contingent interest includes any interest if the amount is determined by reference to:

- any receipts, sales or other cash flow of the debtor or a related person;
- any income or profits of the debtor or a related person;
- any change in value of any property of the debtor or a related person; or
- any dividend, partnership distributions or similar payments made by the debtor or a related person.

The Secretary of the Treasury may also adopt regulations to deny the portfolio interest exemption "where denial of the exemption is necessary or appropriate to prevent avoidance of Federal income tax".[7]

The legislative history of the changes to the portfolio interest rules suggest that the primary concern of Congress was the possibility that foreigners could avoid US withholding tax on interest "that is contingent on profits generated by the disposition of US real estate"; however, the new rules will impact much more than real estate financing. In addition, the definition of contingent interest as set forth in the portfolio interest rules includes much more than interest which is contingent on "profits". As defined above, the contingency can be based on measures other than "profit", such as cash flow and the increase in value of specific items of property. This is much broader than the concept of "earnings and profits" which is the general measure for the calculation of "dividends".

Finally, both the text of Section 871 and the legislative history clearly indicate that the portfolio interest exemption may be denied to contingent interest payments made by non-corporate persons, such as partnerships. More favourably, the legislative history indicates that the denial of the portfolio interest exemption applies only to the contingent portion of the interest payment, and not to the "normal" non-contingent interest payments made under the same instrument.[8]

The US answer to contingent interest under its domestic law is therefore to treat such payments as interest which does not qualify for the portfolio interest exemption. Since US internal law imposes a 30 percent withholding tax on non-portfolio interest paid to foreign persons, it is not necessary under internal law to recharacterize such payments as "dividends". However, since most US tax treaties exempt "interest" from withholding tax, special provisions are needed to ensure that US withholding tax on contingent interest is not prohibited under treaty provisions.

B. Netherlands

The Netherlands does not impose a withholding tax on interest payments unless such interest is paid in respect of bonds and payment depends either on the profits of the payor, or on the distribution of profits by the payor (i.e. "winstdelende obligaties").[9] Further, the obligation to the tax is restricted to such "winstdelende obligaties" of Netherlands resident public limited companies ("naamloze vennootschappen"), closed limited companies ("besloten vennootschappen met beperkte aansprakelijkheid"), open limited partnerships ("commanditaire vennootschappen"), and other entities whose capital is divided into shares.[10] All of the above-referenced entities are taxable as corporations for Dutch tax purposes. Although the interest payment on a "winstdelende obligatie" is subject to dividend tax withholding, the payment is deductible for corporate income tax purposes if it is an arm's length payment. In addition, under Dutch law, a foreign partner in a (transparent) Dutch partnership who is entitled only to a share in the *annual* profits (rather than the hidden reserves and goodwill upon liquidation) will be subject to income tax (rather than withholding tax) and will generally be deemed to receive (profit-sharing) interest.

The literature suggests that under Netherlands domestic law, dividend withholding tax can be withheld on the *entire* amount of "interest" paid in respect of a "winstdelende obligatie", and not merely the profit-sharing portion.[11] The rate of withholding tax on dividends under Netherlands domestic law is 25 percent.

Given the fact that the Netherlands withholding tax on payments made in respect of "winstdelende obligaties" is effected under the Dividend Tax Act, some commentators have suggested that withholding tax on payments from such obligations can be effected under the 1948 Treaty.[12] The fact that

5. IRC Sec. 871(h)(3)(B)(ii).
6. The repeal is effective for interest received after 31 December 1993. It does not apply, however, to any interest paid or accrued with respect to any indebtedness with a fixed term that was issued before 7 April 1993, or was issued after such date pursuant to a binding written contract in effect on such date and at all times thereafter before such indebtedness was issued.
7. IRC Sec. 871(h)(4)(A). The IRS has indicated in Notice 94-39 that it does not currently anticipate issuing regulations.
8. Committee Reports on P.L. 103-66, at 182-184 (Blue Book).
9. Dividend Tax Act (Wet op de dividendbelasting, 1965). Art. 3(1)(f).
10. Dividend Tax Act Art. 1(1).
11. See Commentary to Dividend Tax Act Art. 3, in "Vennootschapsbelasting", *Fiscale Encyclopedie de Vakstudie* (Deventer: Kluwer), at 3-59 to 3-60.
12. See e.g. J.B.J. Peters, "Beschouwingen over het op 29 October 1948 tussen Nederland en Amerika gesloten verdrag ter voorkoming van dubbele belasting", *Weekblad der Belastingen 1949*, No. 3943, at 188. In addition, it should be noted that the Joint Committee Report on the Treaty provides: "Moreover, it is understood that under the present treaty, the Netherlands imposes dividend withholding tax on payments under a profit-sharing bond", Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States of America and the Kingdom of the Netherlands, Joint Committee on Taxation, United States Senate, JCS-15-93, at 6. Peters' view is questionable given the fact that income from "winstdelende obligaties" remains "interest" even though withholding is effected under the Dividend Tax Act.

© 1994 International Bureau of Fiscal Documentation

under its internal law the Netherlands withholding is founded under the dividend withholding rules and the United States classifies similar payments as (non-portfolio) interest, perhaps explains the difficulties encountered in carving out an appropriate exception under the definition of "interest" in the new Treaty.

III. DEFINITION OF "INTEREST" UNDER THE TREATY

Article 12(2) of the Treaty defines interest as follows:

> The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures, and an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit, as well as other income that is treated as income from money lent by the taxation law of the State in which the income arises. The term does not include income dealt with in Article 10 (Dividends). Penalty charges for late payment shall not be regarded as interest for purposes of this Convention.

The above definition literally only excludes "income from debt claims... carrying the right to participate in profits" from the definition of "interest". From a Dutch perspective, this definition seems logical since only truly profit-sharing interest received by foreign persons is subject to tax.[13] From a US perspective, the treaty standard of "participation in *profits*" is much narrower than the corresponding exclusion under the portfolio interest rules which, as explained above, excludes interest which is measured by a number of factors other than "profits". There is, however, little reason to expect that the United States will not interpret the exclusion from interest under Article 12 under the same standards as applicable to the analogous exclusion for portfolio interest. For example, the Joint Committee Report provides that

> ...the interest exemption [under Article 12] does not prevent the Netherlands from imposing the dividend tax on interest paid on profit sharing bonds. Nor does it prevent the United States from withholding tax on contingent interest under the portfolio interest rules as amended in the 1993 Act.[14]

The Treasury's Technical Explanation to the Treaty provides that income from debt claims that carry the right to participate in the profits of the debtor "will be included within the definition of dividends under Article 10 (Dividends) and is, therefore, subject to the provisions of that Article".[15] The Treasury Explanation goes further to provide the following example:

> Thus, for example, income from a debt obligation of a Netherlands resident that carries the right to participate in profits is not covered by Article 12, even if such income is treated as interest under the law of the United States.[16]

Nothing in the text of Article 12, the Treasury's Technical Explanation, the Joint Committee Report on the Treaty, or the various historical documents issued by the Netherlands government directly suggests that the exclusion for contingent interest found in Article 12 is limited to the contingent portion of interest paid on an instrument which calls for contingent and non-contingent payments. A strict textual reading of the treaty language would equally support an interpretation that *all* interest paid on an instrument which carries "a right to participate in the debtor's profits" is excluded from the scope of Article 12. This interpretation would, however, appear to be inconsistent with the underlying policy of the exclusion and, from the US perspective, would be contrary to the analogous provisions of the portfolio interest rules. Such an interpretation would not, however, be inconsistent with the prevailing view regarding Netherlands withholding tax on "winstdelende obligaties".[17] Therefore, it appears to be an open question as to whether the non-contingent portion of "interest" paid to a US person with respect to a "winstdelende obligatie" is subject to Netherlands withholding tax.

Since the right to withhold tax on contingent interest is not governed by Article 12, but by Article 10 (Dividends), one would expect the actual authority to withhold and the rate of withholding to be found in Article 10.

IV. WITHHOLDING ON CONTINGENT INTEREST UNDER ARTICLE 10 (DIVIDENDS)

A. Definition of "dividends"

Article 10(4) of the Treaty defines "dividends" as follows:

> The term "dividends" as used in this Convention means income from shares or other rights participating in profits, as well as income from corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. For the purposes of this paragraph, the term "dividends" also includes, in the case of the Netherlands, income from profit sharing bonds ("winstdelende obligaties") and, in the case of the United States, income from debt obligations carrying the right to participate in profits.

This definition has been expanded to include the profit-sharing bonds and obligations carrying the right to participate in profits which have been excluded from the definition of "interest" for purposes of Article 12. Although a strict textual reading does not necessarily limit the definition to "corporate rights", the emphasis is clearly on shares and similar rights with respect to corporations, rather than individuals or other non-corporate persons such as partnerships.

As discussed in more detail below, the inclusion of non-corporate distributions within the definition of a "dividend"

13. However, a person holding a substantial interest in a Dutch corporate body will be taxed on any interest he receives from such body, profit-sharing or not.
14. Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States of America and the Kingdom of the Netherlands, Joint Committee on Taxation, US Senate, JCS-15-93, at 67.
15. Treasury Explanation, at 30.
16. *Id.* Unfortunately, the example appears to suffer from faulty syntax. The example was probably intended to convey "...income of a Netherlands resident from a debt obligation that carries the right...". In other words, the income is from US sources.
17. See *supra* note 9 and the text related thereto.

© 1994 International Bureau of Fiscal Documentation

under Article 10 is contrary to the provisions of the 1992 OECD Model Treaty and the similar provisions of the US–Germany Treaty. In addition, if the definition of "dividends" was intended to include non-corporate payments, the operative portions of Article 10 should also refer to such non-corporate payments. As also discussed below, this is not the case with respect to the US–Netherlands Treaty.

B. Comparison to OECD Model Treaty

The Treasury's Technical Explanation to the Treaty provides that Article 10(4) "generally conforms to paragraph 3 of Article 10 of the OECD Model Treaty".[18] The OECD Commentary to the 1992 Model Treaty supports the view that for purposes of withholding tax under Article 10, a "dividend" can only be distributed by a "company". The preliminary remarks to Article 10 provide that:

> By "dividends" is generally meant the distribution of profits to the shareholders of companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies.[19]

Further, paragraph 27 of the Commentary to Article 10 of the OECD Model Treaty provides:

> Distributions of profits by partnerships are not dividends within the meaning of the definition, unless the partnerships are subject, in the State where their place of effective management is situated, to a fiscal treatment substantially similar to that applied to companies limited by shares (for instance, in Belgium, Portugal and Spain, also in France as regards distributions to *commanditaires* in the *sociétés en commandite simple*).[20]

It is possible that the US negotiators of the US–Netherlands Treaty intended to include in the definition of "dividends" certain contingent interest paid by partnerships and other non-corporate persons. This possible intention is, however, not explicitly incorporated into the definition set forth in Article 10(4) of the Treaty. Further, the inclusion of distributions made by non-corporate persons such as partnerships within the definition of a "dividend" is somewhat novel. In particular, the inclusion of such items in the dividend article is contrary to the OECD's recommended treatment of such items as indicated above.

The OECD Model Treaty does, however, foresee instances in which "interest" paid by *corporate* bodies may be classified as a "dividend" for purposes of withholding tax. Paragraph 25 of the Commentary to Article 10 of the OECD Model Treaty provides that "Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company". The Comment goes further to list several circumstances in which the contributor of a loan might be considered to share in the risks run by the company. The circumstances listed generally catalogue those factors which would traditionally be relevant to distinguish debt from equity. One factor is whether the "creditor will share in any profits of the company". The instances in which "interest" can be considered a "dividend" for purposes of withholding tax under the OECD Model clearly does not include situations in which the creditor's return is based on non-profit factors such as cash flow.

C. Comparison to US–Germany Treaty

There is, particularly in German treaty practice, some authority for the imposition of dividend withholding tax on distributions from non-corporate entities. For example, Article 10(1) of the 1989 US–Germany Treaty provides:

> ...the term "dividends" includes in the Federal Republic of Germany income under a sleeping partnership (Stille Gesellschaft), "partiarisches Darlehen", or "Gewinnobligation" as well as distributions on certificates of an investment trust.

In this case, however, Article 10(1) specifically does not include distributions which would otherwise not be considered "debt claims". Therefore, the withholding tax applicable to distributions under Article 10(1) of the US–Germany Treaty apply only to participations which would otherwise be classified as equity. This is not the case in the typical "participating debt" scenario with respect to US real estate financing. Vogel[21] argues that dividend withholding tax can be withheld on distributions by German "silent partnerships" even though such partnerships are not "companies" as defined by the treaty. His reasoning is that the definition of "company" under Article 3(1) is not controlling if the "context otherwise requires". In this case, Vogel argues, "if the treaty definition of "dividends" expressly includes income from silent partnerships, it is only logical for the term "company" to be defined differently for purposes of Article 10".

The US–Germany Treaty, however, clearly distinguishes between "debt claims" and "non-debt claims". Article 10(5) deals with debt obligations:

> Notwithstanding the first sentence of paragraph 2 of this Article and paragraph 1 of Article 11 (Interest), income from arrangements, including debt obligations, carrying the right to participate in profits (including in the Federal Republic of Germany income under a sleeping partnership (Stille Gesellschaft), "partiarisches Darlehen," "Gewinnobligation," or "jouissance" shares or "jouissance" rights) 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.

Thus, under the US–Germany Treaty, payments from participating debt which are excluded from the definition of "interest", but which nevertheless are not considered payments from equity, are not reclassified as "dividends" for purposes of the Treaty. Rather, such payments may simply be taxed in accordance with the taxation laws of the source state, irrespective of the nature of the classification and unrestricted by the dividend article as to the amount of tax which may be levied.

18. Treasury Technical Explanation, at 27. The Joint Committee Report contains a somewhat different evaluation: "There is no similar provision in the present treaty or the US or OECD models". See *supra* note 12, at 6.
19. Commentary to Art. 10, 1992 Model Tax Convention on Income and Capital, OECD Committee on Fiscal Affairs, Paris.
20. *Id.*
21. Klaus Vogel, *Double Taxation Conventions* (Deventer: Kluwer), at 567.

© 1994 International Bureau of Fiscal Documentation

D. Authority to withhold tax under Article 10(1) and(2) for distributions not made by companies

Assuming that the Treaty effectively includes non-corporate distributions within the definition of a "dividend" under the definitional provisions of Article 10(4), do the operative provisions of Article 10 allow (or prohibit) the imposition of withholding tax? Article 10(1) provides:

> Dividends paid by a company which is a resident of one of the States to a resident of the other State may be taxed in that other State.

This provision, consistent with the OECD Model Treaty, is restricted to dividends paid by a "company". For purposes of the Treaty, a "company" is defined in Article 3(1) as "any body corporate or any entity which is treated as a body corporate for tax purposes".

Similarly, Article 10(2) provides:

> However, such dividends may also be taxed in the State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other State, the tax so charged shall not exceed...

Again, no mention is made of the taxing rights in respect of "dividends" which are not paid by a "company". Therefore, unless the "context otherwise requires" that for purposes of Article 10(1) the term "company" include non-corporate payors, withholding tax should not be permitted under Article 10. Although it could be argued that the "context otherwise requires" the term "company" be broadly construed, the case for such an argument is not as compelling as under the US–Germany Treaty.

Several arguments can be made that the "context" does not require that the term "company" includes non-corporate persons. First, as noted above, such an interpretation would be contrary to clear statements of policy under the 1992 OECD Model Treaty. Second, the treaty should be interpreted in such a fashion that the US and Netherlands withholding will occur in roughly the same circumstances. A reading which would restrict the US withholding to payments made by corporate entities would place the US withholding rights in rough parity with the rights currently exercised by the Netherlands under its internal law. Third, the statements contained in the Treasury's Technical Explanation and the Senate Joint Committee Report contain no direct statements that US withholding can occur with respect to non-corporate payments. Fourth, the US law in effect during the treaty negotiations did not contain any special provisions with respect to withholding on contingent interest, much less with respect to non-corporate payments of such contingent interest.[22] Finally, had the negotiators intended to allow source state taxation of contingent interest payments made by non-corporate persons, a more explicit statement could have been included in the treaty, as was the case in the US–Germany Treaty.

The German negotiators were quite careful to include within the definition of "dividends" certain distributions from specifically mentioned non-corporate payors. In addition, the German treaty deals with the issue of payments from participating debt which does not constitute equity in quite a different fashion than the US–Netherlands Treaty. As applied to a typical US-source "equity kicker" which is treated as interest under US domestic law, but not qualifying for the portfolio interest exemption, it appears that the tax treatment under the US–Germany Treaty would now be as follows. First, (at least) the contingent portion of the debt would not be considered "interest" as defined in Article 11 since it is "dealt with" in Article 10. Article 10(5) of the US–Germany Treaty would allow the United States to tax the payment in accordance with the laws of the United States (not necessarily as a dividend). It appears the United States will be free to withhold tax on (at least) the contingent portion at the rate of 30 percent regardless of the status of the pure as a corporate or non-corporate person.

E. Rate of withholding tax

It appears that one reason for treating contingent interest as "dividends" under the Treaty was to ensure a reduced rate of withholding tax.[23] The general rate of withholding tax under Article 10 is 15 percent. The 5 percent withholding tax rate is applicable to dividends "if the beneficial owner is a company which holds directly at least 10 percent of the voting power of the company paying the dividends".[24]

The Netherlands Explanation to the Treaty provides that income from "winstdelende obligaties" qualifies for the reduced 5 percent rate under Article 10(2)(a) if the beneficial owner is a company which holds at least 10 percent of the voting shares of the company paying the dividend.[25] Since "winstdelende obligaties" do not themselves carry voting rights, the reduced rate would only apply in situations in which the bondholder is also a direct shareholder.

The position of the United States on this point is not clear since neither the Treasury Technical Explanation nor the Senate Joint Committee Report address this issue.

V. CLASSIFICATION UNDER THE TREATY AS "OTHER INCOME"?

Article 23(1) of the Treaty (Other Income) provides:

> Items of income of a resident of one of the States wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

This article of the Treaty would exempt payments in respect of participating debt made by non-corporate persons from

22. Although the OBRA was enacted prior to the ratification of the Treaty, the treaty had been initialled prior to the enactment of OBRA. Since the Treaty was ratified in December 1993 after enactment of OBRA, the more restrictive language of the Treaty should have precedence over the portfolio interest rules of OBRA. In any event, the legislative history of OBRA indicates the portfolio interest rules were not intended to override existing treaties. See *supra* note 8, at 183.
23. For example, the Senate Joint Committee Report refers to the right to tax contingent interest "at the dividend rate".
24. Treaty Art. 10(2)(a).
25. Memorie van Antwoord, 15 September 1993, Attachment 1, at 3.

© 1994 International Bureau of Fiscal Documentation

source State taxation, unless such payments are "dealt with" in Article 10. Clearly, the general phrase "debt obligations carrying the right to participate in profit" is *mentioned* in Article 10; however, the more specific tax treatment of non-corporate payments is not.

As noted above, strong arguments can be made that the term "dividends" as defined in Article 10(4) does not include non-corporate payments. In addition, the operational provisions of Article 10(1) and (2) do not refer to payments other than those by "companies". Finally, the "context" does not require that the term "company" be expanded beyond the express definition contained in Article 3 of the Treaty.

Therefore, the most supportable solution to the taxation of contingent interest paid by a non-corporate person is that it falls under catch-all provisions of Article 23. In this case, the contingent interest would be exempt from tax in the source State.

VI. CONSEQUENCES FOR WITHHOLDING AGENTS AND TAXPAYERS

A. Uncertainties for withholding agents

The uncertainties inherent in the Treaty rules regarding contingent interest will prove troublesome for withholding agents unless additional guidance is issued. First, US withholding agents will be faced with the issue of whether the Treaty allows US withholding tax on contingent interest payments which are not made by corporate entities. The better view would appear to be that (due to drafting omissions?) the Treaty does not permit withholding tax.

Second, it is not clear how broadly the scope of "debt claims carrying the right to participate in profits" should be read. US withholding agents will undoubtedly rely on the more detailed portfolio interest rules for guidance; however, it appears that the treaty standard of "participation in *profits*" may be narrower in scope than the corresponding definitions under the portfolio interest rules.

Third, US withholding agents must determine if tax must be withheld on the entire amount of "interest" paid under a contingent instrument, or only on the contingent portion. For example, must tax be withheld on the non-contingent portion of a payment made by a corporate payor to a Netherlands person when such interest does not qualify as portfolio interest? If the benefits of the treaty are claimed, will the treaty reclassify the entire amount of the interest as a "dividend"? The better view would appear to be that only the contingent portion of interest is subject to reclassification.

Similarly, Netherlands withholding agents must decide if tax must be withheld on all payments made to US persons in respect of "winstdelende obligaties". Applying principles of Netherlands internal law, it would appear that withholding may be required on all payments. This result would, however, appear to be unjustified if the payments can truly be bifurcated. In addition, one would expect a certain consistency and reciprocity in the tax treatment of payments to and from the respective treaty partners.

Finally, uncertainties exist regarding the proper rate of withholding tax. Although the Netherlands has clearly stated that the 5 percent rate may be available if the creditor is also a shareholder of the payor, the position of the United States is not known.

Due to the uncertainties inherent in all these determinations, it would seem unreasonable for penalties to be imposed on withholding agents for failure to withhold tax in the absence of more detailed guidance.

B. Effect on taxpayers

In general, of course, the interpretation of the Treaty which results in the lowest withholding tax will be most beneficial for taxpayers. With respect to contingent payments made by US corporate debtors, the withholding rate applicable to dividends of 15 percent is certainly better than the statutory rate of 30 percent.[26] The lower withholding rate should make it easier for most Dutch recipients to fully utilize the tax credit for dividends which the Netherlands is required to allow under Article 25(3)(b).

For contingent interest payments made by non-corporate US persons such as partnerships, the position that such payments are not subject to US withholding tax is not necessarily a windfall to Dutch taxpayers. First, such payments will normally be fully includible in the basis for Netherlands taxation and taxed at normal corporate tax rates. In most cases, the exemption from US withholding tax will simply result in a greater portion of the tax revenues being shifted to the Netherlands government. Nevertheless, the absence of US withholding tax could have the following benefits for Netherlands taxpayers. First, there is the obvious cash flow benefit that the Dutch investor will have the complete use of the contingent portion of interest payments until the Dutch income tax must be paid. Second, the exemption from US withholding tax will be a very real benefit for Dutch recipients who are in an overall loss position for Dutch tax purposes. In such cases, a credit for US withholding tax would not be (immediately) available.

C. Opportunities for exempt pension trusts

Investing in US real estate via participating debt by Dutch pension funds may provide an attractive alternative to a direct investment. Under Article 35 of the Treaty, Netherlands-exempt pension trusts may receive an exemption from US tax with respect to dividends and interest. The exemption does not apply if the pension fund is "engaged in a trade or business" in the United States, or to income received from a "related person".

26. As noted above, it appears also to be more favourable than the US–Germany Treaty which allows withholding at the statutory rate (in the case of the US as applicable to interest) of 30%.

© 1994 International Bureau of Fiscal Documentation

A Netherlands pension fund which would invest in US real estate via a partnership[27] would be considered to "engage in a US trade or business" and thus would be subject to US tax on operating income and capital gains. However, if the pension fund were to lend funds as a creditor to the partnership under terms which call for contingent interest, it should not be considered to engage in a US trade or business. The "contingent" portion of the interest payment or "equity kicker" could be classified as interest under US domestic law (and therefore deductible by the partnership), but would be a dividend for purposes of the Treaty. Even if the payment is considered a dividend subject to withholding under Article 10, the US would not be entitled to withhold tax due to exemption granted under Article 35.[28] It should be noted that the same favourable treatment would be available to a participating loan granted by a Dutch pension fund to a US corporation. It should further be noted that the receipt of contingent interest under the note should be exempt from US withholding tax; however, the *sale* of the contingent instrument may be subject to tax under FIRPTA.[29]

D. Triangular cases

Article 12(8) was added to the Treaty by the Protocol in order to address the taxation of interest in certain "triangular cases". With respect to interest, triangular structures involve the lending of funds to US persons via a branch of a Netherlands company. Interest paid by the US borrower was exempt from withholding tax under the 1948 Treaty due to the applicability of the interest article of that treaty. Interest paid to the Netherlands company and allocable to the third (tax haven) country branch was subject to a very low combined rate of tax in the branch jurisdiction and in the Netherlands, since the Netherlands allows an exemption for branch profits.

In order to counter the perceived abuse of such structures, Article 12(8) generally allows the United States to withhold 15 percent tax on US-source interest paid to a Netherlands company and allocable to a third country branch if the interest is not subject to a combined rate of tax of 17.5 percent (21 percent after 1996) in the branch jurisdiction and the Netherlands.

The fact that contingent interest is excluded from the scope of Article 12 also means that such interest should not subject to the anti-avoidance rules of Article 12(8). This may create the opportunity to structure contingent interest payments made by US partnerships or individuals via a branch of a Netherlands company. This structure may be particularly attractive if, as argued above, the Treaty does not allow US tax withholding on contingent interest payments (as dividends) made by US partnerships or individuals to Dutch persons. Of course, "normal" interest payments made via such a structure would continue to be subject to the rules of Article 12(8) and may be subject to 15 percent US withholding tax.

E. Election to claim the old or new treaty

Article 37 of the new Treaty allows taxpayers to claim the benefits of the 1948 Treaty for taxes withheld at source in 1994 if the 1948 Treaty would be more beneficial than the new Treaty. Netherlands taxpayers who receive contingent interest from US sources in 1994 (and which does not qualify for the portfolio interest exemption) would normally wish to claim the benefits of the 1948 Treaty in 1994. This is due to the fact that the 1948 Treaty generally prohibits US withholding tax on such contingent interest.[30] Taxpayers should be aware, however, that they may not "cherry pick" among favourable and unfavourable treaty provisions in the transition year.

As noted above, strong arguments can be made that the Netherlands does not have the right to withhold dividend tax on "winstdelende obligaties" under the 1948 Treaty. Therefore, the new treaty provisions with respect to such profit sharing bonds may also affect a US taxpayer's decision as to whether to claim the old or the new treaty.[31]

27. In most cases, this would include a limited liability company which is classified as a partnership for US tax purposes.
28. It is interesting to note that Art. 6 of the Protocol to the Treaty amends Art. 35 to deny the exemption from withholding tax on REIT dividends representing gains on the disposition of US real property. No similar restriction was included with respect to contingent interest.
29. Treas. Reg. § 1.897-1(h). FIRPTA applies only in situations where there is a "disposition of a US real property interest ("USRPI")". A USRPI includes any interest in US real property "other than solely as a creditor". Thus, a contingent instrument would constitute a USRPI the disposition of which is taxable under FIRPTA; however, the mere receipt of contingent interest does not give rise to gain under IRC Sec. 1001 and hence is not taxable under FIRPTA.
30. Under IRS Notice 94-1, Netherlands taxpayers will be presumed to elect the 1948 Treaty for 1994 unless they expressly indicate a contrary intent.
31. Contrary to the presumption for Dutch taxpayers, US taxpayers will *not* be presumed to elect the 1948 Treaty in 1994. Therefore, in order to elect the 1948 Treaty, an affirmative election must be made.

© 1994 International Bureau of Fiscal Documentation

NETHERLANDS

RECENT CASE LAW

Stef van Weeghel

Tax partner in the New York office of Stibbe Simont Monahan Duhot.

I. INTRODUCTION

The Netherlands has recently witnessed an abundance of decisions by its Supreme Court concerning the application of tax treaties and other aspects of international taxation. This article examines certain Supreme Court decisions handed down between 1 January 1994 and 15 August 1994. All of cases discussed relate to the application of a tax treaty or the *Belastingregeling voor het Koninkrijk* ("BRK"),[1] on issues relating to residence, permanent establishment/business profits, dividends and non-discrimination.

II. RESIDENCE

A. Dual residence and losses[2]

The taxpayer in this case was a Dutch *besloten vennootschap* ("BV"). For the application of the Corporate Income Tax Act 1969 ("CITA") a BV – as a result of its incorporation under Netherlands law – is deemed to be a resident of the Netherlands.[3] In the tax year at issue the sole activity of the taxpayer was the conduct of a business in Ireland; the business was managed and controlled in Ireland. Pursuant to Article 2(1)(f) of the 1969 Netherlands–Ireland tax treaty, the taxpayer was a resident of Ireland for purposes of the treaty.

In the tax year at issue the taxpayer suffered a considerable loss and it requested the Dutch tax inspector to issue a determination that this loss constituted a start-up loss that could be carried forward for an indefinite period of time. Absent the application of a tax treaty, the tax inspector would certainly have issued this determination based solely on the deemed residence of the taxpayer in the Netherlands pursuant to CITA Article 2(4). However, the tax inspector denied the taxpayer the loss and determined the start-up loss in respect of the relevant tax year to be nil.

The Lower Court and the Supreme Court confirmed the tax inspector's determination. For purposes of the treaty, the taxpayer was a resident of Ireland. Pursuant to Article 5(1) of the treaty, the profits of an enterprise of Ireland (i.e. an enterprise carried on by a resident of Ireland) are taxable only in Ireland unless the enterprise carries on business in the Netherlands through a permanent establishment ("PE") situated therein. The Supreme Court decided that the term "profits" should be construed to include not only the positive result from the conduct of an enterprise but also the negative result. Since the loss suffered by the taxpayer was not attributable to a PE situated in the Netherlands, the loss could not be taken into account for Dutch corporate income tax purposes. The Supreme Court explicitly held that the deemed residence rule under CITA Article 2(4) would not change that result.

The decision in this case hardly came as a surprise. In a 1980 decision the Supreme Court had reached the same conclusion in a comparable case that concerned an individual taxpayer.[4]

The Supreme Court decision makes clear that no "double dip" can be achieved where a single BV, non-resident for treaty purposes, has no PE in the Netherlands to which the losses are attributable. For those taxpayers who wish to venture into "double dip" situations, the decision should not be too much of a disappointment. In 1988, the Supreme Court allowed the existence of a fiscal unity between two BV's where the parent company had its effective management in the Netherlands and the subsidiary had its effective management in the United Kingdom.[5]

The subsidiary in the fiscal unity was a resident of the United Kingdom for purposes of the Netherlands–UK tax treaty. The parent company was not, and as a result of the fiscal unity the subsidiary's loss was attributed to the parent company as if the parent company had a PE in the United Kingdom.

B. Dual residence and exit charge[6]

In a second case pertaining to dual residence, the taxpayer was also a BV with its residence for treaty purposes in the other country. Until 6 March 1986 the taxpayer had its effective management in the Netherlands. In 1984 it sold its busi-

1. The BRK is a law of the Kingdom of the Netherlands, which constitutes a quasi treaty for the avoidance of double taxation between the Netherlands and the Netherlands Antilles.
2. Supreme Court, 17 February 1993, published in *Beslissingen Nederlandse Belastingrechtspraak* ("BNB") 1994/163, with case note by Nooteboom.
3. CITA Art. 2(4) reads as follows (translated): "If a body corporate was incorporated under Netherlands law, it will for the application of this law always be deemed resident of the Netherlands."
4. Supreme Court, 12 March 1980, BNB 1980/170, with case note by den Boer.
5. Supreme Court, 29 June 1988, BNB 1988/331, with case note by G. Slot. See F. van Brunschot and S. van Weeghel, "Fiscal Unity, profit (loss) of a permanent establishment", 29 *European Taxation* (March 1989), at 95.
6. Supreme Court, 27 April 1994, published in *Fiscaal Weekblad FED* ("FED") 1994/377, with case note by Smit.

© 1994 International Bureau of Fiscal Documentation

ness assets and deferred the gain realized in connection with the sale by creating a so-called "substitution reserve".[7] On 6 March 1986 the effective management of the BV was shifted from the Netherlands to Spain. Pursuant to Article 4(4) of the 1971 Netherlands–Spain tax treaty, this resulted in BV's being a resident of Spain for purposes of the treaty. According to Article 7(1) of the treaty the profits of an enterprise of Spain are taxable only in Spain unless the enterprise carries on business in the Netherlands through a PE situated therein. The Lower Court determined that no such PE existed in the Netherlands.

Article 16 of the 1964 Income Act Tax provides that profits from an enterprise that have not otherwise been taken into account will be included in the taxable income of the taxpayer in the calendar year in which the taxpayer ceases to derive income taxable in the Netherlands. Pursuant to CITA Article 8(1), this article is also applicable for purposes of determining taxable income of domestic corporate taxpayers. The Lower Court held that shifting the residence to Spain, application of the tie-breaker provision in the treaty and application of the business profits article in the treaty meant that the taxpayer had ceased to derive profits taxable in the Netherlands as of 6 March 1986, and therefore the court concluded that the substitution reserve had to be added to the taxpayer's taxable income; this decision was not overturned by the Supreme Court.

This case is yet another example of a situation where the deemed residence provision of CITA Article 2(4) is of no avail to a taxpayer if residence for application of a tax treaty is assigned to the other treaty country and the treaty denies the Netherlands the right to levy tax in respect of the relevant item of income.

III. PERMANENT ESTABLISHMENT/BUSINESS PROFITS

A. PE profits of an insurance company[8]

The taxpayer in this case was a Swiss insurance company with a PE in the Netherlands. Real property situated in Switzerland, the Netherlands, France, Belgium, Germany and Spain was attributable to the PE.

The Netherlands–Switzerland tax treaty dates back to 1951 and consequently does not follow the text of any of the subsequent OECD Model Conventions. Article 4(1) of the treaty assigns the state where a PE is located the right to tax income from, broadly, commercial activities. Article 4(7) of the Protocol to the treaty contains a set of rules to be used in determining the profits of PEs of insurance companies, one of which embodies a formulary approach. Ten percent of the entire profit of the insurance company with PEs in both states is deducted; this may be taxed in the state where the head office is situated. The remaining 90 percent is divided between the two states according to a premium-based formula. Each country where a PE is located may tax that part of the entire profit less the 10 percent deduction that bears the same ratio as premiums collected in that country divided by all insurance premiums collected by the insurance company.

In the computation of its profits to which the formula was to be applied, the taxpayer had eliminated net income from real property. Article 3(1) of the treaty, in connection with Article 3(2) of the Protocol, provides that real property is taxable only in the state where the real property is situated, even if the real property belongs to a PE. The Lower Court held that in determining the income attributable to the PE only income from real property situated in the Netherlands or Switzerland had to be eliminated. The result of this method would have been that part of the income from real property situated in third states would have been taxed in the Netherlands under the premium formula. This would almost certainly have led to double taxation, as the countries where the real property was situated would not relinquish their taxing rights in respect of the income from real property under applicable tax treaties with Switzerland. The treaties with the Netherlands would also be of no avail, because the personal scope thereof does not extend to PEs situated in a treaty country.

The Supreme Court, however, overturned the decision of the Lower Court and held that income from real property situated in the third countries also had to be eliminated from the base in respect of which the premium-split formula is applied, and in general that the Netherlands may not levy tax in respect of that income.

The case discussed can generally not arise under a treaty following any of the OECD Model Conventions, as Article 6 of those conventions specifically restricts the right to tax to income from immovable property situated in "the other Contracting State". However, the case bears some connection to a situation that is not covered by the OECD Model Convention, i.e. the case of a lower tier PE. The question is what protection, if any, is available against double taxation of profits attributable to a PE in a country, which PE in turn is attributable to a PE in another country, neither of the two countries being the country of residence of the taxpayer. The taxpayer in the above case had argued that the non-discrimination clause of the BRK would allow the taxpayer to rely on the Dutch unilateral decree for the avoidance of double taxation or tax treaties concluded by the Netherlands. The Supreme Court did not have to address this argument, but it would certainly have been interesting to see what its analysis would have been.

7. Art. 14 of the Individual Income Tax Act 1964 – pursuant to CITA Art. 8(1) also applicable in the determination of taxable income of domestic corporate taxpayers – provides that a taxpayer may defer gain in respect of a business asset if the taxpayer has the intention to replace or repair the business asset for a period not extending beyond the fourth calendar year as of the date of realization of the gain. The substitution reserve must be deducted from the value of the substituting asset.

8. Supreme Court, 16 March 1994, BNB 1994/166, with case note by den Boer.

© 1994 International Bureau of Fiscal Documentation

B. Taxation of a limited partner in a Dutch limited partnership[9]

For the second time in the recent past, the Supreme Court has had to decide on the taxation of a foreign limited partner in a Dutch limited partnership. The Supreme Court's decision in this case and in a case decided in 1993 followed remarkable decisions by the Lower Courts in both cases.[10]

Until recently, it was assumed that a foreign limited partner in a Dutch limited partnership would only be considered to earn business income if this limited partner would be entitled to the surplus upon liquidation of the partnership.[11] This position implied that a limited partner could not be taxed in the Netherlands in respect of the profits derived from the limited partnership under Article 7 (business profits) of the OECD Model Convention, if no such entitlement exists. Although under Dutch domestic tax law the limited partner could then still be taxed as earning a "profit share", this would not be possible under the OECD Model Treaty, since the profit share would be covered by Article 21 (other income).

In the 1993 case, the Lower Court held that the limited partner could not carry on a business in the Netherlands, since limited partners under Dutch civil law are precluded from acting on behalf of the partnership or even working in the business of the partnership. If this line of reasoning would have been adopted by the Dutch Supreme Court, the extraordinary result would have obtained that foreign limited partners in a Dutch limited partnership (and not otherwise having a PE in the Netherlands to which the partnership interest would be attributable) would never be taxable in the Netherlands under treaties following the OECD Model Convention.

The Supreme Court, however, reversed the decision of the Lower Court, concluding that two factors were important for attribution of the PE of the limited partnership to the foreign limited partners. First, the partnership interest formed part of the business assets of the partner in its country of residence (Sweden). Second, the partner was directly entitled to the profits of the limited partnership. Under these circumstances the conduct of the business by the partnership had to be attributed to the foreign partner under Article 7(1) of the Netherlands–Sweden tax treaty. The entitlement to surplus on liquidation of the partnership was not addressed by the Supreme Court.

The decision rendered in 1994 concerned a resident of Belgium who was limited partner in a Dutch limited partnership. The taxpayer, an individual, was entitled to the surplus on liquidation of the partnership and there was no doubt that under Dutch domestic tax rules the individual derived profits attributable to a PE in the Netherlands. The Lower Court, however, construed the Netherlands–Belgium tax treaty rather rigidly, concluding that partnership income of the limited partner was taxable only in Belgium. The Lower Court held that Article 7(1) of the treaty in conjunction with Article 3(1)(4) required that the enterprise in the Netherlands should actually be carried on by the resident of Belgium. Since the Belgian resident did not conduct the enterprise there was no room for taxation in the Netherlands. However, the Supreme Court also reversed the decision of the Lower Court. Unfortunately and unexpectedly, the Supreme Court decided the case against the taxpayer based on a peculiarity of the Netherlands–Belgium tax treaty. Article 4(1) provides that a Dutch limited partnership that has its effective management in the Netherlands is a resident of the Netherlands for treaty purposes.[12] Accordingly, the Supreme Court could decide that there were profits of an enterprise of the Netherlands (i.e. an enterprise carried on by a resident of the Netherlands) taxable in the Netherlands, because the enterprise did not carry on business in Belgium through a PE situated in Belgium. Thus, although the Lower Court's decision was reversed, the Supreme Court's decision does not shed any light on the appropriate interpretation of Article 7 of the OECD Model Convention and particularly whether entitlement to a surplus upon liquidation is still relevant,[13] and whether the foreign limited partner should actually carry on the enterprise.

IV. DIVIDENDS

A. Treaty formalities are relevant[14]

Generally, Dutch tax treaties reduce dividend withholding tax from the domestic 25 percent to 15 percent in the case of portfolio dividends and 5 percent in case of substantial shareholdings owned by companies. By the terms of the dividend article, however, the reduction of withholding tax is not self-executing. Article 10(2), second sentence, reads as follows: "The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations." This provision provides the basis for procedures regarding reduction at source or refund of dividend withholding tax.

BRK Article 11(3) contains a comparable provision. Pursuant to this provision and the regulations based thereon a Dutch subsidiary could only distribute dividends to its Netherlands Antilles parent company free of withholding tax (under the prior BRK) if it had obtained the consent of the competent corporate tax inspector. In the case at issue, the subsidiary distributed a dividend without such consent. The

9. Supreme Court, 23 March 1994, BNB 1994/192, with case note by van Brunschot. The case is also discussed by P. Smit "Taxation of a Belgian-resident limited partner in a Netherlands limited partnership", 34 *European Taxation* (July 1994), at 234.
10. The first case was handed down on 10 March 1993, BNB 1993/227, with case note by Hoogendoorn. The case is also discussed by S. van Weeghel in FED 1993/292.
11. See T.H.M. Daniëls, *Issues in International Partnership Taxation*, Series on International Taxation (Deventer: Kluwer, 1991), at 90.
12. Under the OECD Model Convention a person can only be a resident of a contracting state if it is "liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". The peculiarity in Art. 4(1) of the Netherlands–Belgium tax treaty is that a limited partnership (*commanditaire vennootschap*) under the law of the Netherlands which has its effective management in the Netherlands, is a resident of the Netherlands for treaty purposes, even where it is not treated as a corporate taxpayer but as a pass-through entity.
13. Van Brunschot, in his case note under BNB 1994/192, seems to suggest that this criterion is no longer relevant.
14. Supreme Court, 23 March 1994, BNB 1994/233 with case note by Hoogendoorn. The case is also discussed by van der Wal in FED 1994/402.

© 1994 International Bureau of Fiscal Documentation

tax inspector imposed a deficiency assessment against the subsidiary and the subsidiary argued that the assessment could not be upheld, because BRK Article 11(3) is "self-executing". If the subsidiary's argument had been upheld, regulations implementing the dividend article in Dutch tax treaties would have become largely meaningless. The Supreme Court, however, decided differently, i.e. the regulations are justified by the necessity of allowing the tax inspector to determine the correctness of application of the dividend article. The fisc would be denied this opportunity if the dividend article would be deemed self-executing notwithstanding the explicit authority for establishing regulations contained therein.

The Supreme Court decision highlights the importance of complying with formalities in relying on tax treaties. After this decision failure to comply may not only lead to penalties, but also to a loss of treaty protection if the deficiency assessment is imposed after the period for claiming a refund of withholding tax has expired.

An interesting question could be raised in connection with the 1992 Netherlands–US tax treaty. Article 35 (Exempt Pension Trusts) provides – under certain circumstances – for an exemption of withholding tax on dividend and interest received by exempt pension trusts. Article 34 (Regulations) in paragraph 1 provides that the competent authorities of the states may by mutual agreement settle the mode of application of, *inter alia*, Articles 10 (Dividends) and 12 (Interest), but does not refer to Article 35. Nevertheless, the Dutch competent authority has issued regulations prescribing a procedure to obtain reduction at source for persons entitled to the benefits of Article 35 of the treaty.[15] One could seriously question the authority for subjecting pension funds to certain procedural rules where Article 35 is not included in the list of articles in respect of which Article 34 opens a possibility to prescribe regulations.

B. Repurchase of shares[16]

On 25 May 1994, the Supreme Court handed down a judgment on an issue that has remained unanswered for a long time, i.e. whether income from a repurchase of shares by a company is covered by the dividend article or the capital gains article in a tax treaty. The taxpayer, a Dutch national, emigrated to Spain and within five years of his emigration sold shares constituting a substantial interest in a Dutch company to that company.

In 1984 the taxpayer sold 51 shares to the company. Pursuant to Article 49(1)(b)(5)(text 1984) in conjunction with Article 48(4) of the 1964 Individual Income Tax Act, the difference between the amount paid to the taxpayer by the company and the average contributed capital constituted income in respect of shares taxable in the Netherlands. The income to the taxpayer was covered by two articles of the 1971 treaty between Spain and the Netherlands. The income constituted a dividend within the meaning of Article 10(5), but it also constituted a gain from the alienation of shares belonging to a substantial interest within the meaning of Article 14(5). Paragraph 2 of the dividend article allows the source state to tax dividends at 15 percent. Paragraph 5 of the capital gains article, however, allows the source state to tax capital gains derived in connection with the sale of a substantial interest, if this gain is derived by a citizen of the source state who is resident in the other state, who was a resident in the source state in the five years preceding the alienation and who, during that period, owned a substantial interest in the company purchasing the shares. One could read the treaty so as to grant the source state a right to tax without a rate limitation, as the Ministry of Finance did. On systematic grounds one could also read in that article in conjunction with Article 57 of the 1964 Individual Income Tax Act a limitation to tax at a rate of 20 percent.

The issue was therefore: if two articles of a treaty independently assign rights to tax to one of the contracting states, which article takes precedence? An important indication of the answer to this question is found in the commentary to Article 13 of the OECD Model Convention:

> If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of its accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rate in Article 10: such taxation is permitted because such difference is covered by a definition of the term "dividends" contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary related thereto.[17]

The Ministry of Finance had argued that Article 14(5) should take precedence as a *lex specialis*. The Supreme Court, however, decided otherwise. The Court held that neither the language of the treaty nor the explanatory memorandum supported the Ministry of Finance's position. The Supreme Court concluded that Article 10 governed the income and not Article 14, with the result that the income was taxable at a maximum rate of 15 percent.

C. Beneficial ownership[18]

In April 1994, the Supreme Court rendered a significant decision regarding the term "beneficial ownership" in Article 10 of the 1980 Netherlands–UK tax treaty.

Subsequent to the date of dividend declaration but prior to the date on which the dividend became payable, a UK stockbroker had acquired dividend coupons in respect of shares in Royal Dutch Shell. The stockbroker cashed the dividend coupons and the dividend was paid, reduced by the 25 percent dividend withholding tax. The stockbroker applied for a refund equal to 10 percent of the dividend based on Article

15. *Regulation of 30 December 1993*, No. IFZ 93/1292, prescribing the use of form IB 92 USA.
16. Supreme Court, 25 May 1994, BNB 1994/219, with case note by P. den Boer.
17. Commentary to Art. 13 of the 1992 OECD Model Convention.
18. Supreme Court, 6 April 1994, BNB 1994/217, with case note by van Brunschot.

© 1994 International Bureau of Fiscal Documentation

10(2)(b) of the treaty. The relevant part of that article reads as follows:

> [D]ividends may be taxed in the State of which the company paying the dividends is a resident, and according to the law of that State, but where such dividends are beneficially owned by a resident of the other State the tax so charged shall not exceed:
>
> ...
>
> b. in all other cases 15 percent of the gross amount of the dividends;

The tax inspector denied the refund on the grounds that ownership of the shares is a condition for refund of dividend withholding tax. The tax inspector based his position on, *inter alia*, the language of the previous treaty with the United Kingdom, the OECD commentary and the appropriate form for filing for refund as determined by the Netherlands and the United Kingdom in mutual consultation. The taxpayer, however, argued that the language of Article 10 is clear and that neither the text nor the rationale of the provision justify the condition that the recipient of the dividend also be the owner of the shares.

The Supreme Court decided as follows:

> The taxpayer became owner of the dividend coupons as a result of purchase thereof. It can further be assumed that subsequent to the purchase the taxpayer could freely avail of those coupons and subsequent to the cashing thereof could freely avail of the distribution and in cashing the coupons the taxpayer did not act as agent. Under those circumstances the taxpayer is the beneficial owner of the dividend. The treaty does not contain the condition that the beneficial owner of the dividend must also be the owner of the shares and further it is irrelevant that the taxpayer purchased the coupons at the time the dividend had already been declared, because the question who is the beneficial owner must not be answered at the time the dividend is declared, but at the time the dividend is made payable.

This decision is important in many respects. Although modern tax treaties invariably contain the beneficial ownership requirement in the dividend, interest and royalty articles, the meaning of the term "beneficial owner" is at best unclear. Modern tax treaties usually incorporate the requirement in their dividend, interest and royalty articles. Very few treaties, however, contain a definition of the term and case law is remarkably scarce. The above decision now offers guidance on the meaning of beneficial owner. The owner of the dividend need not be owner of the underlying stock as well. However, he must be in a position to freely avail of the dividends and not act as an agent. This seems to be a rather narrow interpretation, along the lines suggested in the commentary to Article 10(2) of the OECD Model Convention:

> Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer... [19]

V. NON-DISCRIMINATION

A. Capital duty[20]

In April 1994, the Dutch Supreme Court handed down three decisions, in which it held the requirement in the *Wet Belastingen van rechtsverkeer* ("BRV") that an exemption of capital duty for certain reorganizations is only available if the contributing company is a resident of a state that is a member of the EU, violates the non-discrimination clauses in the Dutch tax treaties with the United States (1948), Sweden and Japan.

The Netherlands levies capital duty on the contribution of capital to companies resident in the Netherlands. The tax is levied on the net capital contribution or the nominal value of the issued shares should that value be higher. As of 1 March 1989, exemptions are available for "mergers" and "concern reorganizations". Until that date, a preferential tax base was available in those situations. Both the preference and the exemption are based on EC directives. The three basic forms of the exemption are as follows:

i) *Share for share exchange*
A company with a capital divided into shares acquires, against an issue of its shares, at least 75 percent of the shares in another company or it increases such an interest. Both companies, i.e. the company issuing shares and the company of which shares are contributed, must be resident of an EU Member State. The exemption is not applicable, with retroactive effect, if the issuing company divests (part of) the shares acquired during a five year period commencing with the date of the contribution.

ii) *Asset for share exchange*
A company with a capital divided in shares acquires against an issue of its shares all assets and liabilities, or the entire business or an independent part thereof from another company. Both the contributing company and the issuing company must be resident in an EU Member State.

iii) *Concern reorganization*
A company with a capital divided in shares, belonging to a concern, acquires all business assets of like nature from other companies of the same concern, against an issue of shares. The contributing companies and the issuing company must be resident in an EU Member State. A concern is an ultimate holding company, with its wholly (or at least 90 percent) owned subsidiaries.

Under the pre-1989 regime, the share for share exchange exemption was only available if the companies involved did not belong to the same concern. In order to circumvent this requirement, taxpayers maintained that the assets for shares exchange exemption could also be applied in respect of the contribution of a 100 percent-shareholding in exchange for shares, because arguably the 100 percent shareholding qualified as an "independent part of a business". The Supreme Court upheld this position in several judgements.

Under the current regime, taxpayers still take this position in order to circumvent the five-year period as described above. The Dutch Under-Minister of Finance has announced that

19. Commentary to Art. 10(2) of the 1992 OECD model income tax convention.
20. Supreme Court, 27 April 1994, BNB 1994/210, BNB 1994/207 and BNB 1994/209, all three with case note by Zwemmer.

© 1994 International Bureau of Fiscal Documentation

such a transaction will only qualify as an asset for share exchange if the contributing company is engaged in the active conduct of a trade or business, and the assets embodied by the shareholding being contributed have a certain degree of independence so that they could by their nature constitute a trade or business.[21]

The facts of the cases recently decided by the Supreme Court can be summarized as follows:

(1) A US company contributed all shares in three of its Dutch subsidiaries to a Dutch company ("DutchCo") in exchange for DutchCo-shares.
(2) (a) A Swedish company ("SwedishCo") contributed cash to a newly incorporated DutchCo;
(b) Subsequently, SwedishCo contributed all shares in its Italian subsidiary to DutchCo, in exchange for shares in DutchCo.
(3) A Japanese company contributed all shares in a Swiss (non-EU) company ("SwissCo") to DutchCo in exchange for DutchCo shares.

The Supreme Court held in favour of the taxpayers in situation 1, 2b and 3, and against the taxpayer in situation 2a.

Situation 1 (US)
Under Article XXV(4) of the 1948 US–Netherlands treaty, a Netherlands corporation, the capital of which is wholly or partly owned by one or more citizens or corporations of the United States, may not be subjected in the Netherlands to more burdensome taxes (of any kind) than is a corporation of the Netherlands, the capital of which is wholly owned by one or more citizens or corporations of the Netherlands. The government argued that the discrimination, if any, was not based on the status of shareholder (resident or non-resident) but on the place of residence of the contributing company. The Supreme Court found, however, that in case of such a contribution, the quality of shareholder and contributor are so closely connected that any discrimination based on the quality of contributor should also be considered discrimination based on the quality of shareholder. Consequently, the Court held the EU residence requirement in the BRV unenforceable because it violates (indirectly) the non-discrimination clause in the treaty.[22]

Situations 2b and 3 (Sweden and Japan)
Under Article 27(4) of the treaty with Sweden (this case concerns the 1968 treaty; the 1991 treaty contains an identical non-discrimination clause in Article 26 (4)) and Article 25 (4) of the treaty with Japan, enterprises of the Netherlands (i.e. an enterprise carried on by a resident of the Netherlands), the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of Sweden or Japan, respectively, may not be subjected in the Netherlands to any taxation or any requirement connected therewith which is more burdensome than the taxation and connected requirements to which other similar enterprises of the Netherlands are or may be subjected. The Court held that, in view of the rationale of the non-discrimination clause, the phrase "other similar enterprises of the Netherlands" should be interpreted as "other similar enterprises carried on by a Netherlands corporation, the shares of which are held by a resident of the *Netherlands*" (emphasis added); and not as the Lower Court held the shares of which are held by a resident of a state outside the Netherlands other than Sweden or Japan, respectively, and that for the purpose of applying the non-discrimination clause, a tax that is not imposed on the enterprise as such, but on the corporation carrying on that enterprise, should be treated as a tax imposed on the enterprise. The Court held the EU residence requirement violated the non-discrimination clause in the treaties with Sweden and Japan.

Situation 2a (Sweden)
The Court held that even if the cash was contributed by a corporation that was a resident of the Netherlands, an exemption would not be available since such a contribution does not qualify as the contribution of an "entire business or an independent part thereof" (asset for share exchange) or a "line of business" as mentioned in Article 7 (1)(b) of the EU directive. Under these circumstances, no discrimination could take place.

All situations involve an asset for share exchange. An important question is what the Supreme Court will decide when a non-EU taxpayer seeks application of the share for share exchange exemption. A distinction should be made between the situation when the company whose shares are contributed is an EU resident or a non-EU resident.

In the former case, the outcome will be the same. If a Dutch resident corporation contributes the shares in an EU company, the exemption will apply. Thus, denying the exemption where shares in a non-EU resident are contributed would run afoul of the non-discrimination clause.

In the latter case, under the BRV and the EC directive, the share for share exchange exemption is only available if the company whose shares are being contributed is an EU resident. Therefore, under these facts, even if the contributing company is an EU resident, the exemption will not apply. Consequently, the non-discrimination clause can not set aside this requirement, and the exemption will not apply.

It is important to note that in the third situation, SwedishCo contributed all shares in SwissCo (a non-EU company) to DutchCo. Since the asset for share exchange exemption was applied, which does not contain a residence test for the "independent part of the enterprise", the place of residence of SwissCo was irrelevant.

It should be noted that the Under-Minister of Finance is willing to apply the asset for share exchange exemption if certain conditions are met. In the above-mentioned situations, the Supreme Court held that, as a general proposition, a 100 percent shareholding will qualify as an "independent part of an enterprise". The Court did not find any circumstances indicating the contrary. In view of these rulings, the second requirement mentioned above seems somewhat stringent.

21. Resolution of 6 January 1993, No. VB92/2973, *Vakstudie Nieuws* 1993/394.
22. The 1992 Netherlands–US treaty contains a non-discrimination clause that is nearly identical to the non-discrimination clause in the treaties with Sweden and Japan.

© 1994 International Bureau of Fiscal Documentation

In the second situation (under a), cash was contributed to DutchCo. According to the Supreme Court, no exemption was available. The outcome might have been different if SwedishCo had contributed all of its assets (merely consisting of cash) to DutchCo. In 1989, the Lower Court of Den Bosch held that the contribution of cash, forming all of the assets of the contributing company, qualified for preferential treatment under the pre-1989 regime (based on the direct application of the EU Directive; as of 1 March 1989, the BRV explicitly provides for an exemption if all assets are contributed). The Lower Court stressed that capital duty had been paid when the cash was contributed to the contributor. The Under-Minister of Finance has acquiesced to this decision.

In view of this Lower Court decision and the recent Supreme Court rulings, it can be argued that a cash contribution by a USCo to a DutchCo will also be tax exempt, provided USCo contributes all of its assets and liabilities. It should be noted that in this situation no capital duty will have been paid on the contribution of the cash to USCo. However, in the third situation discussed above, the Supreme Court disregarded the fact that no capital duty had been paid in the past.

B. Consolidated return[23]

On 16 March 1994 the Dutch Supreme Court rendered a decision on the issue whether a *naamloze vennootschap* ("NV") incorporated under the law of the Netherlands Antilles, but having its residence for purposes of application of the CITA in the Netherlands, could form a fiscal unity with a Dutch BV as parent company.

The Supreme Court held that the requirement that a subsidiary be a NV or BV incorporated under the law of the Netherlands in order to be part of a fiscal unity, is discriminatory under BRK Article 1(1).

The taxpayer, X NV, was an NV incorporated under the law of the Netherlands Antilles. Its characteristics are to a large extent similar to those of an NV incorporated under Book 2 of the Dutch Civil Code.[24] In the taxable year at issue, 1981, X NV had its residence in the Netherlands. All its shares were owned by a company incorporated under Dutch law, with its residence in the Netherlands. In 1981 X NV's profits amounted to NLG 2,617,656. Its parent company, on the other hand, suffered a loss amounting to more than NLG 2,617,656. If X NV and its parent company had been regarded as a fiscal unity as of 1981, neither would have had taxable profit for that year. Despite the fact that X NV and its parent company were willing to accept the standard conditions for application of the fiscal unity (as published in the Netherlands Gazette of 20 November 1986, No. 225) both companies requested group treatment as of 1 January 1981; this was rejected by the Dutch fisc on the ground that the fiscal unity regime was only available to companies incorporated under the law of the Netherlands. Subsequently, X NV was presented with a tax assessment based on its status as a separate taxpayer.

The Supreme Court confirmed the Lower Court's decision that the term NV as used in CITA Article 15 includes companies which are incorporated only under Dutch law. The Court discussed the legislative history of CITA Articles 2 and 15. Pursuant to CITA Article 2(1)(a), the category of domestic taxpayers not only includes an NV and a BV but also, *inter alia*, "other companies whose capital is wholly or partly divided in shares". The legislative history indicates that this term purports to cover foreign entities that are the economic equivalent of, *inter alia*, the NV and that the legislature did not intend to include foreign entities in the term NV.

The Court further addressed the issue whether the rule embodied in BRK Article 1(1), i.e. in this case that a body corporate incorporated under the law of the Netherlands Antilles not be subjected to any taxation which is more burdensome than the taxation to which an entity incorporated under the law of the Netherlands is subjected, implied that X NV could be a subsidiary as defined in CITA Article 15.

The Court first compared X NV with two entities that – even if incorporated under Dutch law – cannot be subsidiaries as defined in Article 15 CITA, the "partnership with a capital divided in shares" and the "open limited partnership", and concluded that a Netherlands Antilles NV is substantially different from those entities. The Court then proceeded to observe that the nature and structure of the Netherlands Antilles NV make this entity sufficiently akin to an NV incorporated under the law of the Netherlands so as to render unequal treatment thereof (provided it is subject to corporate income tax as a resident taxpayer) in violation of BRK Article 1(1), unless the fact of incorporation under a non-domestic law would lead to such consequences that it could not be said that the company is comparable to a company incorporated under the law of the Netherlands.

The Court considered a number of possible reasons – derived both from the legislative history and documents submitted by the tax inspector – for restriction of the application of CITA Article 15, including the following:

- the consequences of a fiscal unity between entities with differing tax regimes are difficult to assess;
- in case of a fiscal unity with a subsidiary incorporated under foreign law, the relocation of the effective management to a foreign country would lead to termination of the fiscal unity;
- with such relocation, the dividend withholding tax claim on retained earnings may be lost for the Dutch fisc; and
- with a view to foreign losses the consequences are difficult to assess.

The Court addressed each of the above factors and the thrust of its analysis is that in each instance, the undesired tax consequences (from the fisc's perspective) are not unique to the incorporation of the subsidiary under foreign law, but could

23. Supreme Court, 16 March 1994, BNB 1994/191, with case note by Hoogendoorn. The case is also discussed by S. van Weeghel, "Fiscal Unity and Non-discrimination", 34 *European Taxation* (August 1994), at 278 et seq.

24. With certain exceptions, the Netherlands Antilles corporate law system is virtually identical to the Dutch system prior to implementation of the EC Directives on company law.

© 1994 International Bureau of Fiscal Documentation

also occur when companies incorporated under Dutch law would be concerned. This analysis led to the conclusion that X NV's incorporation under Netherlands Antilles law was an insufficient justification for denying it to be part of a fiscal unity with the parent company. The Lower Court's decision was reversed and the case referred to a different court to decide the matter after the Ministry of Finance determined the conditions under which a fiscal unity between X NV and its parent company could be created.

This case is important from the non-discrimination perspective. In a narrow sense, the decision is significant in the context of application of CITA Article 15, and in a broader context, the decision is one of a number of recent decisions that give serious meaning to non-discrimination clauses, clauses that until recently could at best be seen as well intended but unguided missiles.

The question whether a fiscal unity could exist between resident taxpayers where one or both are incorporated under foreign law has lingered for quite some time and several commentators have observed that the condition relating to the specific legal form in CITA Article 15 is discriminatory.[25] Their observations have now been vindicated by the Supreme Court, at least as far as subsidiaries are concerned. As a matter of principle it is now possible to have a fiscal unity with a foreign company. The wording of BRK Article 1(1) is very similar to that of Article 24(1) of the OECD Model Conventions and tax treaties containing that wording will have the same overriding effect. Some commentators have observed that no treaty protection is needed, because the scope of BRK Article 1 is not limited to nationals of the Netherlands, but has general application.[26]

It follows from the decision that it is vital to determine whether the foreign entity at issue is sufficiently akin to a Dutch NV or BV. A Netherlands Antilles NV is a virtual clone of its Dutch counterpart. Presumably, joint stock companies of other EU Member States subject to the same corporate law directives are also sufficiently akin. A case by case comparison may be warranted where corporations of different states of the United States are concerned, and limited liability companies now emerging in different states may have structures too different from the NV and BV to qualify for equal treatment, although much will depend on the applicable Limited Liability Company Act.

On the issue whether a foreign company can, in principle, be a parent company in a fiscal unity, no answer has yet been given, but it is unlikely to be different from the answer in this case.

On 10 August 1994 the Under-Minister of Finance issued a statement regarding the above case,[27] which contains the Ministry's policy with respect to the application of CITA Article 15 to foreign companies with residence in the Netherlands. The criteria for application of Article 15 in respect of a foreign company can be summarized as follows:

- the company must have a capital divided in units which can be alienated without the consent of the other participants;
- the company is subject to tax in the country of incorporation;
- the profit derived by the company does not directly accrue to the participants, but can only be theirs following a formal distribution;
- the company has legal personality and the participants limited liability; and
- all participants must in principle have voting rights in accordance with the nominal value of their shares.

Notably, the statement does not require application of a treaty containing a non-discrimination clause, nor does it restrict the application of Article 15 to foreign subsidiaries.

25. See in particular C. van Raad, "Internationale aspecten van de toepassing van Art. 15 Wet Vpb. 1969", *Weekblad voor Fiscaal Recht*, 1989/5860, at 319.
26. See, *inter alia*, Hoogendoorn in his case note following the decision as reported in BNB 1994/191.
27. Statement re DB94/1842M, not yet published.

© 1994 International Bureau of Fiscal Documentation

NETHERLANDS

TOWARDS A GRADUAL ABOLITION OF DUTCH CAPITAL TAX?

Arnold J. van der Smeede

Tax lawyer at Loeff Claeys Verbeke, Amsterdam, specializing in international taxation. The author would like to thank Wencke van Son, tax law student at the University of Leiden, for her assistance in preparing this article.

I. INTRODUCTION

Traditionally, the Netherlands has played an important role in attracting international business. The reasons for international business to establish a presence in the Netherlands include:

- the participation exemption;
- the favourable tax treaty network;
- the absence of withholding tax on interest and royalties;
- the possibility to negotiate advance tax rulings;
- the lack of formal debt-to-equity rules;
- the absence of exchange control restrictions; and
- the well developed, business-oriented fiscal and financial environment.

During the past few years, the Netherlands has had to contend with increasing competition from other countries within the EU, such as Belgium, Luxembourg and Ireland. These countries now offer comparable or even better tax regimes to attract international business. This development has spawned extensive discussions between entrepreneurs, tax practitioners and the Ministry of Finance regarding measures to keep pace with international competition.

One point which always arises in discussions on improving the Dutch investment climate is the Dutch capital tax. Capital tax is a one-off 1 percent tax levied on equity contributions to any Dutch entity whose capital is divided into shares. Despite the low rate of tax, the large amount of equity contributions on a potential investment in the Netherlands often means that substantial capital tax will be payable. Although the capital tax may discourage potential investors, the high revenue derived has militated against abolition of the capital tax.[1]

This article examines recent case law regarding capital tax, the effect of which is to lessen the negative impact of this tax on the investment climate in the Netherlands.

II. DEDUCTIBILITY OF CAPITAL TAX

As a general rule the Dutch Corporate Income Tax Act ("CITA") allows the costs of incorporating a company, including expenses incurred in connection with modifications to the capital of such company, to be deducted.[2] Therefore capital tax paid on equity contributions to a company with its capital divided into shares is generally deductible for Dutch CITA purposes.

Under the participation exemption a Dutch company is exempt from corporation tax on dividends received from, and capital gains realized on the sale of, qualifying shareholdings.[3] Where a Dutch company holds shares in a qualifying non-Dutch company, the costs relating to such an investment are not tax deductible.[4] Typically, such costs consist of interest paid on a loan to acquire a foreign participation.

In 1977, the Dutch Supreme Court ruled that capital tax paid by a Dutch company on a capital contribution in order to enable this company to acquire shares in a foreign company was a cost relating to the foreign participation.[5] According to the Supreme Court the funding of the acquisition of a foreign participation by equity had to be treated equally with the funding by debt. The Supreme Court held that this capital tax was therefore not tax deductible. Since the Netherlands is often used as a location for holding foreign subsidiaries, it is not surprising that the non-deductibility of capital tax in these situations resulted in a high burden for an operating Dutch holding company.

Fortunately, the Supreme Court has now reversed its earlier judgement. On 2 March 1994 the Supreme Court held that capital tax is a cost which is very closely linked to the legal form of an entity.[6] According to the Supreme Court, capital tax is a cost which arises because of the existence of the entity: it depends on the capital of the company rather than the destination of the capital. The Supreme Court ruled that the capital tax paid on a capital increase to fund an equity injection in a foreign participation is tax deductible.

On the basis of this case, capital tax is now deductible for CITA purposes without any limitation. For a Dutch holding company with shares in a foreign company, this means a reduction of the capital tax burden by 35 percent. Of course this saving can only become effective if the company has income from other taxable sources.

1. In 1993 capital tax provided the Dutch government with more than NLG 500 million in revenue.
2. CITA Art. 9(1)(e).
3. CITA Art. 13-13h.
4. Unless they indirectly contribute to deriving profits taxable in the Netherlands.
5. Hoge Raad 8 June 1977, No. 18 398, *Beslissingen in Belastingzaken* (hereinafter "*BNB*") 1977/176.
6. Hoge Raad 2 March 1994, No. 29 061, *BNB* 1994/164.

© 1994 International Bureau of Fiscal Documentation

III. CAPITAL TAX AND NON-DISCRIMINATION

In addition to the deductibility of capital tax, the Dutch Supreme Court has also ruled on the relationship between exemptions of capital tax and the non-discrimination clauses in (most) tax treaties concluded by the Netherlands. The capital tax exemptions are first discussed in general terms, followed by a discussion of the non-discrimination issue.

A. Exemptions

Under EC Directives,[7] as from 1 March 1989 Dutch legislation exempts certain transactions from capital tax. The most important exemptions are the share merger exemption[8] and the asset merger exemption.[9] These exemptions have reduced the negative effects of capital tax in the restructuring of multinational companies with holding activities in the Netherlands.

The share merger exemption is applicable if the following conditions are met:

- the acquiring company acquires at least 75 percent of the shares in another company, or increases its 75 percent interest;
- the acquiring company issues new shares in exchange for the shares it acquires;[10]
- the company whose shares are transferred is resident in the EU; and
- the acquiring company may not reduce its shareholding below 75 percent or dispose of the acquired shares (or shares already held) within five years of the date of the contribution, except where the shares are again transferred under a qualifying merger or internal reorganization, or where the acquiring company is liquidated.

The asset merger exemption is applicable if the following conditions are met:

- the acquiring company acquires from the contributing company all of its business assets, or an independent part thereof, or all of its assets and liabilities;
- the acquiring company issues new shares in exchange;[11] and
- the contributing company is resident in the EU.

According to the Ministry of Finance,[12] a 100 percent shareholding may be considered an independent part of an enterprise, so that the asset merger may be applicable if the company contributing the shares is engaged in the active conduct of a business,[13] and the activities of the 100 percent shareholding are such that it could by its nature constitute a business.[14]

Where 100 percent shareholdings are involved in a share-for-share transfer, the asset merger exemption is generally claimed, because the five year prohibition on the transfer of shares does not apply. It also provides an opportunity to "play around" with the requirement that one of the companies should be resident in the EU; when the company transferring EU shares is resident outside the EU, the share merger exemption is claimed, but when 100 percent non-EU shares are transferred by an EU company, the asset merger exemption is claimed.

Under Dutch legislation, it can be concluded that no exemption is available where a non-EU resident company contributes shares in another non-EU resident company to a Dutch company. Since neither the company whose shares are transferred nor the company contributing the shares are resident in the EU, neither the share merger nor the asset merger is applicable. One may wonder, however, whether this legislation infringes the non-discrimination clause found in (most) tax treaties concluded by the Netherlands.

B. Non-discrimination

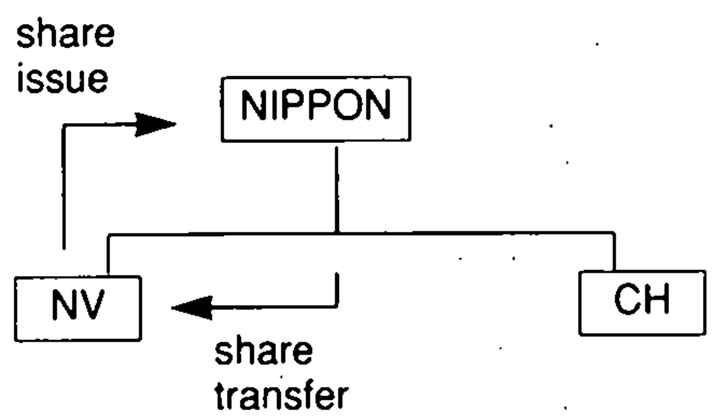
The non-discrimination clause, as far as relevant for this purpose, reads as follows:[15]

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
>
> The provisions of this Article shall,...., apply to taxes of every kind and description.

It follows from the last sentence that, in principle, capital tax is covered by the non-discrimination clause. The relationship between the non-discrimination clause and the capital tax requirement (for an exempt merger) that one of the companies be resident in the EU has been the subject of four Supreme Court cases, three of which related to the situation before 1 March 1989.[16] In order not to complicate matters, I will focus on the case which relates to the new law as summarized above. This case can be summarized as follows:[17]

7. Directive 69/335/EEC and 85/303/EEC. The latter Directive required the EC Member States to exempt certain transactions, which were formerly subject to a reduced rate or which had a reduced taxable base. According to this Directive the exemptions should have been introduced as from 1 January 1986.
8. Wet Belastingen van Rechtsverkeer ("WBR") Art. 37(1) and (2).
9. *Id.*
10. However, it may pay cash (or remain indebted) up to 10% of the par value of the issued shares.
11. *Id.*
12. Resolution of 6 January 1993, No. VB92/2973, *Vakstudie Nieuws* 1993, at 396, under 30.
13. This requirement has been criticized since it is contrary to earlier case law; see Hoge Raad 17 January 1990, No. 26 221, *BNB* 1990/92.
14. This condition is the result of the "MUWI-case" (EC Court, 13 December 1991, CB-164-90). This condition will also be fulfilled if the company which is contributed at that point in time only consists of cash, but acquires a business shortly thereafter (Hoge Raad 23 May 1990, No. 26 439, *BNB* 1990/204).
15. 1992 OECD Model Convention Art. 24(5) and (6). The text does not materially differ from the 1963 and 1977 Model Conventions.
16. Hoge Raad 27 April 1994, Nos. 28 238, 28 239, 28 603 and 28 674.
17. Hoge Raad 27 April 1994, No. 28 603.

© 1994 International Bureau of Fiscal Documentation



Japanese resident company NIPPON contributed all of the shares of Swiss resident company CH to Dutch company NV. NV issued shares to NIPPON in an amount of NLG 91 million. NV claimed the asset merger exemption on the contribution in kind, and argued that under the non-discrimination clause in the Japan–Netherlands tax treaty the requirement that the contributing company should be resident in the EU was not applicable.[18] The capital tax inspector disagreed, holding that no discrimination was present since a contributing company resident outside Japan and the EU would not be eligible for an exemption either. The Court of Amsterdam upheld the inspector's decision.

The Dutch Supreme Court, however, agreeed with NV. The Supreme Court held that in order to determine whether discrimination is present, "other similar enterprises of the Netherlands"[19] should be interpreted as if the NV was held by a Dutch company, rather than by NIPPON. Further, the Supreme Court found the capital tax to be a tax on the "enterprise". Since the asset merger exemption would have been available if the shares in CH were contributed to NV by a Dutch company, the Supreme Court concluded that in such a case the Japanese company is discriminated against, which is prohibited by the non-discrimination clause. According to the Supreme Court, such an extension of the applicability of the asset merger exemption does not conflict with the EU Directive on capital tax.[20]

This non-discrimination case provides for a welcome extension to the exemptions which are available for capital tax. It should be noted, however, that the non-discrimination argument can only be applied where 100 percent shareholdings are transferred, since the asset merger exemption is only applicable in that case. Situations falling under the share merger exemption cannot, in my view, benefit from this new case law, since in claiming the share merger exemption, it is irrelevant where the contributing company is resident. In claiming this exemption, the company whose shares are transferred should be resident in the EU. For instance, when a Dutch company acquires, say, 75 percent of the shares in a non-EU company from another Dutch company in return for shares, it would not be eligible for the share merger exemption. Therefore, no discrimination takes place if a Dutch company which acquires non-EU shares from a non-Dutch shareholder in return for shares is refused the same share merger exemption.

IV. CONCLUSION

The above case law ameliorates the negative effect of the capital tax on the Dutch investment climate, and it can be concluded that the Supreme Court is willing to improve the Dutch fiscal investment climate. The most important step towards such an improvement, however, cannot be taken by the Supreme Court. The abolition of Dutch capital tax is a step which should be initiated by the Dutch Ministry of Finance. In this respect it is important to note that a committee consisting of representatives of the Ministry of Finance and Dutch industry has advised in its first interim report abolition or reduction of the capital tax.[21]

18. Art. 25.4 of the Netherlands–Japan tax treaty does not materially differ from Art. 24.5 of the 1992 OECD Model Convention.
19. See text of non-discrimination clause.
20. Under Art. 7.2 of EC Directive 69/335/EEC as amended by EC Directive 85/303/EEC, it is possible to exempt, apart from the obligatory exemptions, all other transactions.
21. Ministry of Finance, 23 June 1994, No. *AFP* 94/210.

© 1994 International Bureau of Fiscal Documentation

CENTRAL AND EASTERN EUROPE

MEETING TAX OBLIGATIONS IN CENTRAL AND EASTERN EUROPE[1]

Sarah Bolderson and Theodoor Huiskes

Sarah Bolderson is the head of the Central and East European section of the IBFD; **Theodoor Huiskes** is a research trainee at this section.

I. INTRODUCTION

While increasingly more information has become available regarding the tax systems of the various Central and East European ("CEE") countries, there has been little analysis of the relative strengths and weaknesses of each tax system. Whilst it is easy to determine the corporate tax rate in a given central European country, it is more difficult to ascertain the precise rules for determining, agreeing and paying tax liabilities.[2] This article attempts to analyse and to compare the relative merits of the tax compliance mechanisms in eight CEE countries: Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Slovenia.

The methodology of the study comprised the preparation of a detailed questionnaire concentrating on the areas of assessment, return and payment, appeal procedures, clarification of the law and the enforcement powers of the tax authorities. The questionnaires were then completed by tax practitioners in Deloitte Touche Tohmatsu International offices in each country and the results compiled and analysed. Further to this analysis, the tax compliance systems of the eight countries studied were compared on a qualitative basis with reference to certain benchmark standards relating to taxpayers' rights including the right to privacy and confidentiality, the right of access to information, the right to appeal and the right to certainty.

The conclusions of the article focus on compliance and related factors, the interrelationship between taxpayers and tax administrations, and on the need to simplify the tax and compliance systems.

II. ANALYSIS OF RESULTS

Paying tax is not a new phenomenon in central and eastern Europe. These countries had finance and tax inspectorates in place to collect contributions from state-owned enterprises, private entrepreneurs and individuals. However, the practice of levying and collecting tax has changed greatly with the introduction of market reforms. One of the most significant changes has been the huge increase in the number of taxpayers as whole new categories of persons become subject to taxation and are required to keep records, submit returns and pay tax. As many CEE countries have introduced self-assessment, the extent to which taxpayers are informed and educated about fiscal discipline and tax rules has become an important element in the success or failure of tax compliance systems.

Another important aspect is the "taxation culture" in the region. Previously, "tax" had been collected on an arbitrary, negotiable or normative basis. In some CEE countries non-payment of tax was perceived as a statement of independence against oppressive authoritarian powers. Such attitudes change slowly and in many ways change is not fostered by the current economic instability, the growth of the black market and the introduction of relatively high marginal rates of tax. In this context it is perhaps not surprising that the new tax systems rely heavily on "self-enforcing" taxes such as VAT and withholding taxes accompanied by frequent payments, audits and penalties. Although the scope of the survey was wide and significant differences were encountered in each country some general observations may be made:

* There is a widespread use of voluntary compliance methods, (e.g. self-assessment, withholding taxes) placing the compliance burden firmly on taxpayers.

* Formal administrative and judicial appeal procedures for taxpayers have been introduced in all CEE countries with the exception of judicial appeal procedures in Romania.

* Binding advance clearances are available on a limited basis and all the countries surveyed have a form of informal ruling or consultative facility by which taxpayers can obtain interpretation of the law. Interpretative guidelines are also issued by the tax administration or the Ministry of Finance in most of the countries surveyed.

1. This article is an abridgement of a report released in July 1994. The report was the result of a joint project between IBFD and Deloitte Touche Tohmatsu International. An economic overview was provided by the Budapest University of Economic Sciences which has not been summarized in this article. Copies of the report may be obtained from Alexander Dek, IBFD or Paul Glover at Deloitte Touche Tohmatsu International, Hill House, 1 Little New Street, London, EC4A 3TR.

2. However, see IBFD publications *Guide V: Taxation and Investment in Central and Eastern Europe* and *Central and East European Tax Directory* for a comprehensive description of the tax and investment laws in force in all the countries in the region.

© 1994 International Bureau of Fiscal Documentation

* In general court decisions on tax matters do not set legally binding precedents.
* Wide powers of enforcement have been given to the tax administration, e.g. the tax administration can seize a taxpayer's property in order to collect taxes.
* Audits by the tax administration are widely used. The tax administration can also carry out audits of, or request information from third parties in respect of a taxpayer's affairs.
* Highly punitive penalty systems have been introduced with little or no differentiation made between serious offences and cases of minor delay or innocent mistake.
* In most of the countries surveyed penalties are not negotiable but may be mitigated at the discretion of the tax administration.
* The general trend among the countries surveyed is towards the simplification and streamlining of tax legislation and regulations.

A. Clarification of the law

Each country has introduced tax laws which define the taxable person and the scope of the law and contain rules for calculating the taxable base. However, these provisions can be cursory, unclear or ambiguous with key terms left undefined.[3] Lack of clarity in the laws may also be the result of the use of concepts unfamiliar to foreign investors or arise from a clash between domestic and international practices.[4] For these reasons the possibilities for obtaining clarification of the law and thereby a measure of security or certainty is one of the most important and interesting features of the administrative practices.

1. Rulings and advance clearances

Although American or Dutch investors, for example, may not fully recognize the fledgling rulings system in force in the region, a type of ruling is generally available. In fact, in all the countries surveyed, with the exception of the Czech and Slovak Republics, there is an obligation on the part of the tax administration (and other government bodies) to assist taxpayers in the interpretation and application of the law. This obligatory assistance can involve clarification of the specific provisions relating to particular transactions or on hypothetical situations (except in Romania where rulings are only available in respect of a particular case). Rulings are never binding on the tax administration or the taxpayer although they are generally followed in practice – at least until the law changes or a different interpretation is given, perhaps during an audit.

How far the obligation to give advice is met, and how valuable this advice is in practice, varies from country to country. For example, although the Czech tax administration is not obliged to give any sort of rulings, prompt "consultations" are widely available and the authorities are helpful and approachable albeit rather aggressive in some of their interpretations of the tax law. On the other hand there is no effective ruling or consultative practice in Russia despite the fact that tax officials are obliged to give rulings.

Advance clearances, in the sense of gaining certainty of tax treatment prior to making an investment, are generally only available in a limited number of situations and in only some countries. For foreign investors advance clearances are of particular relevance in the area of tax incentives. Currently, advance clearances are available in Hungary and the Slovak Republic regarding the potential investor's eligibility for certain incentives. In both countries the clearances are binding on both the tax administration and the taxpayer.

2. Guidelines

The Ministry of Finance and/or the tax administration of all the countries surveyed (with the exceptions of Poland and Russia) issue guidelines. By guidelines is meant official, published interpretations of aspects of tax legislation, either binding or non-binding. They are often used to express the administration's official interpretation of tax laws in response to widespread inquiries or loopholes in the tax legislation and assist in giving a degree of certainty to taxpayers, particularly useful as they seek to unravel some of the more contentious or difficult provisions. In Hungary, for example, a binding guideline was published at the beginning of 1994 to clarify the tax rules governing benefits in kind as new provisions had radically changed their prior treatment. In Romania and Russia, gaps in the legislation are partially filled by instructions on the application of the law which addresses the detailed implementation of laws and decrees. These instructions tend to be broadly worded with little interpretative content.

3. Court decisions

In general the legal systems in central and eastern Europe are not based on precedent and therefore in all the countries surveyed, except for Bulgaria, court decisions on tax matters do not set legally binding precedents. Whilst this is strictly the case in Poland, in practice tax decisions may be followed in subsequent cases. In any event, as most of the tax laws are generally less than four years old, court decisions are generally not yet available as legal references.

B. Assessment, return and payment

In comparison to the assessment methods used in a centrally planned economy, the compliance burden has now been

3. There are many examples in the region, one explored in detail in an article is the ambiguities of the taxing of leasing in Hungary; see Banjai P., "Taxation of leasing", 34 *European Taxation* (June 1994), at 181.
4. Again, there are many examples to illustrate this; staying with leasing see Roach D., "The tax treatment of equipment leasing", 34 *European Taxation* (August 1994), at 259 for details in the Czech Republic.

© 1994 International Bureau of Fiscal Documentation

placed firmly on the taxpayer; he must generally apply the rules laid down in the tax laws to determine his tax liability, make frequent payments and submit regular returns and act as tax collector himself in respect of numerous payments. Additionally, in certain circumstances, returns must be accompanied by information declarations, a profit and loss statement and balance sheets, statistical information, details of hard currency transactions and any other information the tax authorities request. Contrast the current situation with that under the former system where the tax administration determined the tax due based on a set plan of how much tax had to be paid by the taxpayer. Often the taxable base was not defined by a tax law upon which taxpayers could rely but was assessed arbitrarily or was established through a process of negotiation. In some CEE countries, the assessment system was simply a procedure whereby the state banks directly withheld from the accounts of state enterprises the portion which was considered to be government revenue.

Self-assessment for corporate entities has been widely introduced with the only exceptions being Russia and Slovenia. In CEE countries which use self-assessment the taxpayer must submit his return together with the tax due. Tax payments are generally required on the date the return is submitted or in some cases within a specified time period thereafter. The payment made with the return or on receipt of an assessment is in the nature of a final balancing payment for the fiscal year as corporate entities are required to make frequent advance payments.

In general the advance payments are a monthly obligation based on the taxable profits of the previous year (in Romania, the year to date) although they can be as often as twice monthly, for example, in Hungary.[5] Generally no flexibility is allowed in the amount or frequency of payment, for example, for seasonally fluctuating profits or losses. While ensuring regular injections of cash into the state coffers – an obvious priority in an inflationary environment – this unyielding system can cause serious cash-flow and compliance problems for businesses.

1. Withholding taxes

The widespread use of withholding taxes is a feature of most of the tax systems introduced in the CEE region over the past four years. Tax is withheld at source from a large number of income-type payments made to both residents and non-residents, including salaries and wages, dividends, royalties, rental payments, payments to contractors, interest, management fees, professional fees and payments to sportsmen, artists and entertainers. In many cases the tax withheld represents the final tax liability without any scope for deductions in respect of expenditure incurred by the recipient in earning that income.

The payment of income under deduction of tax at source has proved to be a highly effective method of tax collection within the region. The burden of verification, control and monitoring the tax base on both the tax authorities and individual taxpayers has been reduced and tax is collected either at the time of payment or within a short specified period thereafter. The tax payment must in most cases be accompanied by a return specifying the sources of income from which tax has been withheld and details of the recipients.

2. International aspects

Of particular interest to foreign investors is the procedure in place in the source country where there is a treaty for the avoidance of double taxation which either reduces or eliminates the domestic withholding tax on a payment made abroad (e.g. dividends). A common complaint heard throughout the region is the general lack of international tax expertise of the tax authorities, especially if they are situated outside the capital cities, and particularly in the application of tax treaties. However, perhaps surprisingly, the summary below shows a rather relaxed attitude towards international profit transfers with only Hungary requiring a certificate of residence from the recipient.[6]

	Withholding tax rate applied to payments to non-residents if double tax treaty is in force
Bulgaria	currently, no experience in this area; however, it is expected that treaty rate will be used
Czech Republic	treaty rate used with no prior approval required from tax administration
Hungary	treaty rate used if payer holds residence certificate from recipient; no prior approval required from tax administration
Poland	law is unclear on this point; current practice is to apply treaty rate
Romania	treaty rate used with no prior approval required from tax administration
Russia	treaty rate used with no prior approval required, however, document must be sent to tax authorities stating that tax withheld at lower rate
Slovak Republic	treaty rate used with no prior approval required from tax administration
Slovenia	generally treaty rate is used; if reclaim necessary may take up to one year to receive refund

C. Appeal procedure

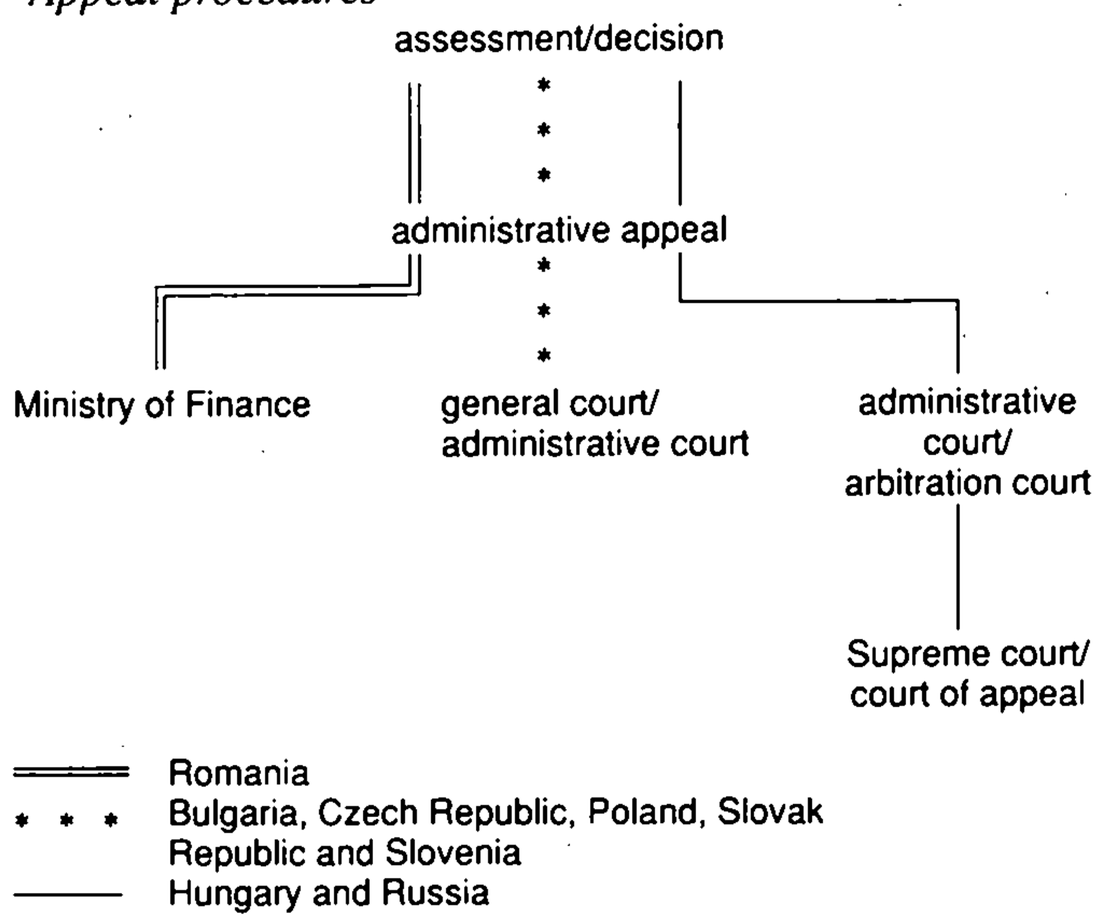
In a centrally planned economy, where taxes were arbitrarily levied, taxpayer appeals were generally not available. One of the features of the administrative reforms throughout the CEE region has been the introduction of formal administrative and judicial appeal procedures. Virtually all assessments

5. If tax liability in the previous year exceeded 3 million forints; see Art. 18(5) read in conjunction with Art. 18(6) and (7) of Act LXXXVI "on Corporate Tax" of 1991 and as subsequently amended.
6. The summary illustrates the practice used at the time the questionnaires were completed and some conflicts in this area may be found between the law and the practice.

© 1994 International Bureau of Fiscal Documentation

and decisions of the tax authorities may be subject to an appeal by the taxpayer and there may be more than one level of appeal. The diagram below graphically shows the appeal procedure in each country:

•*Appeal procedures*



In Romania, appeals concerning profits tax, penalties on late payment or any other amount due to the state budget as required by law may be made to the county tax administration office or the Bucharest tax administration office (whichever is appropriate). If agreement cannot be reached, the taxpayer can lodge an appeal with the Ministry of Finance. The decision of the Ministry of Finance is final. This procedure would seem to create a serious anomaly in the Romanian tax system as the right of independent appeal is generally accepted as an integral element of an equitable tax system.

In Russia, appeals on administrative decisions may be made to arbitration courts and civil courts. A Russian company with no foreign participation can appeal a decision to either court; most prefer the arbitration court as the judges tend to have more experience with tax issues. A Russian company with one or more foreign shareholders can only make an appeal to the civil court. Although in theory a decision of the arbitration or civil courts may be appealed to the Russian Supreme Court, in practice the Supreme Court never agrees to hear tax cases. Thus, in effect the arbitration and civil courts are the courts of last resort for tax disputes.

Generally, appeals to the courts may only be made once the administrative appeal procedure has been exhausted and then only on points of law. However, in Bulgaria and Russia taxpayers have the right to appeal directly to the courts and these appeals are possible on all decisions and not only on points of law.

Making an appeal in each of the countries surveyed does not normally suspend the payment of tax on the due date.[7] In an inflationary environment the value of any tax refund following a successful appeal, which may have taken several years, will have dwindled significantly if interest rates fail to compensate fully for inflation.

D. Enforcement of tax liabilities

In order to maximize the tax revenue take in tax systems which depend on a high degree of voluntary compliance and need to respond to the changing taxpayer base (i.e. a growing small private business sector), wide powers of enforcement have generally been given to the tax authorities. Although reliable data is generally not yet available, anecdotal evidence suggests that tax avoidance and evasion is a major problem throughout the region.[8] An official review carried out by the Slovak Ministry of Finance in 1993,[9] for example, revealed tax avoidance of more than Sk 4.4 billion (approximately $ 133 million) based on an examination of approximately 166,000 returns. These figures are apparently twice that of 1992 and are considered to be the tip of the iceberg with a high level of tax evasion resulting from non-registration for tax.

Tax evasion is considered to be such a problem in Russia that a "tax police" unit has been established to uncover tax fraud and locate unregistered taxpayers. The Russian tax police are not part of the tax administration and report directly to the Ministry of Finance. Despite criticism of the methods employed by the tax police to recover non-registration, large-scale tax evasion and fraud, they are expected to expand in size and indeed are highly effective. According to tax police sources "for every rouble invested in it [the tax police unit], it returned 100 roubles to the Government in 1993".[10]

1. Tax collection

The tax administrations in each of the countries surveyed have been granted more or less the same powers to enforce tax payment. In extreme cases tax collectors can seize property; in other cases they have flexibility to negotiate settlements, allow payment in instalments and waive payment. Other measures granted in order to aid tax collection include the use of presumptive taxes, minimum taxes, set percentage allowances for expenses and estimated profit assessments.

Specific issues face each country in the tax payment area. For example, the level of tax education of taxpayers and the resources available to the tax administration are particularly relevant if self-assessment systems are used. In Russia, a combination of factors including the increase in the number of taxpayers, the introduction of VAT demanding regular inspections of tax declarations and insufficient computer facilities have placed a heavy burden on the tax authorities in implementing the tax reforms. This resulted in 1993 in a situation in which many individuals with average or even above

7. However, suspension while making an appeal is possible in strictly limited cases in Hungary, Poland, the Slovak Republic and in Slovenia.
8. See conclusions of Tanzi V. and Shome P., "A primer on tax evasion", 48 *Bulletin for International Fiscal Documentation* (June/July 1994), at 328. They conclude, *inter alia*, that where tax evasion reaches high levels the role of the tax administration becomes doubly important.
9. See 8 *Tax Notes International*, No. 15 (11 April 1994), at 987.
10. Quotation by Lt-Gen Sergey Almazov, director of the tax police from interview 6 May 1994 on "Russia" TV channel, Moscow.

© 1994 International Bureau of Fiscal Documentation

average incomes were simply beyond the control of the tax administration.[11]

2. Audits

Audits were widely used in centrally planned economies as part of the economic management and control of state enterprises. Following the tax and economic reforms, audits have retained their importance but have refocused their examination on the tax compliance performance[12] of businesses and individuals. The tax administrations of all the countries surveyed have extensive auditing powers whereby auditors can enter and search business premises and, in some cases, dwellings of taxpayers, usually with no requirement, or only a notional requirement, to give prior notification to taxpayers.[13] The period auditors can look back during an audit varies from three years in the Czech Republic to six years in Russia. In certain countries the period can be extended by court decision, for example to ten years in Romania, and to 20 years in the Slovak Republic.

Tax administrations may also carry out audits of third parties in order to collect information about a taxpayer. Taxpayers can appeal against the results of the audit in all the surveyed countries using the normal appeal procedures.

3. Penalties

The newly introduced tax systems within the CEE region depend on a high degree of voluntary compliance and this is encouraged by highly punitive penalty systems. Generally, little differentiation is made between serious offences and cases of minor delay or innocent mistake.

Studies of the effectiveness of penalties have shown that a key factor is the ability of the tax administration to actually impose penalties in practice.[14] The effectiveness of the penalty regime appears to vary from country to country. The Slovak experience is perhaps not typical but is illustrative of an extreme response to this problem. In the Slovak Republic, 25 percent of the tax penalties and fines collected by the tax administration are redistributed to its officials as a form of performance bonus. This method of incentive is also used in the Russian tax administration. Unsurprisingly, many taxpayers have claimed that excessive penalties have been levied on them.[15]

In most of the countries surveyed penalties are not negotiable, however, they may generally be mitigated at the discretion of the tax administration. The level of penalties before any mitigation can be high: In Bulgaria companies face a penalty of five times the tax due for late submission of tax returns[16] and the maximum penalty for failure to file an annual tax return in the Czech Republic is 2 million Kcs and persistent offenders can be prohibited from carrying on business.[17]

III. COMMENTARY

A. Taxpayers' rights

The OECD has identified a number of key rights of individual taxpayers which should be recognized and upheld if a tax system in a democratic society is to be equitable and just.[18] Indeed, many OECD countries have found the concept of taxpayers' rights so significant that they have chosen to consolidate the measures taken to protect taxpayers into a "taxpayers' charter" or "declaration". Since the tax administrations have been given wide powers to determine the tax base, to verify information provided by taxpayers and third parties and to collect the tax due, an overview of how far the rights of taxpayers are respected in practice is perhaps due. The key rights identified by the OECD include:

- the right to privacy and confidentiality;
- the right of access to information;
- the right of appeal against decisions of the administration; and
- the right to certainty.

B. Right to privacy and confidentiality

All taxpayers should have the right to expect that the tax authorities will not intrude unnecessarily upon their privacy. In practice this is usually interpreted as avoiding unreasonable searches and requests for information. Extensive information-seeking powers have been given to the tax administrations within the CEE region and to specialist divisions (i.e. tax police) extending to entering and searching business premises and, in some countries, dwellings and to request information from third parties.

In most CEE countries, banks and similar institutions have obligations with regard to the confidentiality of client affairs. However, the tax administration normally has the power to override that confidentiality and to obtain specific information from the bank for tax purposes. Indeed failure by banks and other third parties to provide information can result in their being heavily fined.

With a few exceptions, practitioners in the countries surveyed generally agreed that the privacy and confidentiality of taxpayers was respected. Information received by the tax authorities from a taxpayer, a foreign investor or a foreign

11. See Markina E., "Results of Initial Implementation of Tax Reform", 48 *Bulletin for International Fiscal Documentation* (June /July 1994), at 338.
12. See Hasseldine J., "How do revenue audits affect taxpayer compliance?", 47 *Bulletin for Internal Fiscal Documentation* (July/August 1993), at 424 for an overview of the impact of audits on compliance behaviour.
13. See e.g. for Bulgaria Art. 12 of the Tax Administration Act of 24 June 1993, published in the Official Gazette No. 59 of 9 July 1993.
14. See *supra* note 8.
15. For further criticism on the administration of the Russian tax system, see 8 *Tax Notes International*, No. 31 (1 August 1994), at 331-332.
16. Art. 2, Additional Regulations to Decree 56 On Economic Relations.
17. Arts. 37 (1) and 38 of Act 337 "On Administration of Taxes and Fees" of 5 May 1992 and as subsequently amended.
18. *Taxpayers rights and obligations* (Paris: OECD 1990).

© 1994 International Bureau of Fiscal Documentation

government should, in principle, be kept secret in all the countries surveyed.[19] Where there is a breach of confidentiality the taxpayer has, in Hungary, the Slovak Republic and Slovenia, the right to sue the tax authorities in court. The burden of proof in these cases is placed upon the taxpayer to show that the action of the tax authorities caused him material damages. The tax authorities can also be expected to penalize tax officials who breach confidentiality rules.

C. Right of access to information

Taxpayers should have access to up-to-date information on the operation of the tax system and the way in which their tax is assessed. They should also be informed of their rights, particularly their right to appeal.

The primary means of providing information to taxpayers in most of the countries surveyed is the mass media (newspapers and television) and explanation booklets. The information provided is generally patchy with effective coverage of new laws and amendments but little or no information on penalties, audits and appeal procedures. Only our Hungarian and Slovenian respondents indicated that the tax administration is effective in providing such information and even then information on all aspects of the tax system was not made available. The most common complaints appear to be that scant information is produced about tax laws and procedures and that there is little public education about taxation.

D. Right to appeal

The right to appeal is a central tenant of any equitable tax system which properly protects its taxpayers. In all the countries surveyed, with the exception of Romania, judicial appeal procedures are available to the taxpayer in order to contest the merits of tax assessments and decisions. Currently, there are no specialized tax tribunals set up to deal with tax matters and appeals taken to the courts are heard by judges with little or no experience in taxation. Practitioners' views of the appeal procedures in their country varied: the process is regarded as expensive and bureaucratic in all but Bulgaria and Hungary; however, time delays in settlement are not a significant factor in any country. In Romania, the Czech Republic and Poland the appeal procedure is not perceived as independent and outcomes can vary to some extent depending on the region in which the appeal is heard. The problems are most severe in Romania where the final decision rests with the Ministry of Finance and no recourse to the courts is allowed.

E. Right to certainty

Investors from OECD countries are accustomed to a relatively high degree of certainty as to the tax consequences of their actions, and must therefore be disappointed when doing business in the CEE region, where regulatory change can be rapid and unpredictable. However, in contrast with the previous central planning system great strides have been made to improve this area. These improvements include the following:

(1) the new tax laws define who are the taxable persons and the scope of the law and provide rules for calculating the tax base in place of the previous arbitrary/ negotiation systems;
(2) foreign investment legislation provides guarantees to foreign investors against expropriation, confiscation and nationalization. In Romania, the foreign investment law guarantees that foreign investments are to be governed by the rules in force at the time of their establishment;[20]
(3) a system of rulings, both informal and formal, is largely in place for explanation and clarification of tax provisions; and
(4) retroactive amendments of tax laws are generally not made, except where they benefit taxpayers, or are restricted to minor changes (although retroactive amendments are not technically permitted they can occasionally happen in practice however).

Taxpayer certainty can obviously be improved if legislation is carefully and clearly drafted. Often, the experience in central and eastern Europe is that drafting is imprecise with key terms left undefined. Entering into a consultation process with representatives of taxpayers and the tax profession when drafting new legislation might help governments prevent these sorts of problems.

In summary, an overview of taxpayers' rights in the CEE countries surveyed gives the conclusion that, although great improvements have been made, there is still much to do. Areas of particular concern are the fields of taxpayer education and assistance, and certainty. These two aspects are interrelated and in the current economic climate, are difficult objectives for the tax administration to achieve. However, increased taxpayer awareness could help change the tax culture and thus improve compliance across the whole tax system.[21] Increased certainty would give security and promote foreign investor confidence in the country. The almost universal removal of blanket tax holidays throughout the region[22] perhaps indicates a realization that tax preferences do not in themselves significantly increase capital inflow from abroad. Instead it is arguable that improving the certainty and overall reasonableness of the tax rules will best facilitate foreign investment.

19. See e.g. Art. 16, Russian Federation Law on basic principles of the taxation system of 27 December 1991.
20. Art. 11 of the Law on Foreign Investment (Law 35/1991).
21. See Jenkins G.P. and Forlemu E.N., "Enhancing voluntary compliance by reducing compliance costs: a taxpayer service approach", Harvard University development discussion paper No. 448 May 1993, for a discussion of making taxpayer compliance more effective and efficient if the tax administration puts greater emphasis on assistance.
22. Whilst the recent trend has been for central European countries to remove their tax holidays, in particular those granted specifically to foreign investors, all of the countries in the survey retain or have reintroduced tax incentives. The incentives in force, with some exceptions, tend to be more narrowly focused and targeted, either to specified geographical areas, i.e. of high unemployment, for reinvestment and development purposes, or large-scale investments. For an overview of the tax incentives in the whole CEE region, see Erdös, G., "Tax incentives fall short", *International Tax Review* (March 1994), at 37-39 and (April 1994), at 8-10.

© 1994 International Bureau of Fiscal Documentation

IV. CONCLUSIONS

The reform of the tax administration goes hand in hand with tax law reform. Indeed without the mechanisms to implement tax laws, reforms cannot be achieved.[23] However, many CEE countries have failed to fully recognize this central fact and have paid little attention to the effects uncertainty, onerous compliance burdens and heavily punitive systems have on foreign investors and citizens alike. Despite this, great improvements have been made and continue to be made.

A. Compliance

For foreign investors, regulatory compliance obligations in CEE countries can represent a heavy burden. This is compounded by several other factors: unexpected changes made to laws and regulations,[24] an unstable economic climate and ineffective public information systems. The tax systems are supported by heavy penalty regimes and the widespread use of audits. This combination of factors produces something of a compliance quagmire; for foreign investors the system is onerous, bureaucratic and complex, whilst citizens can be left simply not knowing how to comply with their tax obligations. The introduction of certain constructive measures by the tax administration might improve compliance and help create a more positive image of taxes and tax officials. Constructive methods could include programmes of public education and assistance, the introduction of binding rulings and advance clearances and the continued simplification of the tax system.

B. Interrelationship between taxpayers and tax officials

No real consensus emerges from a review of the relationship between taxpayers and the tax administrations within the region. Some countries have adopted a more open style with tax officials providing taxpayer assistance, rulings and some flexibility (e.g. Hungary and the Czech Republic) whereas others seem to take a more distant (Russia) or casual attitude (Romania). Considering the differences in cultural and historical backgrounds, this diversity is not unexpected.

No country has yet developed a taxpayers' charter or declaration which enshrines taxpayers rights. Increased confidence that taxpayers in similar circumstances would be treated consistently and that taxpayers with similar sources of income would be subject to the same control procedures, would weaken the prevailing culture of non-payment and evasion. Currently, a great deal of regional variation is encountered, with Russia representing an extreme case where local authorities go so far as to levy taxes which they have no legal right to impose.

C. Simplification

Since the reforms began some emergent trends are becoming clear. Firstly, measures are being taken or planned in order to make the tax systems more neutral with respect to domestic entities and foreign entities. These measures include the elimination or reduction of special incentives and preferences granted only to foreigners and make the system simpler to administer and reduce distortions. Secondly, tax rates and brackets have been streamlined and simplified with the steep progressivity apparent several years ago greatly reduced in most countries. Special tax rates for different sectors and sources of income are also being eliminated or phased out. These steps make taxes easier to compute and administer and help to remove the incentive to artificially reclassify one type of business as another. Thirdly, in many CEE countries, reduced compliance requirements have been introduced for small businesses including the granting of lump sum expense deductions and reduced filing and record-keeping responsibilities.[25] As the tax systems are simplified and refined, compliance can be expected to improve.

'Change' has been the key-word underlying all discussions of commerce and taxation in central and eastern Europe. Whilst the rapid pace of change has been perceived as a disincentive, creating uncertainty and insecurity, some positive trends are emerging. This positive and forward-thinking view was echoed by the practitioners who contributed to this survey. In spite of their day-to-day problems, the consensus of opinion was that the tax administration would be able to adapt to meet the future needs of each country.

23. Many references possible, a recent source is Bird R.M., "The administrative dimension of tax reform in developing countries", in *Tax Reform in Developing Countries* who states that the administrative dimension should be placed at the centre rather than the periphery of tax reform efforts.

24. See Mamet, L., "No end to tax reforms?", 34 *European Taxation* (August 1994), at 267 for details of Russian recent legislative and policy changes.

25. Poland introduced lump sum taxation for small-scale business activities from 1 January 1994. Taxpayers subject to this lump-sum taxation pay tax as a percentage (2.5%-7.5%) of their turnover, and are not required to keep extensive financial and accounting documentation. However, the Polish Ombudsman has challenged lump sum taxation on the grounds of it being unconstitutional. The Constitutional Tribunal has not yet heard the case.

© 1994 International Bureau of Fiscal Documentation

NEW ZEALAND

RAISING THE THRESHOLD FOR TAXPAYER COMPLIANCE: A NEW ERA OF COMPLIANCE STANDARDS AND PENALTIES

Adrian J. Sawyer

M. Com (Hons), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand. **Adrian Sawyer** is a lecturer in taxation and business law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch, New Zealand. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He has published in professional and academic journals, including *The Chartered Accountant's Journal of New Zealand, Current Taxation* and the *Bulletin*. He is a *Bulletin* correspondent for New Zealand and is a consultant for the New Zealand Treasury on effective tax rate research. He is a member of the New Zealand Society of Accountants and is on the Canterbury/Westland Branch of the Society's Tax Committee. Previously he was an investigating accountant with the New Zealand Inland Revenue Department.

I. INTRODUCTION

The proposals in a discussion document[1] issued by the New Zealand Government on 29 August 1994 are directed at addressing deficiencies in the current compliance and penalties regime. The discussion document attempts to directly confront sophisticated forms of non-compliance through tightening the structure of taxpayer obligations and penalties. A common theme is encouraging taxpayers to comply with their obligations, including the payment of the correct amount of tax on the due date(s). The current New Zealand tax system dates back in many instances to a system set up in 1916. Nearly 80 years have passed, with greater sophistication in business activity and only piecemeal additions to the Inland Revenue Acts to recognize these developments.

A self-assessment environment has steadily developed as tax administration and technology permits. Allowing taxpayers the opportunity to comply with clear legislation and certainty of the rules is proclaimed as vital to the effective administration of a self-assessment system. However, sanctions for non-compliance need to reflect both the current conditions and encourage non-compliers to become compliers. The content of the discussion document when viewed collectively, is a positive step forward in improving taxpayer compliance. With the input from consultation, this may be a memorable development in taxpayer compliance in New Zealand and serve as a pilot study for reviewing the expected standards of compliance and enforcement penalties in other jurisdictions. Use of the consultation process has received political support through a public statement by the current New Zealand Minister of Revenue, entitled "The Generic Tax Policy Process".

A. Overview of the proposed reforms

The proposed reforms are comprehensive in terms of the current standards and requirements for taxpayers. The proposed penalties are certainly higher and more closely reflect the seriousness of failing to comply with obligations under the Inland Revenue Acts. In the discussion document, the reforms are summarized in Table 1.[2] While the contents of Table 1 may appear comprehensive upon first analysis, the discussion on several aspects of the changes in the detailed provisions is short on specifics or is in need of modification if the overall intentions of the changes are to have a reasonable opportunity of success.

Further discussion of the content of these proposed reforms appears later in this article.

B. Benefits of the reform

This comprehensive review of taxpayer standards and penalties is directed at achieving a number of substantial benefits for taxpayers, the New Zealand Inland Revenue Department ("IRD") and the Government. The proposed changes are offered in the context of the findings of the Organizational Review Committee concerning the restructuring of the IRD.[3] Increasing clarity and fairness in the tax system are the founding principles that the Committee's recommendations and the discussion document's proposals are based upon.

The purported benefits of reforming taxpayer standards and penalties are:[4]

- protection of tax revenues;
- increased fairness for taxpayers;
- clear, comprehensive and effective penalty regime that leads to full compliance with the tax system;
- introduction of return-filing standards that support the current self-assessment tax environment.

The discussion document presupposes that voluntary compliance is regarded as the norm and non-compliance is socially unacceptable. It also indicates that as part of the Organiza-

1. New Zealand Government, *Taxpayer compliance, standards and penalties – a discussion document* (Wellington: Government Printer, 1994).
2. *Id.* at 2-3.
3. Organizational Review Committee, "Organizational Review of the Inland Revenue Department", Report to the Minister of Revenue (and on tax policy, also to the Minister of Finance) (Wellington, April 1994).
4. New Zealand Government, *supra* note 1, at 3.

© 1994 International Bureau of Fiscal Documentation

Table 1: Key Reforms

TAXPAYER STANDARDS (CHAPTER 5)
- Taxpayers must act reasonably in meeting all their tax obligations.
- Failure to take reasonable care in meeting tax obligations will lead to a penalty.
- Where the tax at stake is large, taxpayers will need to have a reasonably arguable position in support of the way they have applied the law.
- Taxpayers will be penalized for entering into abusive tax avoidance arrangements and for tax evasion.

CIVIL PENALTIES (CHAPTER 6)
- A standard $ 50 penalty will apply for late filing of annual returns.
- The penalty for late payment will be 5% plus an additional 2% per month.
- New civil penalties will be prescribed for negligence, gross negligence, abusive tax avoidance and evasion.
- The penalty for not having a reasonably arguable position will be set at 25%, the same level as the penalty for negligence.
- Penalties will be reduced for voluntary disclosure.
- Hindrance of the Commissioner of Inland Revenue can result in a penalty.
- Limited remission will be available for penalties applied for late filing and late payment.
- Remissions will not generally be available for penalties arising from breaches of reasonableness standards.
- The Commissioner will be able to apply to the court for a court order requiring a taxpayer to provide information or a return.
- The publication of the names of non-compliers will be extended to include cases of abusive tax avoidance.
- Current additional tax and penal tax provisions will be repealed.

CRIMINAL PENALTIES (CHAPTER 7)
- A maximum term of five years' imprisonment will be introduced for tax evasion.
- Community service and periodic detention will be available for offences with imprisonment terms.
- The maximum fines will be increased to $ 25,000 for first offences and $ 50,000 for second and subsequent offences.
- The penalties for failure to furnish information, failure to disclose information, and failure to maintain records will be standardized across Inland Revenue Acts.

INTEREST (CHAPTER 8)
- A comprehensive interest regime for under and overpayments of tax will be introduced.

TAX ADVISERS (CHAPTER 9)
- The offence of aiding and abetting will be extended to include aiding and abetting abusive tax avoidance.

tional Review Committee's recommendations, disputes will be handled fairly and quickly and tax administration will be based on legislation that is well understood by taxpayers and presented in the simplest manner possible.[5] For some groups of taxpayers and their peers, tax compliance will not necessarily be viewed as the norm and non-compliance may even be seen as socially acceptable, particularly as a means of redressing imbalances between taxation requirements and public goods or services received in return. Furthermore, the current New Zealand tax system, in spite of moves directed at simplification, is not well understood by taxpayers (and by many tax agents) and is not expressed in the simplest manner.[6]

C. Key questions

The discussion document sets out a number of key questions on which the Government invites submissions. The areas highlighted in the discussion document encompass significant policy issues contained in the proposed changes and to this end, the Government seeks constructive feedback. The areas are broad in scope, and in many instances, critical to the success of the changes in improving taxpayer compliance:[7]

- How appropriate are the design principles and guidelines?
- What are the merits of the expectation that taxpayers will take reasonable care in meeting their tax obligations and what impact will this have upon taxpayers?
- What are the merits of requiring taxpayers to take a reasonably arguable position where the tax at stake is high and the legal interpretation unclear?
- With self-assessment, is disclosure of the basis which taxpayers have assessed their liability sufficient grounds for a reduction in penalties if tax understatement is subsequently established?
- Are the degrees of culpability adequately reflected for negligence, gross negligence, abusive arrangements and evasion?
- What are the best means of deterring taxpayers from entering into arrangements which have a (dominant) objective of gaining a tax advantage?
- Are the penalties for understatement offences and relativities between them set appropriately, fully recognizing the severity of the acts they sanction? Are the penalties reasonable?
- Is a maximum term of imprisonment of five years for tax evasion appropriate?
- What are the necessary features of a two-way interest regime and how will this affect compliance? What practical problems may occur?
- What compliance costs may be associated with introducing a two-way interest regime, especially the changes that taxpayers will be required to make to their tax compliance obligations?

A number of these questions are considered during the course of this article as aspects of the proposals are discussed and critically evaluated. The approach centres around suggesting improvements and modifications which are directed at enabling the intentions underlying the proposals to come to fruition.

II. BACKGROUND TO THE REVIEW

The discussion document outlines the existing compliance standards and penalties. This is facilitated through an overview of the tax administration and compliance structure, the design principles which underlie the proposals for

5. *Id.* at 4.
6. See for example, L.M. Tan and G. Tower, "The Readability of Tax Laws: An Empirical Study in New Zealand", 9 *Australian Tax Forum* (1992), at 355; L.M. Tan and S. Tooley, "Tax Simplification: Progress to Date", 48 *Bulletin for International Fiscal Documentation* (May 1994), at 236; and L.M. Tan and S. Tooley, " Simplification – What do Practitioners' Think?", 73 *The Chartered Accountants' Journal of New Zealand* (16 June 1994).
7. New Zealand Government *supra* note 1, at 5, para. 1.8.

© 1994 International Bureau of Fiscal Documentation

change, and the weaknesses and flaws in the existing compliance standards and penalty structure.

A. Tax administration and compliance

Frequently quoted statements, including "paying taxes is a basic obligation of all residents of a democratic society", "revenue must be raised to fund government services" and "collection authorities must be able to collect revenue in the most efficient and fairest way possible", are all present in the discussion document.[8] Efficiency as interpreted by the Government is achieved when revenue is raised in a manner which minimizes the compliance costs to taxpayers, administrative costs to Government and costs to the overall economy (and impliedly resulting in minimal deadweight losses).[9]

A tax system has two principal dimensions:
- a specified base and applicable rates; and
- administrative procedures for collecting revenues and enforcing compliance.

The discussion document addresses the latter dimension only. The importance of voluntary compliance under self-assessment is emphasized in the discussion document.

The need for an effective audit programme is emphasized, accompanied by legislation that comprehensively addresses the compliance requirements for all taxpayers. This environment must be kept in perspective through necessary checks and balances, including the need to maintain some restraint on the powers of the IRD, in order to preserve fundamental rights of taxpayers. The IRD has a taxpayer charter which includes the right to fair treatment by the IRD; pay no more than the correct amount of tax; and confidentiality of tax affairs. These rights will be extended by the proposals in the discussion document to include an impartial quantification of tax liability made in accordance with tax law; treatment of every taxpayer's individual affairs with no more or less favour than others; and a succinct statement of taxpayers' obligations under the law.

New Zealand has legislated for certain fundamental rights in its Bill of Rights Act 1990 ("BOR Act"), which applies to all persons in New Zealand. In the BOR Act, the rights provide for, *inter alia*:
- minimum standards of criminal procedure, including the presumption of innocence, ... and the right to appeal conviction and sentence (Section 25);
- persons not to be subjected to retroactive penalties or double jeopardy (Section 26);
- observance of the principles of natural justice (Section 27).

Limited instances of restrictions on these rights are permitted where the restrictions are "... *reasonable limits prescribed by law as can be demonstrably justified in a free and democratic society*" (emphasis added). Several proposals in the discussion document call into question these fundamental rights, especially the presumption of guilt for the late filing of a return and late payments, and having a "judge" that is independent or free from bias, when the IRD imposes penalties without providing any prior opportunity for taxpayers to make their case. Creation of a comprehensive schedule of taxpayers' rights would be useful,[10] especially in light of the presumption of the taxpayer's guilt in many instances.

B. Design principles

The discussion document signals clearly what will be expected of taxpayers and their agents. Emphasis is placed on the objectives of increasing the effectiveness of incentives to comply with tax laws and imposing costs on those who do not comply, with a clear linkage between taxpayer's obligations and sanctions for non-compliance. The objectives or initiatives are based upon four broad principles: fairness, efficiency, clarity and effectiveness. Every feature of the system is expected to reflect these principles. Each of these principles will be briefly considered in turn.

1. Fairness

The measures must be consistent with the fundamental rights of New Zealanders if they are to be fair, with all taxpayers treated equitably. The discussion document outlines the following principles:[11]
- the regime should recognize that most taxpayers are honest and make a genuine attempt to honour their taxation responsibilities;
- new measures should make the system fairer by providing strong incentives to all taxpayers to comply with the law;
- obligations, standards and penalties should be designed in such a way that they can be imposed impartially and consistently;
- the standards that taxpayers are expected to meet, and the penalties applied to them, should recognize the differing circumstances and abilities of individual taxpayers;
- sanctions should be consistent with the seriousness of the offence and the culpability of the offender;
- the penalties' regime should be consistent with the principles of the Bill of Rights.

2. Efficiency

Reforms must complement the efficient operation of the tax system, requiring practicable legal and administrative initiatives, and minimal compliance costs. Preferably costs of compliance should fall on the revenue rather than taxpayers where this is possible.

8. *Id.* at 7.
9. A recent study on deadweight losses in the New Zealand economy was prepared for the New Zealand Business Roundtable by W.E. Diewart and D.A. Lawrence, *The Marginal Costs of Taxation in New Zealand* (Swan Consultants (Canberra) Pty Ltd, ACT, 1993), with extracts in W.E. Diewart and D.A. Lawrence, "The Deadweight Costs of Taxation in New Zealand", Paper presented to the 1993 Conference of the Economic Society of Australia, Perth, 27-29 September 1993.
10. A proposal along these lines has been provided by the Taxation Institute of Australia, "Taxpayers' Bill of Rights", 28 *Taxation in Australia* (1993), at 50-53.
11. New Zealand Government, *supra* note 1, at 11.

© 1994 International Bureau of Fiscal Documentation

The following efficiency guidelines are recognized:[12]

- the regime should not impose excessive costs on taxpayers who comply;
- standards must be enforceable and penalties must be able to be imposed without undue cost to the tax administration;
- compliance-related initiatives should exist solely to encourage compliance, either directly from the non-compliant taxpayer or via signalling. They should not be used as a revenue-raising mechanism;
- the regime should encourage taxpayers to pay their tax liabilities on time;
- compliance initiatives should minimize taxpayers' efforts on tax planning and avoidance.

3. Clarity

The Government believes that legal processes should be clear and easily understood, with sanctions consistent across all revenue statutes and applied consistently. Currently, New Zealand's tax system falls short of exhibiting clarity and it is not readily understandable. Nevertheless a positive step forward is imminent with an increase in consistency in application of sanctions:[13]

- taxpayer obligations and standards must be clear;
- sanctions should be consistent across the Inland Revenue Acts and in line with sanctions for similar offences in other areas of the law;
- penalty measures should be encoded in statute wherever possible;
- discretions should be kept to a minimum but be consistent with the need for the system to be fair.

4. Effectiveness

Finally, the discussion document recognizes that for the system to be effective, it should encourage compliance with the law:[14]

- the penalties should deter future non-compliance, both by the taxpayers who are penalized and those who are not;
- standards, incentives and penalties must be consistent with and support the obligations of taxpayers in the self-assessment environment;
- the compliance and penalties regime must be in line with community standards;
- the structure of the compliance regime should be comprehensive;
- the design of obligations, standards and the penalties regime should recognize the complex nature of transactions occurring in the commercial world.

C. Current legislative structure

The provisions detailing taxpayer obligations and standards of behaviour, and the sanctions that are provided to enforce these obligations and standards have not kept pace with the changing nature of tax legislation. Several enforcement provisions in the legislation are nearly 80 years old, while the activities of taxpayers and the variety of business activities have altered substantially over the years. Currently there are a substantial number of gaps in coverage, flaws in design and inconsistencies in application within the revenue statutes.

The discussion document highlights as major gaps in the current legislation the absence of sanctions for serious non-compliance, such as carelessness and overly aggressive interpretations, an unclear statement of the standards expected of taxpayers and ad hoc use of money interest charges. Flaws in the current design include confusing sanctions (such as additional tax and money interest for the same aspect of non-compliance), an emphasis on monetary penalties to the virtual exclusion of non-monetary penalties (a problem where the taxpayer cannot pay the fine and is discharged without penalty) and sanctions with high administration costs (such as prosecution for failure to file a return). Inconsistencies which exist in the current legislation include the extensive level of penal tax (up to 300 percent of the deficient tax, an amount determined at the Commissioner's discretion on a case by case basis). Other inconsistencies encompass varied sanctions for identical offences under different revenue acts (such as for failing to file an income tax return under the Income Tax Act 1976 (NZ) and the equivalent under the Goods and Services Tax Act 1985 (NZ)), different interpretations of "use of money" charges across statutes and the costs of applying certain existing sanctions.

The Government prefers a comprehensive review of the compliance and penalties provisions rather than introducing further ad hoc components to a legislative environment which is seriously flawed in both concepts and application. To this end, the politicians are to be congratulated. To illustrate the current weaknesses, Appendices 1 and 2[15] from the discussion document appear as Appendix 1 to this article.

III. THE PROPOSALS

The remaining parts of the discussion document are largely directed at providing the detail and reasons behind the proposed changes to the compliance obligations and the sanctions for non-compliance outlined earlier. Taxpayer standards are addressed with both the new civil and criminal penalties, an outline of the concept of a two-way interest system and a foreshadowing of the issues surrounding setting tax adviser standards. The commentary on the latter issue is extremely limited and dismissive of imposing standards of expected conduct, framed in a positive fashion, directly upon tax advisers.

12. *Id.* at 12.
13. *Id.* See also *supra* note 6.
14. *Id.* at 13.
15. These appendices compare the existing New Zealand system to the regimes in Australia, Canada and the United States.

© 1994 International Bureau of Fiscal Documentation

A. Taxpayer standards

The core of the new regime is a positive standard of reasonableness; every taxpayer will be expected to attain the standard of a "reasonable person". Sanctions will accompany this regime to ensure taxpayers take their obligations seriously and that they honestly perform the tasks required of them.

Late filing of returns and late payments will bring about an automatic imposition of a penalty, with limited provision for remissions to ensure the system is "fair". This presumes guilt on behalf of the taxpayer until he can prove his innocence, at his expense. On first appearance, this approach is not only contrary to the BOR Act, but it has the potential to be a sizeable money earner for the revenue authorities (and government).[16]

The discussion then turns to revealing what the Government perceives to be encompassed by the required standard of "reasonable care". The discussion focuses on the common law standards of reasonable care in the area of torts. Conduct which gives rise to a breach of a duty of care is unsettled and in many respects unclear, in New Zealand at present.[17] Ascertaining whether a taxpayer has satisfied the reasonable care test of acting in the manner that a reasonable person with the taxpayer's skills and knowledge would have, is expected to generate substantial litigation and comment. The New Zealand Government is not committed to any particular policy as to how taxpayers and their agents will be treated where the agent completes the tax return. This is a major component of the regime and requires clear indication of the Government's preferred direction before any legislation is enacted to enable effective consultation.

The "reasonably arguable position" standard requires taxpayers to interpret the law in a reasonable way, i.e. the merits of the arguments in support of the taxpayer's position will be evaluated. The genesis of the concept originates from Australian and US revenue law. The test is "as about as likely as not", although little guidance is provided on what will satisfy this test. The only indication of the scope of this test is that the prospect of the taxpayer's interpretation being upheld by the courts must be substantial, but need not be as high as 50 percent. The test will be objective, and will apply when the tax involved is substantial ($ 10,000). The threshold chosen is the same as applies in Australia, but this "direct copying without adaptation" fails to recognize the difference in exchange rates and relative income levels between Australia and New Zealand.

Breaches of the reasonable care standard will be penalized, with the penalty depending upon whether the breach arises from negligence, gross negligence, evasion or abusive avoidance (where the dominant or substantive objective is to produce a tax advantage – a very "woolly" definition). Where a taxpayer discloses his position in his tax return, the discussion document proposes that this could be used as a mitigating factor in adjusting the level of penalty imposed.

Tax evasion and avoidance is particularly topical in New Zealand at present with recent controversy in the New Zealand Parliament and news media over use of the Cook Islands' tax haven by large corporations to "avoid or evade tax" occupying the limelight. The result of this publicity is a Commission of Inquiry set up to investigate the matter. The substantial effort involved in discussing abusive avoidance appears directed at preventing the activities alleged to have occurred in the Cook Islands from "avoiding" sanction in New Zealand in the future. The dividing line between negligence and gross negligence, and a concise definition of abusive avoidance are absent from debate in the discussion document, yet these matters will be of fundamental concern to many taxpayers.

B. Civil penalties

Civil penalties will be imposed by the Commissioner and may take the form of either monetary or non-monetary nature. The penalties are designed with the intention of being imposed impartially, consistently, in a timely manner and at minimum cost. The civil standard of the "balance of probabilities" will apply, but with the onus of proof on the taxpayer to discharge the Commissioner's contention of abusive tax avoidance. This is a further instance of the failure to recognize a basic right set out in the BOR Act, despite the claim that the taxpayer is in the best position to produce evidence related to the transaction to counter the Commissioner's assertions.

The late filing fee is rigidly set with minimal situations recognized for remission. It is suggested that to reflect the spirit of the Bill of Rights, the penalty should only be imposed where the taxpayer cannot provide a reasonable excuse for the late filing of the return. Furthermore, depending upon the severity of the late filing, a selection from a narrow range of late payment penalties may be made by the Commissioner. There is no reference to the remission of late payment penalties in the proposed regime. Various understatement penalties are recommended, although the applicable penalty will depend upon the degree to which the required standard has been breached. The discussion document summarizes the processes involved in arriving at a penalty. A summary of the penalties and how they may be reduced with voluntary disclosure appears in Table 2.[18]

16. The discussion document states that the proposed changes are not intended to be a revenue earner yet; with 116,530 returns outstanding for the 1991/92 year as at 30 June 1993, the late filing fee could bring in $ 5 – $ 6 million additional revenue.

17. For a discussion and recent commentary, see P.J. Downey, "Incrementalism in Tort", *New Zealand Law Journal* (March 1992), at 113; and J. Manning, "Tort", *New Zealand Recent Law Review* (1994), Part II, at 150.

18. Table 2 is modified from Table 4 in the discussion document to include suggested improvements to the standard penalties and reduced penalties following voluntary disclosure. The modified figures appear in brackets. Table 4 appears on page 32 of the discussion document, *supra* note 1.

© 1994 International Bureau of Fiscal Documentation

Table 2: Proposed Penalty Rates

Standard	Standard penalty	Reduced penalties for disclosure before audit	Reduced penalties for disclosure during audit
Evasion	150 (150 - 200)%	30 (50 - 75)%	120 (125 - 175)%
Abusive avoidance	125 (125 - 140)%	25 (25 - 30)%	100 (100 - 115)%
Avoidance	(100 - 120)	(20 - 25)%	(80 - 90)%
Gross negligence	100 (75 - 100)%	20 (15 - 20)%	80 (75 - 80)%
Negligence	25 (25 - 75)%	5 (5 - 15)%	20 (15 - 20)%
Lack of reasonably arguable position	25 (25 - 30)%	5 (5 - 10)%	20 (15 - 20)%
Hindrance	Flat penalty amount (10 - 25)%	N/A	N/A
Late payment penalty	5% late payment penalty plus 2% per month, (with remission of entire amount if justified)	N/A	N/A
Late filing fee	$ 50 flat penalty ($ 50 - $ 250, but not automatic)	N/A	N/A

The discussion document clearly states that the instances of remission will be few. This clearly indicates that once a penalty is imposed it will be a rare situation for remission. A penalty for "extreme" cases of hindering the Commissioner is to be introduced. Hindrance includes deliberate delays in responding to IRD inquires, refusing access to premises and destroying records. However, taxpayers will still be permitted the opportunity to claim privilege over documents and legal advice.[19] Extreme forms of hindrance will not be defined until a draft Bill emerges for select committee consideration early in 1995, leaving tax advisers and taxpayers "in the dark".

One form of non-monetary sanction that receives favourable attention is the publication of names of non-compliers. The literature supports the publication of names of non-compliers as a mechanism with the potential to improve compliance, provided it is accompanied by formal sanctions.[20] Non-monetary sanctions are particularly effective where the business and professional reputation, and integrity of the taxpayer is vital to maintaining customers and suppliers. Abusive tax avoiders[21] will have their names published[22] in addition to the current practice of publishing the names of tax evaders, provided the abusive tax avoider did not make a voluntary disclosure prior to completion of the audit. It is suggested that where a voluntary disclosure occurs during an audit, then serious consideration should be given to publishing the name of the non-complier where either evasion or abusive tax avoidance occurred.

C. Criminal penalties

The Government proposes to have both monetary fines and terms of imprisonment as penalties for tax evasion. Considerable space is allocated in the discussion document to discussing the appropriate term of imprisonment penalty for tax evasion. The recommendation is a maximum term of five years' imprisonment, and fines which may accompany or be substituted for imprisonment, of up to $ 25,000 for the first offence and up to $ 50,000 for a second and subsequent offence. The Crimes Act 1961 (NZ) provides for a term of five or more years' imprisonment for fraud, and the Companies Act 1993 (NZ), up to five years' imprisonment and a fine of up to $ 200,000 for fraud.

The discussion document states that one purpose of the proposed changes is a closer alignment of penalties for similar offences. It is submitted that the Government's arguments display the best of intention but fail to deliver the "best" result in light of this fundamental overriding purpose. Imprisonment terms should be permitted to exceed five years for very serious cases of tax evasion in order to be consistent with the Crimes Act, otherwise tax fraud may be seen as less serious than other forms of fraud.[23] Fines should be higher than those proposed, especially for companies, to facilitate consistency with the Companies Act. It is suggested that fines of up to $ 50,000 for a first offence and up to $ 100,000 for second and subsequent offences would increase compatibility between the relevant statutes. In terms of overall fairness, reducing the fine to maximum levels of approximately $ 10,000 for a first offence and $ 25,000 for second and subsequent offences where voluntary disclosure occurs before an audit, would assist to encourage voluntary disclosures and consequently raise the level of compliance.

A failure to furnish or disclose information will attract penalties which are consistent across all Inland Revenue Acts. Penalties for aiding, abetting or inciting another person to commit an offence will subject this person to the same penalty as the principal offender. The discussion document also states that it is the Government's intention to allow the Commissioner to bring criminal proceedings without requiring recourse to the New Zealand Police or the Serious Fraud Office, although this option will remain open for serious or complex cases of tax evasion or abusive avoidance.

D. Interest

A novel feature of the proposed changes is a two-way interest regime, whereby under or late payments will attract interest. This feature should act as an incentive for taxpayers to pay the correct amount on time, but overpayments will receive interest in recognition of the deprival of use of funds experienced by taxpayers. The approach conceived by the Government is to apply commercial rates of interest, but

19. Both common law privilege and privilege as provided for in Sec. 20 of the Inland Revenue Department Act 1974 (NZ).
20. See for example, G.R. Violette, "Effects of Communicating Sanctions on Taxpayer Compliance", 11 *The Journal of the American Taxation Association* (1989), at 92; and within New Zealand, D.J. Hasseldine and S.E. Kaplan, "The Effect of Different Sanction Communication on Hypothetical Taxpayer Compliance: Policy Implications from New Zealand", 47 *Public Finance* (1992), at 45.
21. The characteristics of abusive tax avoidance are not defined in the discussion document.
22. Publication occurs in the New Zealand Mercantile Gazette.
23. It is my contention that tax evasion is one example of fraud against the Crown (or State).

© 1994 International Bureau of Fiscal Documentation

maintaining the interest regime separately to the penalties regime. Therefore, penalties of 5 percent on the day after the due date, and 2 percent for each month thereafter until payment is made, will still be incurred on late payments, in addition to the interest charge.

Limited discretion to remit interest will be available. No firm proposal has been arrived at as yet and the Government is seeking submissions on this aspect of the system. The earliest possible implementation date is 1 April 1996. Interest will be calculated on a daily basis and will be deemed assessable income on overpayments and a deductible expense on under or late payments. Interest will be calculated from the due date of payment to the actual date of payment on a daily basis, but will not be compounded.

The rate on underpayments will be tied to the market rate for short-term borrowings, and for overpayments the market rate for short-term deposits.[24] This feature assists in ensuring that use of the IRD as a bank will not be encouraged; rates offered on overpayments will be "market rates" and no higher. IRD rates exceeding market rates has been a phenomenon in recent years in New Zealand when a 10 percent rate of interest was payable on overpayments, with market rates on deposits in the region of 6.5 – 7.5 percent. The IRD's rate is now at 6 percent.

Rates will be reviewed annually, although the Government will permit the IRD to review its rates more frequently if a "wide market movement" occurs. The frequency of rate changes will depend upon market conditions. Determining when the basis point changes are sufficient to warrant close monitoring and when these changes are sufficiently large and "permanent" to warrant a change in the IRD's rate are vital components of the interest regime. Compliance costs and administrative costs must be kept to a minimum as far as is practicable.

A suggested approach to address wide market movements could incorporate the following stages. When a 50 basis point change occurs, the rate in the market is closely monitored, and if there is a further 50 basis points rise in the next two weeks, then a change in the IRD rate would be expected. The new rate will be the old "tax" interest rate plus the movement (100 or more basis points). If this rate remains for a further two weeks, then it will be the new applicable rate and taxpayers will receive a two week lead time notification that this new rate applies. Movements in both directions and in both short-term markets must be considered.

E. Tax advisers

The Government is seeking to initiate discussion on the role of tax advisers and how their conduct will be "regulated" by the proposed changes. The definition of a tax adviser adopted in the discussion document is sufficiently wide to include lawyers, accountants, employees or other persons who prepare or file returns, arrange payment of tax, advise on the tax treatment of proposed and completed transactions, advise on structuring transactions to minimize tax, advise and represent taxpayers in disputes with the IRD and represent the taxpayer in the Taxation Review Authority or the courts. While the Government maintains the belief that most tax advisers display high standards of conduct, it is acknowledged that a significant number of tax advisers have been or are involved in devising (blatant) tax avoidance schemes. Research has yet to be conducted in New Zealand to determine the degree to which tax advisers contribute to non-compliance; an area that requires urgent attention.

There is also an assumption that tax advisers who are unscrupulous in their behaviour and incur liability for their clients will soon lose their clients and go out of business – the free market in operation. Many tax advisers in New Zealand do not belong to professional associations that have codes of ethics and required standards of conduct; consequently there is no body to oversee their behaviour. While some tax advisers may become "tax agents" on the IRD's agency list, many tax advisers are not on this list. Furthermore, even if a tax adviser is on the agency list, it may be some time before an adviser is removed from the list as a result of the IRD ascertaining that the adviser's behaviour significantly contributed to non-compliance. Removal from the agency list in New Zealand does not prevent the tax adviser from preparing tax returns.

The Government's preferred approach is to permit taxpayers to recover any fine, penalty or additional tax from their tax adviser where it was the adviser's negligence that caused the liability to fall on the taxpayer. This approach, it is submitted, imposes excessive and unjustified obligations on taxpayers to monitor their tax adviser to determine if evidence exists to support legal action directed at pursuing a claim against their adviser, founded upon negligence. As a direct consequence of maintaining this high level of vigilance and pursuing legal action, taxpayers will have incurred significant legal and compliance costs. Direct action by the IRD against tax advisers, where negligence may be determined more readily from the information at the IRD's disposal, will not only reduce taxpayers' costs, but total legal costs as well. This presupposes some form of direct action against a tax adviser where the adviser was the primary instigator of deliberate action or was negligent and caused the taxpayer to suffer loss. It follows that there are compelling reasons worthy of research addressing the issue of encouraging the IRD to instigate direct action against tax advisers, without dispensing with the possibility as indicated in the discussion document. This potential action would be additional to the aiding, abetting and inciting offence, which in the current environment, is rarely pursued by the IRD and meets with success on even fewer occasions.

The Government rejects outright the US approach of direct promoter and preparer penalties on tax advisers. This approach is primarily supported by the contention that it would cause significant civil rights implications.[25] This con-

24. The New Zealand 90 Day Bank Bill rates may be a useful "base" rate.
25. Intuitively this argument does not hold water since the United States, the "home of civil rights", has had promoter and preparer penalties for a number of years. Furthermore, a sizeable literature has developed which is generally supportive of preparer and promoter penalties.

© 1994 International Bureau of Fiscal Documentation

tention is proffered without determining the contribution of tax advisers to the level of taxpayer non-compliance in New Zealand. Without undertaking the research to substantiate this contention, non-compliance may not be reduced to the extent that a preparer and promoter penalty environment may provide.[26] Discussion is strangely absent on the implications of whether tax adviser "licensing" or "registration" should be a prerequisite before a tax adviser may prepare and file returns with the IRD. This practice exists in the United States[27] and from the New Zealand context, it is worth pursuing the concept through research since licensing or registration may be a vital catalyst in raising the professional and ethical standards of tax advisers and the level of taxpayer compliance. Furthermore, it may be more effective in "weeding out" tax advisers who fall short of the standard than the indirect method proposed in the discussion document.[28]

IV. IMPLEMENTING THE REFORMS

The Government's legislative programme provides opportunity for consultation and for thorough attention to be given to submissions. Draft legislation should be open to scrutiny before the Christmas break in December 1994, with formal introduction of legislation to the New Zealand Parliament in early 1995. The regime is unlikely to take effect until 1 April 1996, with the two-way interest proposal possibly requiring a longer time frame.

The proposed penalties will be prospective in operation; consequently the legislation in force when the offence was committed will apply, and cases before the courts prior to the application date of the new regime will be heard under the "old penalty" regime. The discussion document does not refer to situations where an audit is in process when the legislation changes, or if the computational requirements of an audit are complete but it is awaiting the determination of the deficient tax and recommendations for the appropriate offences to charge the taxpayer with. The IRD and the Government will instigate a taxpayer education programme once details of the final version of the regime are complete, including providing forms, booklets and returns, and advice.

It is of interest to note that prior to the introduction of more stringent penalties and higher expected standards of compliance, revenue authorities on behalf of governments may instigate a tax amnesty.[29] There has been no public statement whether this will precede the implementation of the proposed changes in the discussion document, although this may arise within the foreseeable future.

One other issue not referred to in the discussion document is when "time shall run against the Commissioner". It is implied in the discussion document that it will run from the time when the Commissioner issues an assessment (the current situation). However, in light of the strict obligations to be imposed upon taxpayers, the Commissioner should also be required to observe high standards. This may be facilitated through maintaining efficient computerization and high quality staff. Therefore, time should run from when the return was filed. It would not be practical or fair to determine that time will run from when the return was due to be filed, since late filings might then be encouraged. For example, circumstances may arise where the penalty for late filing is less than that which could have been imposed had the Commissioner been afforded the opportunity to pursue the range of available penalties.

The discussion document provides a comparison of the current and proposed regimes, with the focus on the difference between the penalty and prosecution action available under these regimes. The change in direction to permit the Commissioner to initiate the action against taxpayers is given prominent reference in these two appendices.

V. CONCLUSIONS

The preparers of the discussion document are to be congratulated on a long-overdue statement of the need to improve taxpayer standards, levels of compliance and to introduce higher penalties for the non-compliers in New Zealand. A wide range of issues are covered and the essential characteristics of the proposed changes are succinctly presented in the discussion document. However, some fundamental details are absent for several of the significant proposed changes and the opportunity for a comprehensive improvement to the existing system has not been fully utilized in every instance. When input from consultation is included, this may signal the commencement of further positive developments in taxpayer compliance in New Zealand.

When viewed collectively, in most instances the proposed changes are an excellent example of how to balance the Commissioner's and taxpayers' interests within the stated objectives of the recommended changes to current taxpayer compliance obligations, standards and penalties. Unfortunately,

26. Research on preparer penalties includes: S.E. Kaplan, P.M.J. Reckers, S.G. West and J.C. Boyd, "An Examination of Tax Reporting Recommendations of Professional Tax Preparers", 9 *Journal of Economic Psychology* (1988), at 427; K.M. Collins, C.J. O'Neil, and J.M. Cathey, "Tax Practitioners' Reactions to Return Preparer Penalties", 3 *Advances in Taxation* (1990), at 15; B. Erard, "Taxation with Representation: An Analysis of the Role of Tax Practitioners in Tax Compliance", 52 *Journal of Public Economics* (1993), at 163, K.J. Newberry, P.M.J. Reckers and R.W. Wyndelts, "An Examination of Tax Practitioner Decisions: The Role of Preparer Sanctions and framing Effects Associated with Client Condition", 14 *Journal of Economic Psychology* (1993), at 439, and in a New Zealand context, P.J. Anderson, "Tax Professionals, Compliance and the Case for Preparer Penalties", 11 *Asian-Pacific Tax & Investment Research Centre Bulletin* (1993), at 185.

27. Circular 230 grants CPAs, lawyers and enrolled agents (who have passed an IRS exam) the right to practise before the IRS.

28. If New Zealand were to move in this direction, the IRD's requirements for registration or licensing would need to be monitored by an independent authority to ensure the licensing and registration requirements are necessary, fair and reasonable in both scope and application.

29. For a discussion on the use of tax amnesties, see D.J. Hasseldine, "Increasing Voluntary Compliance: The Case of Tax Amnesties" 6 *Australian Tax Forum* (1989), at 509-523, J. Alm, M. McKee and W. Beck, "Amazing Grace: Tax Amnesties and Compliance", 43 *National Tax Journal* (1990), at 23, J. Alm and W. Beck, "Tax Amnesties and Tax Revenues", 18 *Public Finance Quarterly* (1990), at 433, J. Alm and W. Beck, "Tax Amnesties and Compliance in the Long-run: A Time Series Analysis", 46 *National Tax Journal* (1993), at 53, and M. Gratez and L. Wilde, "The Decision by Strategic Non-filers to Participate in Income Tax Amnesties", 13 *International Review of Law and Economics* (1993), at 271.

© 1994 International Bureau of Fiscal Documentation

the treatment of several important aspects indicates cursory analysis without recourse to the overseas literature or to undertaking research in New Zealand. This is typified with the failure to determine the impact of tax agents on tax compliance in New Zealand and the rejection of preparer and promoter penalties without a foundation of rigorous research to support this policy approach. However, a consistent "code" of compliance standards, penalties, offences and introduction of a two-way interest regime should ensure that another aspect of New Zealand's tax legislation addresses the environment of the 1990s, although it is only a part of the ongoing reorganization and rewriting of the revenue statutes in New Zealand.

APPENDIX I

Summary of Current Penalties for Understatement: New Zealand and Overseas

Income Tax Only

Penalties	USA	Australia	Canada	New Zealand
Fraud/Evasion[1]	Civil penalty of 75% on the portion of the underpayment	Civil penalty of 75% on the portion of the shortfall.	The greater of $ 100 or 50% of the tax incurred from the discrepancy.	Penalty tax of up to treble the deficient tax.
Negligence	*Accuracy-Related Penalties* Negligence or disregard of rules or regulations – 20%	*Shortfall Penalties* Lack of reasonable care 25%. Recklessness 50%.	Penalty loss of 10% where the taxpayer fails to report income for a second or subsequent time within three years. Gross negligence – the greater of $ 100 or 50% of the tax incurred from the shortfall.	In cases of the taxpayer being guilty of default, an original due date will be set. This will result in an additional tax of 10% with 10% incrementals every six months.
Large Shortfalls	Substantial understatement 20%.	Lack of reasonably arguable position 25% (Interpretation issues)	None	None
Avoidance	Penalties for non-registration of "tax shelters".	Tax avoidance 50% (reduced to 25% if there is a reasonably arguable position).	Penalties for non-registration of "tax shelters".	None
Promoter Penalties	Penalties for "abusive tax shelters".	None, except "bottom of the harbour" schemes.	Penalties for non-registration of "tax shelters".	None
Preparer Penalties	Range of penalties.	None	None	None

1 Criminal sanctions are also available for these offences however, they are not covered in this chart.

© 1994 International Bureau of Fiscal Documentation

Current Interest and Penalty Regimes: New Zealand and Overseas

Penalties	USA	Australia	Canada	New Zealand
Administration Systems	Self-assessing.	Self-assessing.	Self-assessing.	Self-assessing.
Filing Returns	Penalty of $ 500 imposed for filing frivolous returns.			
Late Filing Penalty	1. 5% of tax due for each month that return is late. Maximum penalty = 25% of tax due. 2. If return is more than 60 days late, minimum penalty = $ 100 or amount of tax due, whichever is the smaller.	200% of tax payable or $ 20, whichever is the greater. Penalty reduced if taxpayer has a good compliance record.	1. 5% of the unpaid tax as at return filing date; and 2. 1% of unpaid tax for each month that return remains outstanding. Maximum = 17% of unpaid tax.	1. No late filing fee. 2. Prosecution for non-filing.
Late Payment Penalty	½% of unpaid tax for each month that the tax remains unpaid. Maximum penalty = 25%.	Late payment penalty tax = 8% pa calculated on a daily basis.	Late payment penalty interest applies. Refer below.	For most taxes, late payment penalty =10%, plus 10% incremental penalty imposed every six months thereafter.
Interest	Debit interest charged on unpaid tax from the due date, to date of payment. Compounds daily. Rate = federal short term rate plus 3% points. Rates are adjusted quarterly.	Late payment penalty interest imposed on tax unpaid from due date. Rate for January 94 to June 94 = 8.7%. Rate adjusted six monthly. Interest also imposed on reassessments of tax from original due date to date on which amended assessment is made.	Interest imposed on unpaid tax from due date. Rate = average Treasury Bills plus 2%. For example January 92 to March 92 = 11%. Rate adjusted quarterly. Interest charged on late or deficient tax instalments. Calculated at 50% of interest payable on instalment, that amount exceeds the greater of $ 1,000	Applies to provisional tax, and tax in dispute. **Provisional Tax** Two way interest calculated on amount of RIT less provisional tax paid. Commences from third instalment due date to date of payment or terminal tax due date, whichever is earlier. Debit rate = 9%, credit rate = 4.5%. **Tax in Dispute** Debit/credit interest calculated on tax in dispute, over period of deferral. Rate = 7%.
Underestimation Penalty		Liable if amount estimated <85% of RIT. Calculated at 16% of RIT less provisional tax estimated.		Liable if amount estimated is <80% of RIT. Calculated at 10% of RIT less provisional payments made by third instalment.

© 1994 International Bureau of Fiscal Documentation

INTERNATIONAL

CONSUMPTION TAX RULES

Ken Messere

Ken Messere was head of the OECD Fiscal Affairs Division from 1971 to 1991, and is the author of *Tax Policy in OECD Countries: Choices or Conflicts?*

I. Introduction

II. The GATT Rules
- A. Preliminary rules
- B. The trade disputes of the 1960s
- C. Criticisms of the GATT rules and possible alternatives
- D. Administrative considerations
- E. Evaluation of the GATT rules

III. The EU Rules
- A. Preliminary rules
- B. Rate approximation of VAT and excises
- C. Some general considerations
- D. The transitional regime: January 1993 to end 1996
- E. The post-1996 options regarding VAT transactions between registered traders

I. INTRODUCTION

The aim of this article is to describe and analyse the international consumption tax rules and to enquire in the light of the theoretical literature, and political and administrative constraints how they might be improved.

Though eventually NAFTA might develop separate rules, for the time being there are two main sets of international consumption tax rules, conceived in different circumstances and for different purposes. The first is the 1962 General Agreement on Tariffs and Trade (GATT), aimed at regulating the impact of taxation on trading relations between independent nations. The second is the growing body of law in the European Union (EU) aimed at promoting both fair trade and increasing economic convergence between the member states of the EU. This legislation, whether embodied in the 1957 Treaty of Rome or enacted under powers bestowed on the EU's institutions by that and subsequent treaties, has as its main purpose the approximation of national provisions in the field of consumption taxation in the interests of fair competition in trade between member states, the removal of tangible or intangible barriers to the flow of goods and services across the EU's internal frontiers, and the establishment of an objective basis (VAT) for part of the "own resources" system of national contributions to the EU's budget.

One major difference between the GATT and EU rules is that the former have remained unchanged since 1962, while the latter have undergone much modification – especially over the last few years – and are still evolving.

Another difference between the two sets of rules is that in the simpler world of the GATT, though there have been many other misunderstandings and ambiguities – as noted below – the difference between the origin principle and destination principle applied to internationally traded goods and services is clear. Leaving aside the minor case of small exports by private travellers up to the allowances permitted by the importing country, where, leaving aside the duty-free shop case, the origin principle usually prevails, the GATT rules unequivocally provide for the destination principle, whatever criteria are chosen to distinguish between the two principles, which are broadly three:

		origin	*destination*
(a)	rate of tax finally applied	that of exporting country	that of importing country
(b)	which country finally gets the revenue	exporting country	importing country
(c)	where tax is levied	in exporting country	in importing country

As described in Section II the means of applying the destination principle to such multi-stage taxes as VAT and cascade taxes create complications, but the principle is clear.

For intra-community trade, the situation is much less clear under the EU rules, still to be finalized: first, because different arrangements apply to VAT and excises; second, because different arrangements apply to different kinds of transactions, notably transactions between registered traders and other transactions with special rules for non-commercial and mail-order transactions below a certain limit; and third, because the concept of "import" and "export" has been abolished with respect to trade between EU member countries, being replaced respectively by "acquisition" and "delivery" or "supply', while VAT remains a multi-stage tax, payable each time a transaction takes place with refunds of taxable inputs for all but the final consumer. It accordingly becomes much more difficult to apply unambiguously the concept of "origin" and "destination" in intra-community trade, and the terms have in practice been used in an inconsistent and contradictory way by different commentators.

The greater complications under the EU arrangements result from the objectives of reconciling freedom of member countries – within limits – to fix their VAT and excise rates with the absence of physical controls at the border when goods cross member country frontiers. Under the VAT "transitional

© 1994 International Bureau of Fiscal Documentation

system" operating since 1 January 1993 a deferred payment method, akin to the arrangements automatically applied under retail sales tax systems, applies to most commercial cross-border transactions, and apart from a few special schemes unequivocally reflects the "destination" principle. A report on its working is due by the end of 1994. However, the future is much less clear and is still to be decided. The original Cockfield 1985 proposals prescribed the credit mechanism or clearing house method (described in more detail in Section III) for most commercial transactions. Here is one area where incompatible terminologies arise. For public finance economists the clearing house system is seen as a way of retaining the effects of the destination principle under criteria (a) and (b) above, whereas for administrators and traders it embodies the origin principle under criterion (c) above. Without the word "finally" under criteria (a) and (b), there would be some ambiguity because under the clearing house system, the rate is initially that of the origin country and the origin country initially gets the revenue. Administrators and taxpayers are apt to think in terms of the initial situation and economists in terms of the final situation.

However, more importantly, to talk at all of the deferred payment method or the clearing method in terms of "origin" and "destination" is already to create confusion, because "origin" and "destination" are being used in a different sense – or what the logicians would call at a different level of language – from the criteria used in (a), (b) and (c) above. These two methods are simply devices to implement what is unambiguously the destination principle in the case of the deferred payment method and ambiguously in the case of the clearing house method.

Confusion is compounded by EC parlance which utilizes the "origin" principle, to be adopted by 1997, in a completely different sense, as the levying of tax on all transactable provisions wherever the seller and buyer happen to be. It would seem that this description simply reflects the fact that VAT is a multi-stage tax and again refers to methodology not to principles according to the criteria earlier referred to, since it leaves entirely open which country will finally receive the consumption tax revenue and what will be the final VAT rate on the goods traded between EU countries. (The arguments become more dense because, for obvious political and sensible reasons, the concepts of importation and exportation, never used in federal countries, have been abolished regarding trade within the EU, but this does not seem of relevance to the analytical arguments.) One suspects that the only reason for using "origin" in this new sense is ideological in returning to the concepts of the founding fathers of the Treaty of Rome who, however, used it in a totally different sense, according to criteria (a) to (c) above and under the assumption, since found to be unrealistic, that consumption tax rates would be identical in EU countries. I have been informed that for this reason, the post-1997 regime has been dubbed by one British Treasury official as the "principle of false origin'. Accordingly, "origin" in Community parlance is not used in Section III where future Community possibilities are discussed in more detail.

"Origin" and "destination" in their primary sense remain useful analytical tools to discuss developments in the EU as well as GATT, and in Section III the following terms are used with the following meanings:

(i) *(Full) origin principle*: Criteria (a), (b) and (c) are all followed. (The word "full" is omitted except when contrasted with "restricted" under (ii)).

(ii) *Restricted origin principle*: An expression coined by Shibata (1967), at 193-94. Origin principle applied to trade between EC countries, destination principle to trade with non-EC countries.

(iii) *Modified destination principle*: An expression coined by me to describe EU transitional arrangements. All commercial transactions for excises and most commercial transactions for VAT between member countries follow the destination principle, but the origin principle applies to certain transactions (see III.D. for details).

(iv) *(Full) destination principle*: Criteria (a), (b) and (c) are all followed (the word "full" is omitted except when contrasted with "modified" under (iii)).

To conclude this introduction on a brief personal note, I should mention that my first acquaintance with international tax policy came in 1964 when I was recruited by the OECD to write a report on the border tax adjustment practices prevailing under the GATT rules. I spent much of the next six years writing on this topic (see Bibliography) and participated between 1966 and 1970 in numerous OECD meetings in Paris and GATT meetings in Geneva. With six years work on a relatively narrow topic one could hardly fail to become an expert. In contrast, though aware of some of the theoretical literature on fiscal federalism in general and the EU consumption tax harmonization policy in particular, I began to explore in detail recent developments in the EC rules only a few months ago, and for a time was completely bewildered by the contradictory reports of what was supposed to be happening in the EU, as well as by the inconsistent terminology used to define what was "origin" and what was "destination'. For this reason I am more than usually grateful to friendly commentators for correcting my many errors and misunderstandings.[1] Everyone seems to disagree with everyone on some aspects of what should happen in the EU and how they should be described, which together with the uncertainties of what is going to happen between now and 1997, makes this a most intriguing area to explore.

1. Especially for detailed comments on two earlier versions of this article from Peter Wilmott, Director General of DG XXI of the EC Commission, Valerie Strachan, Chairman of the British Customs and Excise, as well as Richard Bird and Sijbren Cnossen. Though I have incorporated suggestions from all four, none of them is committed to agreement with the contents of this article. I am also grateful to Richard Vann for some useful comments on the first draft of this article.

© 1994 International Bureau of Fiscal Documentation

II. THE GATT RULES

A. Preliminary remarks

The GATT rules permitted the destination principle to be applied to consumption taxes on internationally traded goods, but disallowed it for other kinds of tax, to which the origin principle had to apply.[2] In practice, with the exception of small purchases by travellers, all countries apply the destination principle to consumption taxes[3] and the origin principle to other kinds of tax, though as described in more detail in II.B., there used to be some exceptions and borderline cases, and border tax adjustments had to be made according to the general consumption tax in force to achieve the destination principle. In particular, it was often necessary to refund exporters tax paid in the exporting country and to charge imported products with tax at the rate levied in the importing country on similar products, and under some of these systems with an additional export rebate and import surcharge to compensate for domestic *taxe occulte* borne on domestic products.

B. The trade disputes of the 1960s

Criticisms of the GATT rules, at a time when exchange rates were fixed, took two forms:

- the first was that they were ambiguous and this ambiguity was being taken advantage of by a number of European countries to improve their balance of trade situation through back door devaluation;
- the second was the allegation that they had little economic rationale and gave an inherent balance of trade advantage to countries relying heavily on consumption taxes, or at any rate to those *increasing* their relative reliance on consumption taxes (continental Europe) as opposed to those relying mainly on income taxes and not increasing consumption taxes (Canada, Japan, United States).

During the 1960s there were many technical misunderstandings resulting partly from the fact that different arrangements were required to put into effect the principle of destination according to the varying kinds of domestic systems of general consumption tax then existing. These systems included single-stage taxes where there was only one levy on sales, and multi-stage taxes where there were levies on all sales, although in some multi-stage countries sales from wholesalers to retailers and/or retailers to consumers were exempt or subject to lower rates. Single stage systems varied between those where tax was levied on sales by manufacturers ("MST"), those where tax was levied on sales by wholesalers ("WST") and those where it was levied on sales by retailers ("RST"). Multi-stage systems varied between those where sellers obtained credit for tax previously paid (VAT) and those where they did not (cascade systems). Among the big seven OECD countries alone all these tax systems co-existed. Thus:

MST	Canada (federal), Japan (some products)
WST	United Kingdom
RST	Canada and United States (both non-federal), Japan (some products)
VAT	France
Cascade	Germany, Italy.

Different border tax adjustments (hereafter "BTA") had to be made to achieve tax neutrality between exports and imports on the one hand and domestically produced goods sold on the home market on the other, because the amount of tax at pre-exportation and pre-importation stage paid on the latter varied from considerable to zero according to the system in force. This is illustrated in Table 1.

Table 1

THE BORDER TAX ADJUSTMENT MECHANISM UNDER DIFFERENT KINDS OF GENERAL CONSUMPTION TAX

EXPORTS

	Type of Tax	Method of adjustment	Amount refunded
A	Manufacture and wholesale sales taxes	Exporter does not usually pay tax but sometimes tax already paid is refunded	Usually none, but if so actual tax previously paid
B	Retail sales taxes (RST)	Exporter does not pay tax	None
C	Value added taxes (VAT)	Exporter does not normally pay tax, but any tax paid on his inputs is refunded(1)	Actual amounts of tax paid(1)
D	Cascade taxes	Tax already paid by exporter refunded	Estimated tax paid on similar domestic products sold on the home market

IMPORTS

	Type of Tax	Method of Adjustment	Amount Charged
A	Manufacture and wholesale sales	Domestic rate of tax charged sometimes at time of importation, sometimes on subsequent domestic sales	Same as tax charged on similar domestic products
B	Retail sales taxes (RST)	As A, but more often charged later on subsequent domestic sales	As A
C	Value added tax (VAT)	As A (1)	As A (1)
D	Cascade taxes	Tax paid at time of importation	Estimated tax paid on similar domestic products sold on the home market

(1) This is according to the transparent VAT system preferred originally by the EC Commission under which exporters pay VAT on their inputs and get it refunded when goods are exported, and VAT is paid at the time of importation, but it is possible under VAT to adopt the RST model as France has largely done for exports and the Netherlands for both exports and imports. Currently all EC countries use the RST model under the deferred payment method applying to intra-community trade.

2. This is somewhat an over-simplification. The GATT rules refer neither to the principle of origin nor destination. Moreover, they indicate minimum requirements rather than insisting that countries should take full advantage of their rights (see Arts. 3 and 16 of the GATT rules).

3. Mostly, because although this is the theoretical result, the defects of certain tax administrations and low tax compliance in certain countries may mean that in practice no tax will be paid on some internationally traded goods in the country of destination and that the country of origin might recoup some of the tax on certain goods at the rate then in force.

© 1994 International Bureau of Fiscal Documentation

The increase in European BTA was always due, in one form or another, to countries' varying BTA treatment of taxes occultes,[4] which are most appropriately defined as consumption taxes on auxiliary materials, capital equipment and services used in production, marketing or transportation of taxable goods. The amount of taxe occulte varies according to the consumption tax system. It is almost non-existent in most VAT systems, relatively light in sales tax systems, but was very important in cascade tax systems. Excises on diesel oil used in the transportation of goods also represent an important source of taxe occulte. The normal practice in the 1960s was to make BTA for taxe occulte arising from cascade taxes, but not for taxe occulte arising from other consumption taxes, as set out in Table 2.

4. When analysing the *taxe occulte* phenomenon in the mid-1960s, I found the obvious English translations 'hidden tax' or 'occult tax' respectively ambiguous and grotesque and finding no other English translation decided to remain in French. Most subsequent commentators have followed my preference.

Table 2

Simplified Analysis of Border Adjustments for Taxe Occulte under General Consumption Taxes during the Sixties

A Cascade systems	B1 Refund on exports to take account of taxe occulte paid on similar domestic products (1964)	B2 Changes to border adjustments(1) between 1964 and April 1968	C1 Equalization import taxes to take account of taxe occulte paid on similar domestic products (1964)	C2 Changes to border adjustments(1) between 1964 and April 1968
Austria	Yes, but probably under-compensation	Increases	As B1	As B2
Belgium	Almost none	Increases	Yes, but probably under-compensation	As B2
Germany	Yes, but probably under-compensation	Abolition 1/1/68 when VAT introduced	As B1	As B2
Italy	Yes	None	As B1	As B2
Netherlands	Yes, but probably considerable undercompensation	Increases	As B1	As B2
Spain	Yes, with possible over-compensation	None	As B1	Increases
Sales taxes and VAT				
Canada (federal & provincial sales taxes)	None	None	As B1	As B2
France (VAT)	None	None	As B1	As B2
Japan (Commodity tax)	None	None	As B1	As B2
United Kingdom (Purchase tax)	Export rebate scheme introduced October, 1964(2)	Export rebate scheme abolished April, 1968(2)	None	None
United States (State & Local Sales taxes)	None	None	As B1	As B2

(1) Apart from those designed to reflect changes to tax rates on domestic products.
(2) See text for details of export rebate scheme.

Source : Border tax adjustments and tax structures in OECD Member Countries (Paris, OECD 1968)

© 1994 International Bureau of Fiscal Documentation

The problem of making BTA for taxe occulte is that it is virtually impossible to know how much taxe occulte has been borne by particular products, because it could not be known how often a product had changed hands and where in the production distribution value had been added. Also export rebates and import equalization charges through which BTA are carried out have to be based on averaging and it is very difficult to ascertain whether BTA on exports and imports under-compensate or over-compensate for the amount of taxe occulte borne by similar domestic products sold on the home market or are about right. In practice, there were, however, good reasons for believing that in most European countries there was usually under-compensation rather than over-compensation.

Ironically, initial US fears of European cheating through over-compensation of taxe occulte from cascade taxes gave way to fears of BTA escalation, on the grounds of removing under-compensation. A number of European countries with cascade systems, noting that their BTA for taxe occulte were less generous than those of other countries with similar systems, began to increase them. In addition, between 1968 and 1973 all cascade countries (except Spain) went over to VAT. Insofar as taxe occulte was insufficiently compensated under cascade systems and barely existed under VAT, the change in itself was balance of trade advantageous.

Though the main problem was the effect of the escalation of European BTA on the US balance of trade, there were several others:

- Within the original six EC countries,[5] the Commission acted as a referee in the many disputes among them as to whether they were justified in increasing BTA as they were frequently doing.
- The United Kingdom created a precedent not followed by any other country, in providing for exporters a rebate in respect of the excises they paid on hydrocarbon oils for the transportation of exported goods, as well as purchase tax on such products as light bulbs and stationery, notwithstanding that British taxe occulte was much less than that of most of its trading partners.[6] There was not, however, a corresponding import surcharge, as under cascade tax systems.
- Germany joined in on the side of the angels by artificially revaluing its currency through a negative customs duty and an export tax of 3 percent, which though not using the BTA mechanism, had similar effects in the reverse direction to what was happening in almost all other cascade countries.[7]
- Australia was breaking the GATT rules by giving exporters rebates in respect of their payroll taxes[8] and a few other countries were doing likewise with property and other minor taxes but nobody seemed to mind in those days about such small transgressions.
- Another international conflict arose because a number of developing countries were claiming that the GATT principle of destination, enhanced in Europe by the move from cascade taxes to VAT with higher nominal rates, had adverse effects on their trade balances.

Between 1965 and 1970 the BTA question was discussed intensively first in OECD and then GATT. Both organizations came to the same conclusions that there was no sufficient reason for a change in the GATT rules, though each initiated a consultation procedure, under which one country could make a complaint if it considered its trading position was likely to be adversely affected by an increase in BTA or changes in tax structure in another country. Such consultations occurred in the late 1960s and early 1970s when Germany, the Netherlands and Belgium in turn abandoned their cascade taxes for VAT. Little evidence was furnished that these changes had significant effects on balance of trade positions, and after the 1971 Smithsonian agreement to move to flexible currencies nothing further of importance happened on the dispute about BTA for consumption taxes, though there were some problems on the income tax side with the US DISC 22– not discussed in this article.

C. Criticisms of the GATT rules and possible alternatives

The main argument, based on the assumption of fixed exchange rates, that BTA practices were not trade-neutral centred on the proposition that taxes eligible for BTA are shifted back to varying degrees into factor costs and that taxes not so eligible for BTA are partially shifted forwards into product prices. The theoretical argument then runs that in these circumstances, countries relying more on eligible taxes have a built-in balance of trade advantage (the static argument) and that existing BTA practices permit countries to improve their balance of trade position either by increasing BTA eligible taxes or by substituting BTA eligible for BTA ineligible taxes (the more important dynamic argument).[9]

Taking first the case of eligible general consumption taxes, there really is no unanimity as to whether VAT and sales taxes are fully, more than fully, or less than fully shifted forwards into product prices, or even whether it is meaningful to talk in macro terms about their shifting.

While it remains unclear how consumption taxes are shifted, it must equally remain unclear whether heavy reliance on them conveys a balance of trade advantage under then-existing BTA practices in the context of fixed exchange rates, and, a fortiori, whether an increase in such taxes would have some of the effects of a devaluation.

5. Belgium, France, Germany, Italy, Luxembourg and the Netherlands.
6. Between 1964 and 1968. The scheme was abolished when sterling was devalued.
7. After 1968 when it was alleged that the German move to VAT had devaluation effects at a time when Germany had a balance of payments surplus. The measure was abolished shortly afterwards, when the German currency was revalued.
8. Analogous to the UK export rebate scheme in the sense that if export rebates for payroll taxes had been followed by continental Europe, Australia would have been a net loser.
9. It was generally accepted that the major excises on alcoholic drinks, tobacco and hydrocarbon oils were fully shifted and no objections were made to full BTA for these taxes.

© 1994 International Bureau of Fiscal Documentation

Writings on the shifting of non-eligible taxes concentrated on the corporation income tax ("CIT"). It is even more unclear how far CIT is shifted forwards in the short run – if at all. Also no consensus emerged on the trade effects of a substitution of VAT for CIT under existing BTA rules. Apart from doubts as to whether CIT is shifted forwards in the short term, an additional argument that such a substitution would be unlikely to have favourable balance of trade effects, is that certain commentators found no evidence to believe that they are shifted downwards (i.e. that prices of goods would be reduced if CIT were reduced).

Much less was written in the BTA context of the shifting of other ineligible taxes, though there was some discussion on the shifting of employers' payroll taxes – mostly earmarked for social security benefits. Even if they are in the long run mostly shifted back into lower wages, there is evidence to suggest that in the short run they may well be partially absorbed in higher prices. It is also increasingly believed that personal income tax and employers' social security contributions are often shifted into higher prices by way of wage-push inflation. While opinions are likely to continue to differ on the relative forward shifting of consumption taxes on the one hand and income and payroll taxes on the other, it is not generally denied that consumption taxes are likely to be shifted forwards much more and more quickly than other kinds of tax.[10]

There were also quite fallacious arguments by certain Americans who misunderstood the nature of VAT as it operates in Europe and who argued that VAT was more like an income tax than a sales tax and less likely to be shifted as much into prices.[11]

At the political level, it was above all the United States, supported by Canada and Japan, which were arguing that the BTA rules should be changed, because of these countries' greater reliance on income taxes, ineligible for BTA, though many observers believed that the shifting argument suggested that it was the European countries which were in fact disadvantaged by the GATT rules because of their much heavier social security contributions, together with the accompanying taxe occulte from excises on hydrocarbon oils which have always been much heavier in Europe than in North America.

Even though it was sometimes conceded that any balance of trade advantages for certain countries inherent in their tax structure had been neutralized over the years, the feeling persisted outside Europe that there was some injustice in 100 percent BTA for consumption taxes and none for others; worse was the belief that countries could improve their balance of trade positions by switching their reliance from other taxes to consumption taxes; and worse still that countries could improve their balance of trade position by increasing BTA rates under cascade systems without changing domestic rates, on the pretext that there had previously been undercompensation for taxe occulte borne on domestic products.

Hence there was a plethora of suggestions for changes to the GATT rules under such titles as "standstill" and "ceiling'. Table 3 summarizes all the possible alternatives I could then think of to the GATT rules, most of which were proposed at some time during the 1960s. However none of these alternatives appeared to improve on the basic GATT rules from the point of view of economic rationale and all of them appeared to involve impossible administrative complications, as now discussed.

10. Another relevant point suggested to me by Cnossen is that it may be easier for business to shift forward consumption taxes on domestic markets than international markets, where competition is likely to be greater.
11. Examples are given in Messere (1979), at 483.

© 1994 International Bureau of Fiscal Documentation

Table 3
THEORETICAL ALTERNATIVES TO THE GATT RULES IN THE CONTEXT OF THE NINETEEN SIXTIES

	A Economic rationale	B Administrative consequences	C Other relevant comments
1. Eligibility for all taxes (in whole or in part)	More rational than existing system only if it is considered that all non-consumption taxes are shifted (as much as consumption taxes if eligibility in whole)	Difficult to work out appropriate rebate and equalization tax and to verify it is correct	Additional objection is the undesirability of escalation in border tax adjustments
2. Eligibility for certain non-consumption taxes(in whole or in part) such as corporation taxes, social security and industrial property taxes	Possibly more rational than existing system if there were agreement on relative forward shifting of such taxes in relation to that of consumption taxes	As B 1	Rate differentials between corporation taxes are slight. Otherwise as C 1
3. Total ineligibility for all taxes (i.e. origin principle)	More rational than existing system only if it is considered that all taxes are more or less equally shifted	Much more difficult to work than existing systems	Federal States with consumption taxes at state level prefer destination principle
4. Partial eligibility for all taxes (i.e. origin principle) (a) a fixed percentage of the domestic rate (ceiling)	More rational than existing system only if consumption taxes are shifted forward less than 100%	As B 3	Governments may find political difficulties in taxing domestic products at higher rates than similar imported products and in taxing exports
(b) no increase in border tax adjustments (standstill general)	More rational than existing system only if assumptions in A 1 above are accepted	The same as B 3 when there is an increase in consumption tax rates	Would perpetuate existing differences in border tax adjustment practices. Governments would be unable to increase domestic consumption taxes unless prepared to face difficulty of C 4(a)
(c) no increase in border tax adjustments without change in domestic taxation (standstill modified)	As 4(b)	No difficulties	Would perpetuate existing differences in border tax adjustment practices
(d) no increase in border tax adjustments without balance of payments difficulties (standstill modified)	Rational only if border tax adjustments are considered an appropriate way to adjust balance of payments	As B 4(b)	Problems of interpretation: What counts as balance of payments difficulties and over what period? Should it be confined to trade account?
(e) no adjustments in respect of taxes paid at earlier stages	None	Avoids need for averaging	It would place countries operating cascade systems at disadvantage
(f) no adjustments in respect of taxes occultes	More rational only if taxes occultes are shifted forwards less than consumption taxes on the goods themselves	As B 4(e)	It would place all countries in the same position (and thereby worsen the competitive position of cascade countries making border adjustments for taxes occultes)
5. Border tax adjustments permitted to agreed ceiling irrespective of tax structure	As B 3. Likely to discriminate against countries with high consumption taxes or with high taxation in relation to GNP	As B 3	As 4(a)

Source K. Messere (1966) – Hitherto unpublished.

© 1994 International Bureau of Fiscal Documentation

D. Administrative considerations

It has for some time been appreciated that the term border tax adjustments is misleading in that the adjustments may take place before or after goods cross frontiers; and for this reason, the 1972 GATT report suggested replacing the term "BTA" by "TA" or "tax adjustments applied to goods entering into international trade". However the term BTA (or TA) is also systematically misleading in a more subtle sense in that it suggests that making BTA (or TA) is a choice to do something (whether at the border or otherwise) and by inference that *not* making BTA (or TA) is a choice to do nothing. It is perhaps this misleading linguistic form that is responsible for the general neglect of the practical difficulties of not making full BTA (or TA) for consumption taxes, for nothing seems easier than doing nothing.

In practice, not making BTA would be a choice to do nothing, *only if* both rates and systems of the consumption taxes of the importing and exporting countries were identical. In all other circumstances, any coherent modification of the destination principle turns out to be an administrative nightmare. Full application of the origin principle would entail that the taxes of the exporting country were fully charged and the tax of the importing country not charged at all, except at post-importation stages. Tax administrations would have to ensure that exports bore the same tax as goods sold to consumers on the home market and since exports usually take place at manufacturing or wholesale stage, while most consumption taxes are levied on sales by retailers to consumers, their value would have to be marked up to a retail value to ensure equal tax treatment between exports and goods sold on the home market. On the import side, tax administrations would have to ensure that imports (not liable to domestic tax) were segregated from domestic products (which would be so liable) at each sale from importer to final consumer. All this would involve extra revenue controls and extra work for traders who would have to segregate imported and domestically produced goods both physically and from an accounting point of view. (See also Table 3 column B on the administrative difficulties of departing from a full destination principle and Table 4 on the consequences of inaction by the fisc when goods cross borders.)

In contrast, whether applying the principle of destination involves doing something or nothing depends on the consumption tax system in force in the importing and exporting country. If two trading countries both have retail sales taxes, making BTA normally involves doing nothing when goods cross frontiers, since tax has not yet become due at the time of exportation or importation and consequently the goods are treated in exactly the same way as domestically produced goods sold on the home market. In other circumstances what has to be done to achieve the destination principle is usually quite simple, at least under VAT, the only other system than RST currently in force: input VAT paid by exporters is refunded at exportation and importers may be obliged to pay VAT at the rate in force in the importing country. And even under VAT the RST suspensive mechanism, where nothing needs to be done to implement the destination principle has frequently been chosen. Under VAT systems countries have varied in their choice between doing nothing and doing something simple. Some countries impose tax at the time of importation, others wait for the first sale within the country when imports are treated in the same way as domestic products; some countries rebate tax on exporters' inputs, others allow exporters tax free supplies (see Table 4). As already noted, under the current transitional arrangements in the EU the second option is obligatory, and transactions between EU countries operate under the RST suspensive mechanism.

THE NORMAL TAX CONSEQUENCES OF DOING NOTHING WHEN GOODS CROSS BORDERS

	System of importing country			
System of exporting country	Manufacturer stage sales tax	Cascade tax	Retail stage sales tax	VAT (2)
Manufacturer sales tax	Total taxation in exporting country; none in importing country (origin principle)	Total taxation in exporting country plus partial taxation in importing country (1)	Total taxation in both countries(1) (complete double taxation)	Total taxation in both countries (1)
Cascade tax	Partial taxation in exporting country; none in importing country	Partial taxation in both countries (1)	Partial taxation in exporting country plus total taxation in importing country(1)	Partial taxation in exporting country plus total taxation importing country(1)
Retail stage sales tax	No taxation at all (3)	Partial taxation in importing country;(1) none in exporting country(3)	Total taxation in importing country(1) none in exporting country(3) (destination principle)	Total taxation in importing country; none in exporting country (3)
VAT (2)	Partial taxation in exporting country; partial in importing country(1)	Partial taxation in exporting country; partial taxation in importing country(1)	Partial taxation in exporting country and partial taxation in importing country(1)	Partial taxation in exporting country and partial in importing country(1)

(1) At post-importation stage as regards imports.
(2) When not adopting the suspensive RST mechanism, as frequently happens in practice – see Table 1.
(3) Provided export is made by a registered trader.

To summarize, the destination principle for consumption taxes provides a simple way of ensuring that goods internationally traded accrue to and are charged at the rate of tax of the importing country. Often, nothing has to be done at all, and when it does, there is no need for complicated controls, segregation of imports from indigenous products and products destined for the home market from products destined for export and there is no need for verification as between coun-

© 1994 International Bureau of Fiscal Documentation

tries that the system is working properly. There is no need for averaging or verification, since BTA are exact and transparent. If BTA increase (or decrease) that is only as a consequence of changes in domestic rates of tax or, more rarely, of changes in the domestic consumption tax system. Coherent theoretical alternatives to the destination principle for consumption taxes, whether a fully fledged origin principle or compromises of the "ceiling" or "standstill" variety (see solution 4c, 4d and 5 in Table 3) would, on the contrary, create very serious practical difficulties and provide obstacles to international trade.[12]

Practical difficulties would also arise if BTA were to be made for non-consumption taxes. Whilst the amount of excises, sales taxes and value added taxes levied on particular products is known, it is very difficult to formulate any kind of generally accepted rule for estimating the appropriate rate of export rebate and import equalization tax to apply to other taxes which might affect the price of internationally traded goods. Any rules to give effect in full or in part to the principle of destination for non-consumption taxes would have to be based on averaging which, even if accurately calculated, would involve relative over-compensation for some products and under-compensation for others. Even if rules were generally agreed, it would be virtually impossible for other countries to verify that they had been accurately applied. Equally, unilateral abandonment of the origin principle for income, payroll or property taxes would inevitably invite retaliation from other countries. In short, the work involved for national and international civil servants would be enormous and worse than useless, since the sole result would be to inhibit international trade.

E. Evaluation of the GATT rules

As understanding of the theoretical objectives and practical difficulties to any basic modification of the GATT rules began to be appreciated, and perhaps more importantly that BTA escalation for taxe occulte and fixed exchange rates both came to the end, peace broke out. All countries accepted that there was no need for changes in the fundamental rules, i.e. principle of destination in full for consumption taxes and principle of origin in full for all other taxes, which it was realized was not only the best but also the only feasible international rule. Understandably, in view of agreement on this main issue, the GATT Working Party preferred not to get involved in subsidiary issues where the GATT rules were ambiguous or deficient, however timorous this decision may now seem.[13]

It is clearly desirable that the international rules should be unambiguous, if only because experience has shown that countries with balance of payments problems may try to take advantage of any such ambiguities. There are a number of areas where GATT could take a more robust approach than has so far been done:

- One clear improvement would be to outlaw BTA for taxe occulte. This was not possible in the 1960s because taxe occulte was so heavy under cascade systems that countries with such systems would have been penalized too much. Now that there are no cascade systems in industrialized countries and are unlikely to be in the future because the economic inefficiencies of such systems are universally recognized, there is no reason why it should not be made clear that BTA for taxe occulte are illegal. Without such clarity, there is always the risk that some country will follow British practice of the 1960s, which could lead to a protectionist trade war as other countries retaliated.
- Second, GATT could react more speedily to countries which apply the destination principle to non-consumption taxes. GATT's weak response in the 1972 report to Australia (and perhaps other countries), granting export rebates for payroll taxes in the 1960s, and to the US DISC in the 1970s again illustrates the danger of backdoor protectionism.
- Third, the GATT could establish criteria for the taxation of cross-border services. The criterion for taxation may be in the country where the service is rendered or where it is carried out (e.g. an architect in country A draws up the plans for a building in country B). It is understood that outside the EU, VAT countries are not always consistent and that either double taxation or non-taxation of cross-border services could consequently result. The EU has opted primarily[14] for taxation where the service is carried out, which seems more consistent with the destination principle and GATT should perhaps look into the possibility of making the same rule mandatory, however difficult it may sometimes be to implement this in practice – e.g. when a multinational enterprise exports a service to several countries. It may accordingly in practice be easier to go for an origin principle for services, which would be analogous with the internationally recognized principle for services under the income tax. In principle, this seems an area where GATT rules should be estab-

12. Of course it is always possible to impose on an ad hoc basis in a particular country a negative customs duty in the form of an export tax and import subsidy as Germany did for a short while after the 1968 move to VAT (see *supra* note 7). It is also possible to construct a theoretical VAT where the origin principle could apply, rate discrimination applying at the production rather than final output level, but this would frustrate the intention of industrialized countries and lose all the technical advantages of VAT, as I argued in reply to Longo (*National Tax Journal*, December 1980, at 503).

13. Thus para. 15 of the GATT Working Party Report (1972) stated:
The Working Party noted that there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax and that these could be subdivided into
a) "taxes occultes" which the OECD defined as consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods. Taxes on advertising, energy, machinery and transport were among the more important taxes which might be involved. It appeared that adjustment was not normally made for taxe occulte except in countries having a cascade tax.
b) certain other taxes, such as property taxes, stamp duties and registration duties...which are not generally considered eligible for tax adjustments. Most countries do not make adjustments for such taxes, but a few do...
It was generally felt that while this area of taxation was unclear, its importance as indicated by the scarcity of complaints reported in connection with adjustment of taxe occulte - was not such as to justify further examination.

14. Under the EC Sixth Directive exported non-financial services rendered mainly to businesses are taxed at the recipients' place of business, if mainly to consumers at the supplier's place of business. The text assumes that most cross border services will be mainly to business. The appropriate taxation of financial services remains a separate topic not covered in this article.

© 1994 International Bureau of Fiscal Documentation

lished to avoid double or non-taxation, but further discussion seems necessary on how this might be done.

A fourth problem, which should perhaps be mentioned in view of current concerns with environmental or ECO taxes, can I believe be ignored in the context of the GATT rules. First, in the absence of an important tax on carbon dioxide emissions (not for the time being feasible) these taxes are of little importance in revenue terms. Second, in practice they almost invariably take the form of minor excises to which the destination principle has to apply.

A fifth and much more important problem is how to interpret "like or similar products" when not discriminating between imports, exports and domestic products sold on the home market, but here I have nothing to add to the 1977 GATT report[15] on this complex problem, which is especially important in a would-be single market, e.g. how far is highly taxed French cognac and UK whisky a similar and competing product to excise-free German and Italian wine?

III. EU RULES

A. Preliminary remarks

The conclusion of Section II is that apart from a few minor defects and ambiguities, all is clear and well with the GATT rules. On the contrary, despite a quantum jump over the last years to establish new EU rules, there remains some uncertainty about what will happen after the transitional period finishes in 1996. The EU choice has to be influenced, though not entirely determined, by the degree of harmonization of rates of consumption taxes that its member countries are willing to accept. If these rates are too far apart, for the reasons set out in Section II there is no practicable alternative to the destination principle: if they are identical or almost identical there is a prima facie case for adopting the restricted origin principle, which is the most obvious way of abolishing fiscal controls at frontiers, one of the main objectives of the single market. It would be idle to pretend that the abolition of such controls will not involve some increase in tax evasion and for a long time some member countries preferred to retain them.[16] However, it has now been accepted that such controls are inappropriate for a single market, as well as being extremely costly,[17] and the question still to be resolved is just how to proceed after the transitional period in respect of transactions between registered traders situated in different EU member countries. As regards excises it appears unlikely that there will be any change from the destination principle operated by way of bonded warehouses as exists at present. For value added tax the choice is between continuing with the deferred payment method, changing to the credit clearing house method or, more radically, adopting the restricted origin principle. The final Section III.E. attempts to evaluate the advantages and disadvantages of these three options.

In addition to the disagreement between those who wish to achieve the approximation of consumption tax rates that would enable the EU to apply the restricted origin principle and those anxious to preserve the right of EU member countries to be free to choose their own rates, there are many other points of conflict concerning the relative priorities to be placed, *inter alia*, on:

- robustness against tax avoidance and evasion,
- simplicity of administration,
- certainty of application,
- non-distortion of intra-community trade.[18]

Of relevance to the choice to be made are:

- degree of VAT and excise rate approximation likely to be obtainable in practice over the next years (III.B.);
- some general considerations relevant to the choice (III. C.);
- some of the advantages and disadvantages of the present modified destination principle prevailing under the transitional arrangements (III.D.).

B. Rate approximation of VAT and excises

The founding fathers of the EC hoped for identity or near approximation of consumption tax rates, and as recently as 1987 the EC Commission thought its member countries might be persuaded to approximate VAT rates and have identical excise rates, on the grounds that the permitted differences in VAT rates rendered divergencies in excise rates unnecessary. This proposal never had any chance of success, since not only do the excise rates of EU countries diverge greatly but most of them are very far from the excise average, so that harmonization of excise rates would have resulted in what would clearly have been unacceptable budgetary consequences for some countries and politically impossible excise increases for others. The more recent proposals shown in Tables 5 and 6 proposing *minimum* VAT and excise rates are much more plausible and have already been mostly implemented.

Table 5 provides in summary form the 1987 proposals and the 1992 excise rates Directive. The minimum rates for excises are almost entirely observed, exceptions being Greece, Italy and Spain for cigarettes and Luxembourg for all forms

15. Para. 18 of the GATT Working Party Report stated:
With regard to the interpretation of the term "... like or similar products ...", which occurs some sixteen times throughout the General Agreement, it was recalled that considerable discussion had taken place in the past, both in GATT and in other bodies, but that no further improvement of the term had been achieved. The Working Party concluded that problems arising from the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "*similar*" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "*similar*": the product's end-users in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality. It was observed, however, that the term "... *like* or *similar* product ..." caused some uncertainty and that it would be desirable to improve on it; however, no improved term was arrived at.

16. E.g. Britain, Ireland and Italy according to Cnossen and Shoup (1987), at 79-81.

17. Ceccini (1988) estimated that the removal of border controls would reduce costs to the principal sector by around ECU 8 billion and reduce administrative costs in the publicity sector by between ECU 0.5 and 1 billion.

18. Another example of conflicting objectives is provided by Bird (1993) in relation to the incompatibility of certainty and simplicity.

© 1994 International Bureau of Fiscal Documentation

of hydrocarbon oil. France was below the minimum for cigarettes and beer but in 1993 increased rates to the minimum requirement. It should, however, be added that it is not difficult to conform to the minimum of zero for both still and sparkling wine and also that there remains a very wide spread between maximum and minimum rates which may be summarized as follows:

	Maximum	Minimum
Cigarettes	Denmark & Portugal (around 63%)	Greece (around 33%)
Beer	Ireland (around 9 ECU per plato)	France, Germany Luxembourg (EC minimum of 0.748)
Wine (still)	Ireland (around 275 ECU/hectolitre (0%)	Greece, Germany, Italy, Portugal, Spain
Wine (sparkling)	Ireland 544 ECU, UK 274 ECU per hectolitre	Greece, Italy, Luxembourg, Portugal, Spain (zero)
Spirits	Ireland 400 ECU per litre	Greece, Spain (EC minimum of 46 ECU per litre)
Leaded petrol	France, Italy, Netherlands, Portugal over 500 ECU / 1000 litres	Luxembourg under 350
Unleaded petrol	France, Italy, Portugal over 470 ECU / 1000 litres	Denmark, Luxembourg, under 300

The above figures which relate to 1993 should be regarded as approximate, for sources tend to vary for rates on excise products sometimes using ECU, sometimes national currencies, and sometimes but not invariably adding VAT on cigarettes, alcoholic drinks and petrol, and sometimes by preferring to show the total tax factor in the price. However, the great differentials are due primarily to the differences in excise rates. Such differences make it much less plausible to abandon the destination principle for excises than for VAT, as already reflected in the transitional arrangements. It is also understood that the EC Commission has no plans to depart from the destination principle for commercial intra-community trade in excise goods in the foreseeable future.

TABLE 5

EC HARMONIZATION PROPOSALS[1]

	VAT		
	Standard Rate	Lower Rate	Higher Rate
August 1987 proposal[2]	14% to 20%	4% to 9% on defined products	None
Current proposals[3]	at least 15%	two rates 5% or 9% (transitional phasing out of zero rates and those below 5% are also permitted)	None

Excises

August 1987 proposal[2] on alcoholic drinks (ECU per L1)

alcohol for beverages (per L1 of pure alcohol)	1 271
intermediate products	85
wine (average 11 percent)	17
beer (average 12.5 plato)	17

Current Proposals[3]

A minimum rate of zero for wine 0748 per plato or 1.87 per degree of alcohol for beer and 46 ECU/hectolitre for spirits.

On Cigarettes[4]

August 1987 proposal[2]

cigarettes (specific excise per 1000) 19.5 ECU ad valorem + VAT as percentage of retail price 52-54.

Current Proposal[3] (a minimum for 100 cigarettes specific plus ad valorem)
57% of retail price exclusive of VAT.

Hydrocarbon Oils

August 1987 proposal[2] per 1000 litres
a) leaded petrol 340 ECU, b) unleaded 310 ECU, c) diesel 177 ECU, d) liquid petroleum gas 85 ECU,
e) housing gas oil at 50 ECU, f) heavy fuel oil (per k)

Current proposal[3] per minimum 1,000 litres,
(a) leaded petrol 237 ECU, (b) unleaded petrol 287 ECU,
(c) diesel 245 ECU, (d) domestic fuel 18 ECU,
(e) heavy fuel 18 ECU.

1. All these proposals would be mandatory, except current proposals on lower VAT rates.
2. Completion of the internal market: approximation of indirect tax rates and harmonization of indirect tax structure Global Communication from the Commission (Com(87)320Final/2 Brussels 26 August 1987).
3. Rates Directive of 19 October 1992 (92/77/EEC).
4. As cigarettes constitute well over 90% of the consumption of tobacco, details are not given on cigars, cigarillos, smoking tobacco and other manufactured tobacco.

Table 6 which provides VAT rates for both January 1992 and January 1994 indicates the persuasive influence of the EC Commission's 1992 rates directive. In 1992 nearly half the EU countries had a luxury rate, while in 1994 only Portugal had one; by 1994 all member countries had conformed to the proposal for a minimum 15 percent rate, whereas before 1992 Germany, Luxembourg and Spain had lower rates.

© 1994 International Bureau of Fiscal Documentation

Table 6
EU COUNTRIES' VAT RATES IN JANUARY 1992 AND 1994

	January 1992			*January 1994*		
	Standard rate	*Lower rates*	*Higher rates*	*Standard rate*	*Lower rates*	*Higher rates*
Belgium	19.5	6 & 12	–	19.5	1.6 & 12	–
Denmark	25	–	–	25	–	–
France	18.6	2.1 & 5.5	22	18.6	2.1 & 5.5	–
Germany	14	5.7 & 8	–	15(2)	7	–
Greece	18	4 & 8	36	18	4 & 8	–
Ireland	21	0, 2.3 & 10	–	21	0, 2.5, & 12.5	–
Italy	19	4 & 9	38	–	–	–
Luxembourg	15(1)	3 & 6	–	15	3,6,12	–
Netherlands	18.5	2 & 6	–	17.5	6	–
Portugal	16	0 & 8	30	16	5	30
Spain	13	6	33	15(3)	3 & 6	–
UK	17.5	0 (2)	–	17.5	0	–

General Notes
Figures are percentages of tax exclusive retail sales price.

In January 1994 zero rating applies to any great extent only in Ireland and the United Kingdom, in 1992 also in Portugal. In both 1992 and 1994 they are non-existent in France, Greece and Italy and are minimal in other EU countries.

The removal of higher rates in France, Greece, Italy and Spain took place during 1993. Before 1992 there were numerous higher rates in these countries and in Belgium as well.

There are reduced rates in certain areas in France (Corsica), Greece (several islands) and Portugal (Madeira and the Azores).

(1) Increase from 12 to 15. January 1992
(2) Increase from 14 to 15. January 1993
(3) Increase from 13 to 15. January 1993

C. Some general considerations

My remarks are quite brief, first because it is not the theoretical issues which are likely to influence what will happen and second because I have nothing new to add to what has been said by others.[19] Also to simplify matters, this section refers only to VAT on intra-community transactions between registered traders, some remarks being made on other kinds of transactions in D. below. Cnossen (1990) summarizes the main factors that are of relevance to the choice between the restricted origin principle and some form of the destination principle as "setting up the sales tax base between two or more jurisdictions as fairly as possible (inter-jurisdictional equity), in a manner that does not interfere with consumer and producer choices, particularly decisions about the location of manufacturing (locational neutrality), and in a form that is as simple and certain as possible for the taxpayer and the tax administrator (administrative feasibility)".

a) *Inter-jurisdictional equity* refers to a fair distribution of tax proceeds from the production and consumption of internationally traded goods, both as between the two or more jurisdictions involved and the taxpayers of each jurisdiction. It is now widely agreed that the equal treatment rule[20] under which there should be no consumption tax differentiation between similarly placed producers and consumers is the appropriate criterion to apply. To provide a concrete example of its application, assume State A has a VAT rate of 25 percent (the highest existing in the EU) and State B a VAT rate of 15 percent (the lowest permitted by EU rules); under the origin principle, if a registered trader in B exports to A refrigerators that compete with similar but more highly taxed refrigerators produced in A, State B has a prima facie competitive tax advantage, even though this may be more than offset by the administrative and transport expenses of importing rather than buying locally. This disadvantage disappears under the destination principle, but as Cnossen (1990) pointed out "in its place arises a perceived unfairness against producers of non-traded goods or importers in the exporting jurisdiction in favour of those who produce traded goods and therefore seem to benefit from the exemption or zero-rating of exports. Similarly, if two jurisdictions have different destination-based sales tax rates, the domestic producer in the lower-tax jurisdiction may believe that he has to pay a higher "price of admission" to the higher-tax jurisdiction than the foreign producer has to pay for admission to the domestic market".

Keen (1993) notes "Under the origin principle, it is the prices that consumers face, rather than those received by producers, that are equated internationally: for price differentials would create an incentive for perfectly legal arbitrage, buying in low price countries to sell in high. The consequences of this is *exchange efficiency*: equality of prices means equality across consumers of their marginal willingness to pay for goods, making it impossible to reallocate collective consumption in such a way as to make some consumers better off and none worse off. The choice thus becomes that between production efficiency (under the destination principle) and exchange efficiency (under the origin principle)".

For most countries making up the great bulk of world trade the unfairness of the origin principle is perceived as of much more importance than that of the destination principle.

b) *Locational neutrality* subject to a number of assumptions can be achieved in the long run equally under the origin and destination principle according to the so-called equivalence theorem, which takes into account exchange rates adjustments. However, the literature seems unanimous that too much attention should not be paid to the equivalence theorem, because the assumptions on which it is based are unrealistic and because a shift from the destination to the origin principle would have a number of immediate consequences, as in the short term prices and exchange rates are fixed and the coverage and rates of consumption taxes are not identical.

19. For example, Bovenberg and Horne (1992), Cnossen and Shoup (1987) and Keen (1993).
20. In the literature the benefit-received principle where taxes are considered as proxies for the payment of goods and services supplied by government has also been discussed, but is generally agreed to be irrelevant to the choice between the origin and destination principle (e.g. see Musgrave (1959) and Cnossen (1990)).

© 1994 International Bureau of Fiscal Documentation

Accordingly a shift from the destination principle to the origin principle would increase consumption and decrease production of lightly taxed or exempt commodities, with corresponding effects on imports and exports. In addition, in the absence of other adjustments, a move from the destination to the restricted origin principle would increase the revenues of those EU countries which had a balance of trade surplus within the EU area at the expense of those countries which had a balance of trade deficit.

c) *Administrative considerations*: these are discussed in the final section, where it is argued that in this respect the present transitional arrangements have an advantage over both the clearing house method and the restricted origin principle.

d) *The federal country analogy*: in writings on fiscal matters in the EU, analogies with one or more federal countries are frequently invoked. Such analogies have limited usefulness: first, even within the single market it is inconceivable that the EU will have anything like the taxing power of the federal government of even a very decentralized country such as Switzerland; second, the taxing arrangements of federal countries differ considerably (e.g. see McLure 1983 and Bird 1993). However, the federal analogy is relevant in demonstrating that it is possible to have a wide dispersion of consumption tax rates without the need for border controls.

D. The transitional regime: January 1993 to end 1996

1. VAT on intra-community transactions between registered traders

The destination principle applies but to avoid border controls the deferred payment method is used (as automatically occurs under retail sales tax systems). That is to say exports are exempt from tax, and imports not charged with VAT at the frontier but only on first sale in the importing country. Assuming the destination principle is to remain – itself not sure – an alternative to the deferred payment scheme is the tax credit clearance method, under which sellers would pay initial VAT in the country of origin, but the registered trader in the importing country would receive a credit. An EU wide clearing house would be set up to handle the various claims and net balances would be paid by countries which are net exporters in terms of amounts of VAT paid. The latter method was recommended in the 1985 Cockfield report.

2. Excises on commercial transactions

The destination principle applies but to avoid border controls a bonded warehouse arrangement has been set up, which accordingly to DG XXI of the EC Commission, British Customs and Excise and the private sector, e.g. Jenkins (1993) seems to be working well. As already noted it seems likely that this transitional system will remain a permanent feature after 1996, for while excise rates continue to be so diverse there seems little prospect of a move to the origin principle for intra-community commercial transactions.

3. Purchases by private persons and small traders

The origin principle now applies to purchases by private persons and traders exporting less than ECU 35,000 per year. In this area there is some controversy. It is argued by some that this results in revenue losses for high tax countries, increases in tax evasion and a misallocation of resources. Examples cited are border shopping between neighbouring countries with very different tax rates such as Denmark and Germany or Ireland and Northern Ireland, the plethora of petrol stations in Luxembourg for Belgian and Dutch clients, British beer exported to France to be bought in large quantities by British consumers on day trips, often for sale to British traders who can undercut their competitors. Of course there are fiscal controls to reduce this revenue loss and unfair competition and, though irritating to high consumption tax governments, the macroeconomic effects are slight and there are few signs of countries like Denmark and Ireland reducing their high rates to any great extent. Evidently their revenue needs have the priority over shopping distortions. It is also argued that if consumer preference for lower prices outweighs such other factors as travel costs, currency losses, language problems, etc. this is one aspect of market forces at work and some governments (especially the British) have favoured leaving the approximation of rates to market forces rather than EU dictate. The choice between the two attitudes is largely a matter of value judgement and political priorities (reducing fiscal deficits versus tax cutting), but in its slow but steady march towards origin in specific areas, there has so far been no retreat by the EU and it seems unlikely to happen this time, despite the worries of revenue officials in high consumption tax countries.

4. Mail-order transactions

Under the VAT transitional system, member states were given the option of adopting one of two thresholds (30,000 and 100,000 ECU) where the destination principle remains obligatory and most of them chose 100,000 ECU. Below this threshold exporters may choose origin or destination. Analogous issues arise to those referred to under (3) above. For the moment the limit for a resident of a low tax consumption country to obtain a reduced rate on goods purchased in a high consumption tax country is relatively low, though it is probably fairly easy for a determined person to evade the limit by ordering goods from several different suppliers. If limits increase, there could be a change in shopping habits, perhaps more important than with private purchasers, since mail-order transactions apply throughout the EU, not just between neighbouring countries.

5. Exempt entities

These include banks, insurance companies and government departments. Origin principle for ECU 35,000 or less, destination principle for more.

© 1994 International Bureau of Fiscal Documentation

6. Motor vehicles

When not bought through registered traders these are taxed in the country of registration at the rate prevailing in that country.

E. Post-1996 options regarding VAT transactions between registered traders

This is by far the most interesting, important and open issue regarding future EU rules. Two separate questions are involved: first, should the origin or destination principle apply to VAT transactions between registered traders in different EU countries? Second, if the latter, should the destination principle (under criteria (a) and (b) fourth paragraph of the Introduction) be implemented by the transitional deferred payment method or by the clearing house method? The first is a question of fundamental political and economic importance and opinions vary according to how one views the function of the EU and the weight one attaches to the various arguments for subsidiarity versus integration: the second question seems to be mainly a technical one as to which of the two methods is superior in terms of simplicity, administrative costs and protection against VAT evasion, though normative arguments have been advanced for the clearing house method (see Cnossen and Shoup quotation below).

1. Restricted origin vs. destination principle

Good theoretical arguments have been advanced over the last 30 years for adopting the restricted origin principle for intra-community trade, especially if a single currency becomes a reality. However, I do not believe that the principle of restricted origin will be chosen by the EU, or that it should be chosen in the foreseeable future.

It is unlikely to be chosen, because tax changes require unanimous agreement among member countries and most governments are unlikely to accept the administrative complications and unpredictable changes in their share of VAT revenues from intra-community traded goods that would result from a shift to the restricted origin principle.

There are a variety of reasons for believing a change to the restricted origin principle would be undesirable. First, there are the administrative complications: not only would there be a different regime for intra-community traded goods and those with third countries, but also a different regime for VAT (restricted origin) and excises (destination) as regards goods traded within the EU and to complicate matters still further the major excise goods are also generally subject to VAT. These complications would additionally lead to valuation problems including complications with transfer pricing and revenue sharing. Second, there are the theoretical considerations discussed under C.3. above, where both inter-jurisdictional equity and locational neutrality suggest that the destination principle is to be preferred to an origin principle, whether or not restricted.

2. Deferred payment vs. clearing house method

On what I believe is a very realistic assumption that the EU will after the transitional period remain with a destination principle without border controls, the choice seems to rest between these two methods.[21] In III.D.1. I have described them very briefly, for there are many more detailed accounts of how they work. Among the better is Cnossen and Shoup (1987) which concludes:

> Given the choice between the tax deferral system and the tax credit clearance system, the latter seems to have the edge. As opposed to the deferred payment scheme, the taxes collected 'in advance' from the exporter rather than 'afterwards' from the first inland trader of manufacturer, leaving the security aspect of the tax intact ..... The tax credit clearance system makes the value-added tax truly an EC affair as it integrates each Member State's value-added tax with the tax of other Member States. Export rebates and compensating import taxes may be said to collapse under a comprehensive clearing mechanism. To be sure, cooperation of the various value-added tax administrations would have to be strengthened in order to match exporters' gross tax liabilities with importers' foreign tax credits. But there is no reason to assume that this cannot be done. An agreement on the exchange of information has already been operational since 1979. The EC Commission is involved in verifying the 1.4 percent contribution to the common fund. And in other tax fields there are bilateral precedents such as the corporate tax imputation credits that France pays into the German Treasury.

In a more recent article, Cnossen (1994) while clearly remaining sympathetic to the clearing house method refers to some criticisms of it as follows:

> ... the system exhibits asymmetric interests as regards each Member State's role in allowing a credit for the exporting country's VAT on imports, on the one hand, and paying the VAT on exports to the importing country's tax administration, on the other hand (Lee et al., 1988). The lack of confidence in the system might induce Member States to require detailed information on intra-community transactions which would place an undue burden on business firms. Furthermore, the increase in importer's prices on account of the VAT would increase the payment risk of exporters. In response, the Commission proposed to permit related firms to suspend VAT-liability on cross-border transactions, as is already being done with regard to domestic transactions in Denmark, France, Germany and the Netherlands, and the United Kingdom. Thus, some 80 percent of the EC's internal trade would not be affected by the tax credit clearance system. Furthermore, the Commission proposed to allocate the remaining VAT-revenues on the basis of information culled from the returns of individual importers (and exporters).

21. Cnossen and Shoup (1987) note that in the discussion of their paper, Satya Podder suggested that on goods shipped directly by the vendor to another taxable business, tax should be payable at the rate applicable in the country where the goods are being shipped. Such tax collections, identified separately by the vendor on his return, would be transferred to the country of shipment through a tax credit clearance mechanism similar to the one proposed in this paper. Although the system might be feasible in a federal country with a centrally administered, if rate-differentiated, value added tax for all provinces, it might be too complicated for a common market with independent taxing jurisdictions. Firms resident and taxable in one of the member states would in effect have to become registered and taxable in another member state for their exports to that state. This seems feasible for direct sales, but would be difficult to police for sales between traders, particularly if various intermediaries, such as agents and freighters, are involved.

© 1994 International Bureau of Fiscal Documentation

Whatever may happen after the transitional period, which may well be decided for political reasons rather than technical reasons, my view is that the present deferred payment method is vastly superior to the credit clearing house method and I hope it will prevail beyond the transitional period. Even on political grounds, if the current tendency for subsidiarity over EC Commission regulation persists, it seems doubtful if member countries would be ready to give the Commission the powers envisaged in the last sentence of Cnossen (1994). But my strong preference for the deferred payments system is based primarily on the following technical and pragmatic grounds:

- If 80 percent of the EU's internal trade, as originally proposed in the Cockfield package, were to be subject to the deferred payment method, there would seem little point in setting up a complicated clearance house mechanism to deal with the remaining 20 percent. (However, it should be added, that this 80 percent proposal may well not be retained when proposals for a definitive VAT system finally emerge; if the ultimate proposals were well below 80 percent or conceivably zero, the arguments below have greater force).
- While analogies between direct and indirect taxes are always dangerous, clearing house systems under income taxes, whether more generally under the credit method of relief for double taxation or more particularly between countries with imputation systems, are perceived by both governments and business as not working well. Attempts have been made for over 20 years in OECD to streamline these procedures, but little progress has been made.
- But it is above all the simplicity of the deferred payment method which is its most attractive feature plus the fact that it has been shown to work with VAT countries and had to be used in countries having retail sales taxes. Though there may be greater risk of revenue loss for countries with low compliance and/or inefficient tax administrations, it would appear rational for such countries to improve things at a domestic level rather than to foist a complicated scheme on the majority of EU countries, which do not have these problems.

In conclusion the much recorded divergence between high tax compliance and efficient tax administrations in most North European countries and the contrary in some South European countries poses tax evasion problems for both methods. Tax evasion is going to occur in different ways under each method but it has been decided that this is a price worth paying for the single market. The relative amounts of tax evasion likely to occur under each method will doubtless be further studied and are likely to be a major factor in influencing the eventual choice.

REFERENCES

Aaron H. (ed) (1981), *The value-added tax: lessons from Europe*, The Brookings Institution, Washington D.C.

Berglas E. (1981), "Harmonisation of Commodity Taxes", *Journal of Public Economics*, Vol. 16.

Bird R. (1993), "Cost and Complexity: the GST in international perspective" (in symposium on the simplification of the federal/ provisional sales tax system) Canadian Tax Foundation, Toronto.

Bird R. (1993), "A comparative perspective on federal finance", paper for conference on The Future of Fiscal Federation at Queen's University, Toronto.

Bovenberg A.C. and Horne J.P. (1992), "Taxes on Commodities: a survey", from Kopits (see below).

Cecchini P. with Catinat M. and Jaquemin A. (1988), *The Benefits of a single market*, Gower, Brookfield, Vermont.

Cnossen S. (1994), "Coordination of sales taxes in federal countries and common markets", *Connecticut Journal of International Law*, forthcoming.

— (1990), "Inter-jurisdictional coordination of sales taxes", in *Value added Taxation in Developing Countries*, ed. M. Gillis, C.S. Shoup and G.P. Sicat, The World Bank (1990) Washington D.C.

— (1983), "The irrelevance of the restricted origin principle", *Tax Notes* 15 August 1983, Arlington, Virginia.

Cnossen S. and Shoup C.S. (1987), "Coordination of value-added taxes", ed. S. Cnossen, *Tax Coordination in the European Community*, Deventer: Kluwer Law and Taxation.

The Cockfield Report (1985), *The Completion of the European Market*, EC Commission, Brussels.

Commission of the European Community (1987), "Completion of the internal market: Approximation of indirect tax rates and harmonisation of indirect tax structures", Global communication from the Commission, COM 87 (320), Brussels.

Dosser D. (1964), "Welfare effects of tax unions, *Review of Economic Studies*, Vol. 31.

Gammie M. and Robinson B. (1989), "Beyond 1992: A European tax System", Proceedings of the 4th IFS residential conference, Oxford 1989.

GATT (1972), *Border tax adjustments*, Report of Working Party adopted 2 December 1970, GATT basic instruments and selected documents, Geneva.

Jenkins P.C. (1993), "Commentary on the single market", *VAT Monitor*.

Keen M. (1993), "The World Community: Questions of tax coordination in the European Community, a Survey", *Fiscal Studies* Vol. 14 No. 2, London.

Kopits G. (ed) (1992), "Tax Harmonization in the European Community", IMF Occasional Paper No. 94, IMF, Washington D.C.

McLure C. (ed) (1983), *Tax assignment in federal countries*, ANV Press, Canberra.

Messere K. (1979), "A defence of present border tax adjustment practices", *National Tax Journal* (December 1979).

© 1994 International Bureau of Fiscal Documentation

— (1969), "Some misunderstandings about border tax adjustments, consumption taxes and tax shifting", *OECD Observer* (February 1969), OECD, Paris.

— (1967), "Border tax adjustments", *OECD Observer* (October 1967), OECD, Paris.

Musgrave R. (1959), *The Theory of public finance*, McGraw Hill, New York.

Musgrave R. and Musgrave P. (1980), *Public Finance in theory and practice*, 3rd ed. McGraw Hill, New York.

Neumark Report (1963), "Report of the Fiscal and Financial Committee", *The EEC Reports on Tax Harmonization*, International Bureau of Fiscal Documentation, Amsterdam.

Organisation for Economic Co-operation and Development (OECD) (1994), *Tax information exchange between OECD Member countries: a survey of country practices*, Paris.

— (1988) *Taxing consumption*, Paris.

— (1968) *Border tax adjustments and tax structures in OECD Member countries*, Paris.

Patterson J. (1991), Draft report on completion of the internal market approximation of indirect taxation in the Community up to 1993 and thereafter, Brussels.

Shibata H. (1967), "The Theory of Economic Union", ed. C.S. Shoup, *Fiscal harmonisation in common markets*, Columbia University, New York.

Shoup C.S. (1969), *Public Finance*, Aldine Publishing Co., Chicago.

Sinn H-W. (1989), "Tax harmonization and tax competition in Europe", *European Economic Review*, Vol. 34.

Sullivan C. (1963), *The search for tax principles in the European Economic Community*, Commerce Clearing House, Chicago.

A SUPPLEMENTARY NOTE ON SOME COMPARISONS BETWEEN THE INTERNATIONAL CONSUMPTION AND INCOME TAX RULES[1]

A. Some similarities

The tax rules governing internationally traded goods and services have similar objectives to those governing international capital and income flows: first to avoid both double taxation and non-taxation, thus providing neutrality between international and domestic transactions; second to provide rules for an appropriate allocation of revenues to be shared between the governments of the two countries as well as an appropriate relative tax burden for the taxpayers involved: and third to minimize the possibilities of individual countries adopting unilateral protectionist policies such as subsidies for exports or capital importing income tax incentives.

Under each set of rules there is an allocation of revenues between the two countries involved (country of source and country of residence for income taxation and country of origin and country of destination for consumption taxation) and the problem of deciding what rate should be applied to cross-border capital flows and exported and imported goods. There may also be a similar conflict of interests between developing countries which generally[2] prefer the source and origin principle and industrialized countries which prefer the residence and destination principle.

Under each set of rules there are two main methods of applying the allocation methods. There is an analogy between the exemption method for relieving double taxation of income and the deferred payment method for achieving the destination principle. These are the methods generally preferred by business since there is less paper work and no payment of tax to be later refunded. Such methods are, however, more likely to facilitate tax evasion than the credit method for relieving double taxation and the invoice method of making border tax adjustments, and these latter two methods are mostly preferred by governments and are generally regarded as more neutral and transparent by economists. (However, despite this similarity, the differences are more important, since the exemption method applies the source principle, analogous to the origin principle while the deferred payment system is a means of implementing the destination principle – analogous to the residence principle.)[3]

In a world of unharmonized rates and varying tax administration efficiency each set of rules provides additional possibilities of tax evasion. To reduce these dangers as well as distortions to the single market, analogous solutions have been suggested within the EU in that the EC Commission has proposed a minimum 15 percent VAT rate and the Ruding Committee a minimum 30 percent corporation tax rate.[4]

B. Some differences

One major difference is that the international rules governing consumption taxes are multilateral and those governing income tax are mostly bilateral. The legal authority for the consumption taxes are the 1962 GATT in a worldwide context and the 1957 Treaty of Rome plus EC Commission Directives in the EC context; whereas, while there are a few multilateral conventions and EC directives in the income tax

1. I thank Richard Bird and Sijbren Cnossen for their comments on an earlier draft of this Note; this of course does not commit them to agreement with anything that is said.
2. Richard Bird doubts the usefulness of this dichotomy pointing out that Canada is an industrialized country in some senses and developing in others, but there are many countries where there is less ambiguity. In particular, Latin American countries have in the past argued for both source and origin principles.
3. As pointed out to me by Sijbren Cnossen.
4. However, while tax coordination versus tax competition is a main issue in the corporation tax area, it is of subsidiary importance as regards consumption taxes, which generate far greater revenues than corporation taxes. The desired level of revenues to be obtained from consumption taxes predominantly influences governments in fixing consumption tax rates, whereas low or zero corporation tax rates may and have been chosen by some governments with a view to attracting capital inflows.

© 1994 International Bureau of Fiscal Documentation

field, by far the most important legal instruments are the hundreds of bilateral tax treaties, which though largely based on the OECD model, generally differ from it in certain respects according to the requirements of the negotiating countries.

Another major difference is that in practice the GATT allocation rules are much simpler than those contained in bilateral tax treaties. As argued in Section II of the article, while it is possible to construct many different allocation models, in practice the only coherent solution between independent states not forming part of a common market, is the 100 percent destination principle under which internationally traded goods are taxed at rates prevailing in the importing country, the revenue proceeds accruing to the government of that country. On the contrary, under the allocation rules governing bilateral tax treaties the rate at which the income is taxed and the share of revenues taken by each of the two contracting states varies according to a number of factors, especially the kind of income involved.

A third difference is that the GATT rules are more or less static and apart from the possibility of a few minor changes (see Section II of the article) it is not easy to see how they could be improved. On the other hand, the OECD Model has to be revised continuously to take account of new developments and bilateral treaties are frequently renegotiated.

C. Some interactions

In forbidding border tax adjustments for taxes other than consumption taxes, the GATT rules also apply to income taxes. While threats were made from time to time by countries relying predominantly on income taxes to make BTA for income taxes nothing actually happened until 1972 when the United States introduced its DISC legislation under which a DISC was permitted to earn income from the export sale of domestic products, with part of its income subject to deferral from US income tax. DISC appeared to infringe the GATT rules and a number of European countries took up the matter with GATT: the United States retaliated by arguing that the exemption method of relief from double taxation practised, *inter alia*, by Belgium, France and the Netherlands also breached GATT rules, since through transfer pricing manipulation possible under this method, this could result in an export promoting effect similar to DISC.[5]

It is not unreasonable to look at the international rules on income and consumption taxes together, since both have the objective of providing a level playing field regarding the influence of taxation on the balance of payments and governments in balance of payments difficulties may try to "stretch" or even break either or both sets of rules in the expectation that the retaliation of their trading partners will take some time to materialize. It is possible that the US DISC was largely motivated by the belief quite prevalent in that country, however erroneous it might have been, that the mass European move to VAT constituted an export subsidy. The British export rebate scheme of the 1960s referred to in Section II.B. of the article constituted an analogous case on the consumption tax side. Because of institutional delays, both the British export rebate scheme (1964-1968) and DISC (1972-1984) lasted many years despite their (probable) illegality under the international rules.

The international rules governing income taxes and those governing consumption taxes are completely separate, as are usually the national and international civil servants monitoring these rules. For example, in the EC Commission, different Directorates deal with income and consumption tax, though this was not the case before the mid-1980s. It is difficult to know whether this uncoordinated approach at the international level does much harm.[6] However, there is perhaps a case for examining whether greater international coordination of the two sets of rules would improve matters from the point of view of equity between countries and resistance to tax evasion and avoidance.

5. A panel of three experts, to the surprise of most observers, upheld both complaints. Subsequently GATT came to the evidently correct conclusion that the exemption method did not infringe GATT rules, even though it *could* be used as a means of export promotion through transfer pricing manipulation, whereas DISC clearly did infringe GATT rules.

6. Probably of more importance in practice, but outside the scope of this note, would be greater coordination at national level of income tax, VAT and customs duty administrations to facilitate defence against tax avoidance and evasion and to ensure consistent treatment of transfer pricing practices for income duty and customs purposes (see para. 29 of *Transfer Pricing and Multinational Enterprises* (OECD 1979)).

© 1994 International Bureau of Fiscal Documentation

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.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 51-55 of the January 1994 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

BERNARDI, Luigi; OWENS, Jeffrey.
Tax systems in North Africa and European countries.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 128. 27.- Dfl.
Short comparison of the tax systems in North African countries and some European countries. Taking into account recent developments in the theory of taxation, the authors discuss the main alternatives for reform and constraints experienced by each country.
(B. 13.493)

South Africa

LOUW, Eric S.
Taxation & investment in South Africa.
Amsterdam, International Bureau of Fiscal Documentation. 1994, pp. 198. 450.- Dfl.
Loose-leaf publication in one binder covering extensive background information on business environment, foreign investment, exchange control and fund repatriation, details of the operation of South African corporations and the approach to branches of foreign companies. The description of the South African tax system covers taxes levied by central, provincial and local governments. Details are given on all aspects of income tax for companies and individuals (plus information on non-residents, partnerships, trusts and estates, specific industries, tax avoidance measures and relief from double taxation). Also included are capital taxes, regional levies, VAT, levy on financial services, stamp duties, transfer duty on land and customs & excise.
(B. 13.491)

DIVARIS, C.; STEIN, M.L.
1993/94 Old Mutual Income Tax Guide. 23rd Edition.
Kenwyn, Juta & Company Ltd. 1994, pp. 293.
Quick reference guide illustrating the workings of income tax, undistributed profits tax, donations tax and estate duty in South Africa. The book is based on the law as at 25 October 1993 and on the 1993 income tax returns and information brochures. In relation to individuals it covers the years of assessment ending 28 February and 30 June 1994, and in relation to companies, years of assessment ending during the 12-month period ending on 31 March 1994.
(B. 13.494)

ASIA & THE PACIFIC

COMPARATIVE INVESTMENT INCENTIVES.
Cologne, DEG – Deutsche Investitions- und Entwicklungsgesellschaft mbH., P.O. Box 450340, D-50878 Cologne, Germany. 1994, pp. 150.
Brochure providing comprehensive guidance on critical investment decisions. Summary of comparative investment incentives, framework for the investment incentives programme, operative investment incentives programme. Countries covered: China, India, Indonesia, Malaysia, Pakistan, Philippines, Korea (Rep.), Taiwan, Thailand and Vietnam.
(B. 58.038)

Australia

AUSTRALIAN TAX REPORTS.
Volume 26. Court/AAT 1993.
North Ryde, Butterworths. 1994, pp. 1405.
Report of cases heard before the Administrative Appeal Tribunal for the year of decisions 1993.
(B. 58.034)

DAUGAARD, Daniel; VALENTINE, Tom.
Reforming the taxation of financial arrangements: how many steps forward?
Sydney, Australian Tax Research Foundation. 1994.
Research Study No. 22, pp. 76.
(B. 58.021)

China (People's Rep.)

INTERNATIONAL TAX AND BUSINESS Guide: People's Republic of China.
New York, Deloitte Touche Tohmatsu International. 1993, pp. 70.
The book is designed to provide potential foreign investors with fundamental information about the Chinese environment, including factors a foreign investor should consider in deciding how to start a new operation in the country. These factors include tax planning, employment and labour considerations, financing, and importing and exporting.
(B. 58.025)

India

INCOME TAX ACT, 1961. ACT 43 of 1961 as amended up to Act 32 of 1994.
Lalbagh, Eastern Book Company, 34, Lalbagh, Lucknow 226 001, India. 1994, pp. 512.
Updated edition of the Income Tax Act, 1961 as amended by Finance Act, 1994 (Act 32 of 1994).
(B. 58.027)

INCOME TAX REPORTS ANNUAL Digest 1993.
Madras, Company Law Institute of India Private Ltd., 88, Thyagaraya Road, Thyagarayanagar, Madras 600 017, India. 1994, pp. 1440.
Annual digest of cases on income tax, wealth tax, gift tax, excess profits tax, estate duty and other direct taxes. Reported in the Income Tax Reports Vols. 199 to 204 (1993).
(B. 58.033)

Taiwan

INVESTMENT IN TAIWAN.
Amsterdam, KPMG Peat Marwick. 1994, pp. 66.
Booklet providing general information on topics commonly deemed to be important to business activity in Taiwan. Chapters include: investment considerations, forms of business organizations, taxation, banking and finance, statutory labour requirements.
(B. 58.031)

CARIBBEAN

Bahamas

INTERNATIONAL TAX AND BUSINESS Guide: The Bahamas.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 63.
The book is designed to provide potential foreign investors with fundamental information about the Bahamian environment, including the factors a foreign investor should consider in deciding whether to acquire an existing Bahamian company or to start a new operation.
(B. 18.841)

© 1994 International Bureau of Fiscal Documentation

Cayman Islands

INTERNATIONAL TAX AND BUSINESS Guide: Cayman Islands.
New York, Deloitte Touche Tohmatsu International. 1993, pp. 57.
Guide on Cayman Islands investment environment, tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 18.840)

Netherlands Antilles

INTERNATIONAL TAX AND BUSINESS Guide: Netherlands Antilles.
New York, Deloitte Touche Tohmatsu International. 1993, pp. 80.
The book is designed to provide potential foreign investors with fundamental information about the Antillean environment, including factors a foreign investor should consider in deciding whether to acquire an existing Antillean company or to start a new operation in the country.
(B. 18.842)

EUROPE

BERNARDI, Luigi; OWENS, Jeffrey.
Tax systems in North Africa and European countries.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 128. 27.- Dfl.
Short comparison of the tax systems in North African countries and some European countries. Taking into account recent developments in the theory of taxation, the authors discuss the main alternatives for reform and constraints experienced by each country.
(B. 13.493)

Austria

MADL, Peter.
ABC der Geschäftsgründung. Eine allgemeinverständliche Darstellung aller Rechtsfragen im Zusammenhang mit der Gründung eines Unternehmens. 9. Auflage.
Vienna, Linde Verlag Wien GmbH. 1994, pp. 98.
ABC of establishing a business. Survey on legal issues arising in connection with the establishment of a business.
(B. 113.655)

WESTERMAYER, Hans.
ABC der Lohnverrechnung. 24. Auflage.
Vienna, Linde Verlag Wien GmbH. 1994, pp. 101.
ABC of salary calculation. The booklet provides up-to-date information on the taxation of employment income and various issues connected herewith. The information is supplemented by 39 examples and numerous tables.
(B. 113.567)

WEILER, Franz.
Das Einkommensteuergesetz. Stand 1. Jänner 1994. Unter Berücksichtigung der Steuerreform II.
Vienna, Linde Verlag Wien GmbH. 1994.
Schriftenreihe der Steuer- und Wirtschaftskartei, No. 58, pp. 282.
Text of the Individual Income Tax Law as per 1 January 1994. Includes explanations and commentaries.
(B. 113.527)

DIE UMSATZBESTEUERUNG.
Umsatzsteuergesetz, Weinsteuergesetz, Normverbrauchsabgabegesetz in der ab 1.1.1994 geltenden Fassung. Bearbeitet von Gerhard Kohler.
Vienna, Linde Verlag Wien GmbG. 1994, pp. 203. 350.- AS.
VAT law, law on wine tax, law on the levying of duty on the supply of cars to Austria and on their first registration. Text of the laws, decrees, guidelines and case law as of 1 January 1994.
(B. 113.528)

EGGER, Anton; WINTERHELLER, Manfred.
Kurzfristige Unternehmensplanung. Budgetierung. 7. Auflage.
Vienna, Linde Verlag Wien GmbH. 1994, pp. 303. 680.- AS.
Short-term enterprise planning. Enterprise planning and enterprise management are examined – topics include the setting up of a business plan, drawing up of the budget, analysis, etc.
(B. 113.568)

HANDBUCH FÜR INVESTORENINFORMATION.
5. Auflage.
Vienna, Bundesministerium für Wirtschaftliche Angelegenheiten. 1993.
Manual on investment information issued by the Austrian Ministry of Economic Affairs.
(B. 113.430)

KODEX DES ÖSTERREICHISCHEN RECHTS:
Sozialversicherung. 15. Auflage. Stand 1.3.1994. Bearbeitet von Franz Marhold und Elisabeth Marhold-Wallner. Herausgegeben von Werner Doralt.
Vienna, Linde Verlag Wien GmbH. 1994, pp. 685. 305.- AS.
Sourcebook on Austrian social security law as of 1 March 1994.
(B. 113.718)

Czech Republic

JANKOVSKA, Martina; WANKE, Alexander.
Unternehmen in der Tschechischen Republik. Stand 1.5.1994.
Vienna, Linde Verlag Wien AG. 1994, pp. 79. 194.- AS.
Doing business in the Czech Republic. The authors describe the forms of doing business and the tax system. The booklet also provides business-related information, such as bookkeeping, leasing and franchising.
(B. 113.883)

LIEBSCHER, Christoph; SVORCIK, Otakar.
Die Kapitalgesellschaft nach tschechischem und slowakischem Recht.
Vienna, Linde Verlag Wien GmbH. 1993, pp. 169. 365.- AS.
Introduction to Czech and Slovakian company law.
(B. 112.780)

Germany

FUCHS, Michael; LUDWIG, Bettina.
Die neue Besteuerung ehemals gemeinnütziger Wohnungsunternehmen.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 178. 78.- DM.
The new taxation of housing enterprises which previously served the public purpose. The authors explain the problems accruing to housing enterprises by a 1993 amendment to Sec. 13(3) of the German Corporate Income Tax Law.
(B. 113.709)

KNIEF, Peter.
Das neue Körperschaftsteuerrecht 1994. Gesamtdarstellung mit Beispielen.
Bonn, Stollfuss Verlag. 1994, pp. 352. 48.- DM.
Comprehensive description of the German corporation tax law as amended by the 1993 Tax Act. The author discusses topics such as the new thin capitalization rule (8A KStG), the new provisions governing the treatment of losses, the classification of the corporation's equity and the reduction of the tax rate on distributed and retained profits.
(B. 113.686)

DÖTSCH, E.; JOST, W.F.; THIELEMANN, K.; WEHNER, R.
Die Körperschaftsteuer-Erklärung für 1993.
11. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 474.
72.- DM.
The book gives instructions on filing the corporate income tax forms.
(B. 113.799)

KNORR, Karl Ernst; KLASSMANN, Ralf.
Die Besteuerung der Krankenhäuser. 2. Auflage.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 362. 128.- DM.
Taxation of hospitals. The authors describe the income taxation and VAT applicable to hospitals, including several auxiliary activities exercised by the hospitals.
(B. 113.712)

BREIDERT, Ulrike.
Grundsätze ordnungsmässiger Abschreibungen auf abnutzbare Anlagegegenstände.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 303. 78.- DM.
The authors propose valuation principles and depreciation rules taking into account regular and irregular wear and tear of long-term assets.
(B. 113.889)

© 1994 International Bureau of Fiscal Documentation

KÖHLER, Stefan.
Die Steuerpolitik der deutschen internationalen Unternehmung im Einflussbereich der Hinzurechnungsbesteuerung.
Frankfurt am Main, Peter Lang AG. 1994.
Eur. Hochschulschriften, Reihe V, Volks- und Betriebswirtschaft, Vol. 1491, pp. 328.
The tax policy of a German enterprise under the influence of the International Relations Tax Law. The author examines the German CFC legislation. He designs a model to calculate the tax burden caused by the income allocation rules which apply to foreign passive investment of German corporations.
(B. 113.648)

THÜMLER, Axel.
Körperschaftsteuerliches Anrechnungsverfahren und internationales Steuerrecht.
Frankfurt am Main, Peter Lang AG. 1994.
Eur. Hochschulschriften, Reihe V, Volks- und Betriebswirtschaft, Vol. 1486, pp. 313.
Imputation system and international tax law. The author examines the problem of double taxation arising under an imputation system by the levy of an equalization tax if foreign-source income derived by a parent company is further distributed to the shareholders. He further discusses the economic effects of various solution proposals.
(B. 113.665)

RECHNUNGSLEGUNG UND PRÜFUNG 1994.
Herausgegeben von J. Baetge.
Düsseldorf, IDW Verlag GmbH. 1994.
Schriften des Instituts für Revisionswesen der Westfälischen Wilhelms-Universität Münster, pp. 265. 68.- DM.
Auditing and investigation in 1994. Speeches held by various authors during seminars at Münster University between 1991 to 1993 on the following topics: risk-oriented auditing, group auditing, auditing in banks and trusts, the profession of the auditor, organization of enterprises.
(B. 113.890)

DIE VERANLAGUNG 1994
LOHNSTEUER.
Einkommensteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. 10. Auflage.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 1664. 69.- DM.
The assessment 1994 wages tax. Compilation of German Income Tax Law, implementation directive, administration guidelines and other laws as they are valid for the assessment to German wages tax (income tax levied as withholding tax from employees) in 1994.
(B. 113.715)

BALS, B.
Steuer-Ratgeber zur Einkommen- und Lohnsteuer 1993.
Munich, Verlag Franz Rehm GmbH. 1993, pp. 288. 39.80 DM.
Income tax/wages tax 1993. Guide to the income tax declaration 1993, including texts of the laws and tables to determine tax due.
(B. 113.171)

LINGEMANN, Wolfgang.
Das rechtliche Konzept der Familienbesteuerung.
Berlin, Duncker & Humblot GmbH. 1994.
Schriften zum Steuerrecht, Band 47, pp. 271. 98.- DM.
The legal concept of taxation of families. The author discusses the treatment of a family unit for tax purposes.
(B. 113.739)

SCHNELLÜBERSICHT
EINKOMMENSTEUER.
Für den Veranlagungszeitraum 1993.
Bearbeitet von Heinz Richter und Willi Winter. 28. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 110. 38.80 DM.
Quick reference guide for the 1993 assessment year. Topics include deductions, taxation of employees, professional education, ABC of dwelling-houses, income-related expenses.
(B. 113.634)

STUBER, Helmut; OPPOLZER, Adolf.
Die Einkommensteuer-Erklärung für 1993. 53. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 309. 38.- DM.
Income tax declaration 1993. The book gives instructions to file the income tax form for 1993 as well as the mandatory appendices. Also included is an overview of the most important tax saving structures.
(B. 113.636)

BRANDENBERG, H.B.; BOVELETH, K.H.
Die neuen Einkommensteuerrichtlinien 1993.
Cologne, Peter Deubner Verlag. 1994.
Steuer-Telex Sonderinformation, pp. 99. 38.80 DM.
The new Income Tax Directives for 1993. Explanation and text of the revised 1993 guidelines for the tax administration.
(B. 113.710)

SEIBOLD, W.; STEGMÜLLER, H.; HORN, W.
Die Gewerbesteuer- und Umsatzsteuer-Erklärung für 1993. 45. Auflage.
Bonn, Stollfuss Verlag. 1994, pp. 120. 40.- DM.
Business tax/VAT declaration 1993. Instructions on filing the business tax forms and VAT forms. In particular typical questions regarding the tax base, deductions or liability to tax are answered. The most recent administrative guidelines and case law are considered in the explanations.
(B. 113.635)

SCHAUMBURG, Harald.
Internationales Steuerrecht.
Aussensteuerrecht, Doppelbesteuerungsrecht.
Cologne. Verlag Dr. Otto Schmidt. 1993, pp. 907. 195.- DM.
Comprehensive textbook on German international tax law. Included are basic principles, the system of unlimited and limited liability to tax and the domestic and treaty rules for the avoidance of double taxation.
(B. 113.898)

NEVERMANN, Karsten.
Justiz und Steuerumgehung. Ein kritischer Vergleich der Haltung der Dritten Gewalt zu kreativer steuerlicher Gestaltung in Grossbritannien und Deutschland.
Berlin, Duncker & Humblot GmbH. 1994.
Schriften zum Steuerrecht, Band 48, pp. 346. 148.- DM.
The courts and tax evasion. Comparative study of the case law of the courts in the UK and Germany on matters of creative tax planning.
(B. 113.740)

PRAKTIKER-HANDBUCH 1994.
Allgemeines Steuer- und Verfahrensrecht.
7. Auflage. Bearbeitet von Jochen Thiel, Roland Schiefer und Martina Kappert.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 2088. 115.- DM.
General Tax Law and Procedure Law. 1994 Manual for practitioners regarding tax law (in general) and procedural law. The manual contains tax provisions of e.g. the Fiscal Code, Tax Court Procedure Code, administrative guidelines and case law.
(B. 113.612)

DAHLKE, Kay.
Bilanzprobleme bei Immobilieninvestitionen im Beitrittsgebiet. Ausgewählte Fragen der Darstellung im handelsrechtlichen Jahresabschluss einer Kapitalgesellschaft.
Düsseldorf, IDW Verlag. 1994, pp. 450. 98.- DM.
Auditing problems with real property investments in the new Länder. The author discusses issues in auditing real property investments caused by the German reunification.
(B. 113.713)

STIBI, Bernd.
Statistische Jahresabschlussanalyse als Instrument der steuerlichen Betriebsprüfung. Entwicklung eines Indikators für die Auswahl prüfungsbedürftiger Betriebe.
Düsseldorf, IDW Verlag GmbH. 1994.
Schriften des Instituts für Revisionswesen der Westfälischen Wilhelms-Universität Münster, pp. 282. 68.- DM.
Statistical analysis of year-end closures as an instrument of investigation by tax authorities for tax purposes. The author developed an indicator for the selection of enterprises which need an investigation.
(B. 113.711)

KOHL, Stefan.
Gewinnrealisierung bei langfristigen Aufträgen. Eine kritische Analyse zur Anwendung des Realisationsprinzips in Handels- und Steuerbilanz.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 209. 88.- DM.
Realization of profits from long-term contracts. The author examines the problems in auditing long-term contracts.
(B. 113.888)

MÖSSNER, Jörg Manfred.
Steuerrecht-Fundstellen 1991. Rechtsprechung – Verwaltung – Schrifttum.

© 1994 International Bureau of Fiscal Documentation

Munich, Verlag C.H. Beck. 1993, pp. 483. 123.- DM.
Tax law bibliography 1991. Bibliography to case law, administration, articles and books.
(B. 113.587)

SCHROTH, Klaus-Dieter.
Handbuch zum Aussenwirtschaftsverkehr.
Herne, Verlag Neue Wirtschafts-Briefe GmbH. 1994, pp. 762. 150.- DM.
Handbook for foreign trade. Guide to foreign trade, terms and definitions, law on foreign trade, administration guideline to the Law on Foreign Trade, international business relations, cross border trade, international capital transfer, risks and safeguarding, international contract law, financing of foreign trade, documents and securities.
(B. 113.680)

BAETGE, Jörg.
Konzernbilanzen.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 553. 68.- DM.
Balance sheets of groups. Comprehensive handbook on consolidated balance sheets of groups.
(B. 113.609)

WIRTSCHAFTSGESETZE. 11. AUFLAGE
Düsseldorf, IDW Verlag GmbH. 1994, pp. 969. 48.- DM.
Business laws. Commercial code, corporation law, law on companies with limited liability, law on the increase of capital, law on cooperatives, etc.
(B. 113.611)

STEUERGESTALTUNG BEI VERBUNDENEN
Unternehmen in Europa. Bericht über die IDW Steuerfachtagung am 14-15.9.1993 in Neuss.
Düsseldorf, IDW Verlag GmbH. 1994, pp. 329. 88.- DM.
Tax planning of groups in Europe. Report on the Seminar of the Institute of Auditors in Germany on 14 and 15 September 1993. The topics discussed include location for holding companies, international business structures and reorganizations as well as factors to consider in making Germany a location for holding companies.
(B. 113.610)

Italy

MEMENTO PRATICO IPSOA–FRANCIS
Lefebvre: Fiscale 1994. Aggiornato al 5 febbraio 1994.
Paris, Editions Francis Lefebvre. 1994, pp. 1146.
Comprehensive handbook on direct and indirect taxes. The book is intended to solve all tax practical problems, particularly with respect to computation of taxes, compliance and penalties.
(B. 113.967)

Liechtenstein

KNELLER, Michael W.
Die Haftung für die Verwaltung einer liechtensteinischen Stiftung unter besonderer Berücksichtigung von Art. 159 IPRG.
Zürich, Schulthess Polygraphischer Verlag. 1993.
Zürcher Studien zum Privatrecht, No. 101, pp. 130. 45.- Sfrs.
Liability for the administration of a Liechtenstein-based foundation. The author discusses the private law foundation under Liechtenstein company law and international private law, focusing in particular on the issue of liability.
(B. 113.543)

CARL, Dieter; KLOS, Joachim.
Standort Liechtenstein. Leitfaden für unternehmerische und private Aktivitäten.
Herne, Verlag Neue Wirtschafts Briefe. 1993, pp. 315. 120.- DM.
Guide for entrepreneurial and private activities. An overview and description of the legal system of Liechtenstein, i.e. its company law, tax law, banking law. Sample forms for the opening of bank accounts, depots, the setting up of trusts and institutes and the like are also provided.
(B. 113.454)

Luxembourg

INTERNATIONAL TAX AND BUSINESS
Guide: Luxembourg.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 105.
Information guide on Luxembourg tax system, investment climate, value added tax, accounting and auditing, individual and corporate income taxes, customs duties, municipal business tax, inheritance and gift taxes.
(B. 113.925)

Netherlands

ROMYN, M.
Internationaal belastingrecht. 5th Edition.
The Hague, M. Romyn. 1994, pp. 197. 69.- Dfl.
Fifth updated edition of international tax law in the Netherlands dealing with double taxation agreements and unilateral regulations, including taxation of non-residents.
(B. 114.015)

Slovak Republic

LIEBSCHER, Christoph; SVORCIK, Otakar.
Die Kapitalgesellschaft nach tschechischem und slowakischem Recht.
Vienna, Linde Verlag Wien GmbH. 1993, pp. 169. 365.- AS.
Introduction to Czech and Slovakian company law.
(B. 112.780)

Switzerland

CAGIANUT, Francis; HÖHN, Ernst.
Unternehmungssteuerrecht. 3. Auflage.
Bern, Verlag Paul Haupt. 1993.
Schriftenreihe Finanzwirtschaft und Finanzrecht, No. 46, pp. 855.
Basic principles of taxation, investment and financing, assessment of taxable profit by determining earnings and expenses, restructuring and liquidation.
(B. 113.463)

ZUPPINGER, Ferdinand; BRUNNER-PETERS, Rebecca; UMBRICHT, Robert P.
Das Recht der direkten Bundessteuer 1995.
Zurich, Schulthess Polygraphischer Verlag. 1993, pp. 471.
The Direct Federal Tax Law 1995. Text of the law which will enter into force on 1 January 1995. The text is provided for in the official German, French and Italian languages and in an unofficial English version. An introduction to the Direct Federal Tax Law – in four languages – is also given.
(B. 113.537)

BOLLIGER, Bruno; HÜSSY, René.
Neues Bundesgesetz über die direkte Bundessteuer DBG 1995.
Basel, Helbing & Lichtenhahn Verlag AG. 1993, pp. 334. 68.- Sfrs.
The 1995 Direct Federal Tax Law. The book contains the Direct Federal Tax Law, circulars issued to ensure proper application of the Direct Federal Tax Law, the decree on the levying of the
direct federal tax (the legal basis for levying the direct federal tax up until 31 December 1994), decrees issued with regard to the decree on levying the direct federal tax, the federal law on the harmonization of direct taxation of the cantons and municipalities.
(B. 113.653)

HÖHN, Ernst; ATHANAS, Peter.
Das neue Bundesrecht über die direkten Steuern. Direkte Bundessteuer und Steuerharmonisierung.
Bern, Verlag Paul Haupt. 1993.
Schriftenreihe Finanzwirtschaft und Finanzrecht, No. 64, pp. 460.
The book contains 10 contributions by different authors on the new Federal Direct Tax Law. The topics include: taxable enterprise profit, taxation of corporations, holding and domiciliary companies under the Federal Law on the Harmonization of Direct Taxation of the Cantons and Municipalities, restructuring of enterprises under the new Federal Direct Tax Law and under the Federal Law on the Harmonization of Direct Taxation of the Cantons and Municipalities, withholding taxes, assessment periods, etc.
(B. 113.464)

REHBINDER, Manfred; ZÄCH, Roger.
Schweizerische Gesetze. Sammlung des Zivil-, Wirtschafts- und Strafrechts.
Bern, Stämpfli & Cie AG.; Munich, Verlag C.H. Beck. 1994.

© 1994 International Bureau of Fiscal Documentation

Loose-leaf publication containing a compilation of Swiss laws on civil, economic and criminal law as of January 1994.
(B. 113.523)

United Kingdom

THE COMPANY CAR 1994/95.
London, Touche Ross & Co. 1994, pp. 42.
(B. 113.904)

HARDMAN ON TAX IN BUSINESS
1994/95. A practical guide to the taxation of companies and those who work for them.
Updated by John Dixon and Kevin Thorne.
London, Gee Publishing Limited. 1994, pp. 546. £ 30.-.
This edition is written on the basis of the law and practice in force at 31 May 1994 and incorporates changes made by the Finance Act 1994. Part I includes the system of corporation tax, capital allowances, losses, trading overseas, tax planning. Part II covers VAT. Part III includes payroll procedures and taxes, social security contribution. Part IV discusses the taxation of directors and employees, including benefits in kind, inheritance tax, employee share ownership and share schemes.
(B. 113.987)

NEVERMANN, Karsten.
Justiz und Steuerumgehung. Ein kritischer Vergleich der Haltung der Dritten Gewalt zu kreativer steuerlicher Gestaltung in Grossbritannien und Deutschland.
Berlin, Duncker & Humblot GmbH. 1994.
Schriften zum Steuerrecht, Band 48, pp. 346.
148.- DM.
The courts and tax evasion. Comparative study of the case law of the courts in the UK and Germany on matters of creative tax planning.
(B. 113.740)

INTERNATIONAL

FUNDS AND FUND MANAGEMENT,
An international survey of taxation & regulations.
Dublin, KPMG Stokes Kennedy Crowley, 1 Stokes Place, Dublin 2, Ireland. 1994, pp. 273.
(B. 113.968)

BADURA, Karl-Heinz.
Die besten Steueroasen für ihr Geld weltweit.
Düsseldorf, ECON Verlag GmbH., Postfach 300321, 40403 Düsseldorf, Germany. 1994, pp. 342.
The best tax havens for your money worldwide. This advice book explains worldwide tax havens.
(B. 113.869)

WENEHED, Lars-Erik.
How to calculate. A handbook for international tax practitioners.
Deventer, Kluwer Law and Taxation Publishers. 1994, pp. 296.
This publication describes calculations of the tax effects of cross-border payments within a multinational group of companies.
(B. 113.693)

MIDDLE EAST

Egypt

INTERNATIONAL TAX AND BUSINESS
Guide: Egypt.
New York, Deloitte Touche Tohmatsu International. 1994, pp. 70.
Guide to provide potential investors information about investing in Egypt, information on tax planning, employment and labour considerations, financing, importing, exporting and accounting matters.
(B. 13.492)

Loose-leaf Services

Received between 1 and 30 September 1994

AFRICA

FISCALITE AFRICAINE
release 14
Editions Fiduciaire, Paris.

AUSTRALIA

AUSTRALIAN TAX PRACTICE

- Rulings and Guidelines
  releases 155-157

Butterworths, North Ryde.

BELGIUM

BTW GECOORDINEERDE AANSCHRIJVINGEN
release 11
Kluwer rechtswetenschappen, Deurne.

COMMENTAAR OP HET WETBOEK VAN DE INKOMSTENBELASTING
release 9
Ministry of Finance, Brussels.

COMMENTAIRE DU CODE DES IMPOTS SUR LES REVENUES
release 9
Ministry of Finance, Brussels.

L'INDICATEUR FISCAL
release 93
CED Samsom, Brussels.

CANADA

GLOBAL INVESTMENT IN CANADA
release 108
Prentice Hall of Canada Ltd., Scarborough.

INCOME TAXATION IN CANADA – REPORT BULLETIN
releases 903-906
Prentice Hall of Canada Ltd., Scarborough.

DENMARK

SKATTEBESTEMMELSER
- Moms
  releases 6 and 7
- Skattenyt
- Kronologisk
  releases 19 and 20
- Skattebestemmelser
- Systematisk
  release 12

A.S. Skattekartoteket Informationskontor, Copenhagen.

EEC

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN
- Verdragsteksten en aanverwante stukken
  release 347

Kluwer, Deventer.

FRANCE

FISCALITE PRATIQUE – FISCAL
release 4
Editions Francis Lefebvre, Levallois-Perret.

JURIS CLASSEUR – CODE FISCAL
release 251
Editions Techniques, Paris.

GERMANY

ABC FÜHRER LOHNSTEUER
release 39
Verlag Schäffer & Co., Stuttgart.

DEUTSCHE STEUERPRAXIS – NACHSCHLAGWERK PRAKTISCHER STEUERFÄLLE
Felix
release 158
Verlag Dr Otto Schmidt, Cologne.

EINKOMMENSTEUER- UND KÖRPERSCHAFTSTEUERGESETZ MIT NEBENGESETZEN
Raupach - Herrmann
release 176
Verlag Dr Otto Schmidt, Cologne.

EINKOMMENSTEUERGESETZ – KOMMENTAR
Kirchhof - Sohn

© 1994 International Bureau of Fiscal Documentation

release 54
C.F. Müller Juristischer Verlag, Heidelberg.

HANDBUCH DER BAUINVESTITIONEN UND IMMOBIEL-KAPITALANLAGEN
release 69
C.F. Müller Juristischer Verlag, Heidelberg.

KOMMENTAR ZUM ERBSCHAFTSTEUERGESETZ UND SCHENKUNGSTEUERGESETZ
Kapp
release 32
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM GEWERBESTEUERGESETZ
Lenski - Sternberg
release 72
Verlag Dr Otto Schmidt, Cologne.

KOMMENTAR ZUM ABGABENORDNUNG UND FINANZGERICHTSORDNUNG
release 142
Verlag Dr Otto Schmidt, Cologne.

KÖRPERSCHAFTSTEUER – KOMMENTAR
Kläschen
release 19
Stollfuss Verlag, Bonn.

STEUERERLASSE IN KARTEIFORM
releases 395 and 396
Verlag Dr Otto Schmidt, Cologne.

STEUERRECHTSPRECHUNG IN KARTEIFORM
release 512
Verlag Dr Otto Schmidt, Cologne.

UMSATZSTEUERGESETZ (MEHRWERTSTEUER) – KOMMENTAR
Rau - Dürrwachter - Flick - Geist
release 78
Verlag Dr Otto Schmidt, Cologne.

UMWANDLUNGSRECHT
Widmann - Mayer
release 25
Stollfuss Verlag, Bonn.

INTERNATIONAL

INTERFISC TAX TREATY SERVICE
John Dewhurst
release 62
J.F. Chown, London.

THE INTERNATIONAL TAX TREATIES
release 18
The International Tax Treaty service, In-Depth Publishing Ltd., Dublin, Ireland.

STEUERN IN EUROPA, USA, KANADA UND JAPAN
Mennel
release 27
Verlag Neue Wirtschafts-Briefe GmbH., Herne.

NETHERLANDS

BELASTINGWETTEN (DE BELASTINGGIDS)
release 169
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
Editie J.M.M. Creemers.
release 103
Gouda Quint/D. Brouwer, Arnhem.

BELASTINGWETGEVING
- Loonbelasting
  release 155

Noorduijn BV., Arnhem.

CURSUS BELASTINGRECHT
Mobach
release 219
Gouda Quint/D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING
- Motorrijtuigenbelasting
  releases 35 and 36

Kluwer, Deventer.

FISCAAL FUNDAMENT
release 1
Kluwer, Deventer.

FISCALE MODELLEN
release 60
Kluwer, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER
- Algemene wetgeving inzake douane
  releases 12-14
- Tarief van invoerrechten
  releases 115 and 116

Kluwer, Deventer.

KLUWERS FINANCIEEL ZAKBOEK
release 13
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK
releases 153-155
Kluwer, Deventer.

KLUWERS TARIEVENBOEK
release 438
Kluwer, Deventer.

LEIDRAAD BIJ DE BELASTINGGIDS
Van Soest - Meering
release 129
Gouda Quint/D. Brouwer, Arnhem.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
release 176
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
releases 146 and 147
Gouda Quint/D. Brouwer, Arnhem.

DE SOCIALE VERZEKERINGSWETTEN
- Algemene deel
  release 80
- Coord. SV/Premieheffing
  release 28
- Heffing over uitkeringen en loon
  release 56
- AOW/AWW
  release 67
- AWBZ
  releases 119 and 120

Kluwer, Deventer.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
releases 301-303
Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE
- Algemene deel
  release 240
- Inkomstenbelasting 1964
  release 919
- Investeringsregelingen
  release 167
- Invorderingswet
  release 60
- Lokale belastingen en milieuheffing
  releases 20 and 21
- Loonbelasting
  releases 593 and 594
- Successiewet 1956
  release 174
- Vennootschapsbelasting
  releases 333 and 334
- Vermogensbelasting 1964
  releases 162 and 163

Kluwer, Deventer.

NORWAY

SKATTE-NYTT
A, releases 7 and 8
B, release 8
Norsk Skattebetalerforening, Oslo.

PERU

CODIGO TRIBUTARIO
release 50
Editorial Economia y Finanzas, Lima.

IMPUESTO A LA RENTA
release 70
Editorial Economia y Finanzas, Lima.

IMPUESTO A LAS VENTAS
release 79
Editorial Economia y Finanzas, Lima.

UNITED KINGDOM

SIMON'S TAX CASES
releases 30 and 31
Butterworth & Co., Sevenoaks.

© 1994 International Bureau of Fiscal Documentation

CUMULATIVE INDEX – 1994

I. ARTICLES

Asean:
Victor T. Chew:
A Primer on the Asean Free Trade Area 594

Australia:
Ann O'Connell:
Capital Gains Tax Amendments 176

Michael Dirkis:
The Times They Are A'Changing: Tax Reform in 1993/94 492

Abe. I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Belgium:
Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Benelux:
Paul Sleurink, Hans Decleir and Veronique Sway:
Holding Companies 271

Botswana:
Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

Canada:
Nathan Boidman:
Transfer Pricing: Current Canadian Perspective 457

Marianne Burge:
The Conduit Regulations: Canadian Investors Beware! 469

Robert Couzin:
The Ontario Fair Tax Commission: Tax reform in Action 380

Blair P. Dwyer and Katherine A. Thiessen:
The Division of Canadian Taxing Powers: A Tug of War, with Taxpayers in the Middle 392

James S. Hausman and Kathleen V. Penny:
Cross-Border Reorganizations Involving Canadian Corporations 442

Allan R. Lanthier:
Acquiring, Holding and Financing Canadian Corporations 419

Stephen S. Ruby:
Highlights of the 1994 Canadian Budget 402

Ingrid Sapona:
Taxation of Foreign Affiliates 430

Jacques Sasseville:
Interpretation of Double Taxation Conventions in Canada: An Update 374

Gary J. Webb:
Structuring International Joint Ventures: Canadian Tax Issues to Consider 448

China (People's Rep.):
Jinyan Li:
New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64

Implementing Regulations for the New Income Tax Law 250

Cuba:
Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Denmark:
Bente Møll Pedersen:
Joint taxation: A Unique Way of Reducing Corporate Tax 574

Dominican Republic:
Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

France:
Olivier Delattre and Clotilde Fournier:
Tax Regime of Holding Corporations 281

Pierre-Jean Douvier:
Three Percent Tax on Real Estate in France 89

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

Germany:
Dr Thomas Töben:
Holding Companies 285

Hong Kong:
Ian Harris:
Budget Bonanza 257

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

India:
G.K. Kawatra:
1994/95 Budget 197

International:
Pierre-Jean Douvier:
Choosing the Right Location for Pooled Services of a Group of Companies 7

Lynette V. Eastmond:
Public International Law Aspects of Some Transfer Pricing Issues 351

Diane Hay, Frances Horner and Jeffrey Owens:
Past and Present Work in the OECD on Transfer Pricing and Selected Issues 508

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Parthasarathi Shome and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Vito Tanzi and Parthasarathi Shome:
A Primer on Tax Evasion 328

Bruce Zagaris:
Financing Participation in Caribbean Basin Investment and Trade in the Aftermath of Reduced Section 936 567

© 1994 International Bureau of Fiscal Documentation

Israel:
Taxation of Corporations 141

Japan:
Vicki L. Beyer
1994 Tax Reforms 487

Latin-America:
Ruben Diaz, Jr.:
Selected Tax Aspects of Investment 306

Liechtenstein:
Dr Norbert Seeger:
The Differential Tax Treatment of Offshore and Domestic Companies 579

Malaysia:
Veerinderjeet Singh:
The 1944 Budget and Recent Developments – The Path to Sustainable Growth 94

Mexico:
Barry Larking:
International Tax Treaty Developments: The Mexican Experience 537

New Zealand:
Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Adrian J. Sawyer:
Tax Implications of the New Companies Act 1993 167

Update on the Tax Implications of the New Companies Act 1993 504

Adrian J. Sawyer:
A Proposed Binding Ruling Regime 582

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Pakistan:
Ahmad Khan:
1994-95 Budget 592

Poland:
Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland – Implications for the Foreign Investor 123

Portugal:
William T. Cunningham:
Recent Developments 185

Russia:
Dr Elena Markina:
Results of Initial Implementation of Tax Reform 338

Qatar:
Finbarr Sexton:
Taxation Regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

Singapore:
Lee Fook Hong:
1994 Budget 347

Switzerland:
Dr Nico H. Burki:
Holding Companies 292

Wiliam Bush:
Low Tax Opportunities 183

United Kingdom:
Michael McGowan:
Setting up a UK International Holding Company 296

United States:
David M. Benson and Matthew M. McKenna:
Deductibility of Interest and Other Financing Charges in Computing Income 310

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Peter J. Connors and Michael F. Patton:
New Transfer Pricing Penalty Regulations Require Immediate Action to Avoid Overvaluation Penalties 529

Peter J. Connors and Robert M. Spevack:
Does The Brown Group Case Spell the Effective End of Subpart F? 534

Kenneth J. Krupsky, Esq.:
New IRS Transfer Pricing Documentation Requirements 321

Leonard W. Rothschild, Jr.:
California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3

Worldwide Combined Reporting Ruled Constitutional as *Barclays* Loses in the US Supreme Court: What are the Options for a Foreign-Based Company? 525

James J. Tobin and William R. Seto:
Hybrid Entities 315

II. REPORTS AND DOCUMENTS

International:
Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 521

III. IFA NEWS 41, 200, 260, 269, 371, 545, 598

IV. CONFERENCE DIARY 55, 81, 137, 207, 267, 327, 483, 506, 578

V. BIBLIOGRAPHY
- Books 45, 103, 150, 201, 261, 358, 476, 547, 606
- Loose-leaf services 49, 107, 154, 205, 266, 366, 480, 559, 613
- List of addresses of the major publishing houses appearing in the Bibliography 51

© 1994 International Bureau of Fiscal Documentation

LIST OF AUTHORS – 1994

Esther L. Aristy and Pedro O. Gamundí:
Tax and Investment in the Dominican Republic 33

David M. Benson and Matthew M. McKenna:
Deductibility of Interest and Other Financing Charges in Computing Income 310

Vicki L. Beyer:
1994 Tax Reforms 487

André H. Boekhoudt and Thomas P. North:
Withholding Tax on "Contingent Interest" under the New US–Netherlands Treaty 630

Nathan Boidman:
Transfer Pricing: Current Canadian Perspective 457

Sarah Bolderson and Theodoor Huiskes:
Meeting Tax Obligations in Central and Eastern Europe 648

Marianne Burge:
The Conduit Regulations: Canadian Investors Beware! 469

Marianne Burge and Cym Lowell:
How to Avoid US Transfer Pricing Penalties 180

Dr Nico H. Burki:
Holding Companies 292

William Bush:
Low Tax Opportunities 183

Peter J. Connors and Michael F. Patton:
New Transfer Pricing Penalty Regulations Require Immediate Action to Avoid Overvaluation Penalties 529

Peter J. Connors and Robert M. Spevack:
Does the Brown Group Case Spell the Effective End of Subpart F? 534

Victor T. Chew:
A Primer on the ASEAN Free Trade Area 594

Robert Couzin:
The Ontario Fair Tax Commission: Tax Reform in Action 380

William T. Cunningham:
Recent Developments 185

Marc Dassesse:
Introduction of the "Economic Reality" Test in Belgian Tax Law: Years of Uncertainty Ahead? 127

Hans Decleir:
See under Paul Sleurink, Hans Decleir and Veronique Sway

Olivier Delattre and Clotilde Fournier:
Tax Regime of Holding Corporations 281

Ruben Diaz, Jr.:
Selected Tax Aspects of Investment 306

Michael Dirkis:
The Times They Are A'Changing: Tax Reform in 1993/94 492

Pierre-Jean Douvier:
– Choosing the Right Location for Pooled Services of a Group of Companies 7
– Three Percent Tax on Real Estate in France 89

Blair P. Dwyer and Katherine A. Thiessen:
The Division of Canadian Taxing Powers: A Tug of War, with Taxpayers in the Middle 392

Lynette V. Eastmond:
Public International Law Aspects of Some Transfer Pricing Issues 351

Julio Escolano:
See under Parthasarathi Shome and Julio Escolonao.

Clotilde Fournier:
See under Olivier Delattre and Clotilde Fournier

Pedro O. Gamundí:
See under Esther L. Aristy and Pedro O. Gamundí

David A. Gantz:
Implications of Free Trade Arrangements for Investment in the Caribbean Basin 211

Abe I. Greenbaum:
State Excise Taxes and The Constitution: *Capital Duplicators Pty. Ltd. v. Australian Capital Territory (1 & 2)* 239

Ian Harris:
Budget Bonanza 257

James S. Hausman and Kathleen V. Penny:
Cross-Border Reorganizations Involving Canadian Corporations 442

Diane Hay, Frances Horner and Jeffrey Owens:
Past and Present Work in the OECD on Transfer Pricing and Selected Issues 508

Kevin Holmes and Mark Russell:
The New Underlying Foreign Tax Credit and Foreign Dividend Withholding Payment Regimes 111

© 1994 International Bureau of Fiscal Documentation

Frances Horner:
See under Diane Hay, Frances Horner and Jeffrey Owens

Theodoor Huiskes:
See under Sarah Bolderson

Glenn P. Jenkins:
Modernization of Tax Administrations: Revenue Boards as Instruments for Change 75

Annette T. Johnson:
Taxation of Foreign Investment in The Republic of Cuba 130

Philippe Juilhard:
Transfer of the Avoir Fiscal to Non-residents: New Rules, Opportunities and Practical Considerations 191

G.K. Kawatra:
1994/95 Budget 197

Ahmad Khan:
1994-95 Budget 592

Michael Kobetsky:
Foreign Banks: Defining the Personality 243

Piotr Kowalski:
See under Matthew O'Shaughnessy and Piotr Kowalski

Kenneth J. Krupsky, Esq.:
New IRS Transfer Pricing Documentation Requirements 321

Allan R. Lanthier:
Acquiring, Holding and Financing Canadian Corporations 419

Barry Larking:
International Tax Treaty Developments: The Mexican Experience 537

Lee Fook Hong:
- 1994 Budget 347

Leonard D. Levin:
A Short History of the Portfolio Interest Exemption and US Real Estate Investment by Non-Residents and Foreign Corporations: Too Much of a Good Thing 624

Jinyan Li:
- New Individual Income Tax – Unified Taxation of Citizens and Foreigners 64
- Implementing Regulations for the New Income Tax Law 250

Cym Lowell:
See under Marianne Burge and Cym Lowell

Dr Elena Markina:
Results of Initial Implementation of Tax Reform 338

Michael McGowan:
Setting up a UK International Holding Company 296

Matthew M. McKenna:
See under David M. Benson and Matthew M. McKenna

Ken Messere:
- Consumption Tax Rules 665

Thomas P. North:
See under André H. Boekhoudt

Ann O'Connell:
Capital Gains Tax Amendments 176

Matthew O'Shaughnessy and Piotr Kowalski:
Vat in Poland - Implications for the Foreign Investor 123

Jeffrey Owens:
See under Diane Hay, Frances Horner and Jeffrey Owens

Michael F. Patton:
See under Peter J. Connors and Michael F. Patton

Bente Møll Pedersen:
Joint Taxation: A Unique Way of Reducing Corporate Tax 574

Kathleen V. Penny:
See under James S. Hausman and Kathleen V. Penny

Leonard W. Rothschild, Jr.:
- California's New "Water's Edge" Election Enhances Business Opportunities for Foreign Investors: the US Supreme Court to Rule in *Barclays* Case 3
- Worldwide Combined Reporting Ruled Constitutional as *Barclays* Loses in the US Supreme Court: What are the Options for a Foreign-Based Company? 525

Stephen S. Ruby:
Highlights of the 1994 Canadian Budget 402

H. Onno Ruding:
International Tax Policy at the Crossroads: New Developments and Possible Avenues for Reform 619

Mark Russell:
See under Kevin Holmes and Mark Russell

Ingrid Sapona:
Taxation of Foreign Affiliates 430

Jacques Sasseville:
Interpretation of Double Taxation Conventions in Canada: An Update 374

© 1994 International Bureau of Fiscal Documentation

Adrian J. Sawyer:
- A Proposed Binding Ruling Regime 582
- Raising the Threshold for Taxpayer Compliance: A new Era of Compliance Standards and Penalties 655
- Tax Implications of the New Companies Act 1993 167
- Update on the Tax Implications of the New Companies Act 1993 504

Dr Norbert Seeger:
The Differential Tax Treatment of Offshore and Domestic Companies 579

Finbarr Sexton:
Taxation Regime for Foreign Entities Following the Fundamental Reform of Existing Income Tax Regulations 14

William R. Seto:
See under James J. Tobin and William R. Seto

Parthasarathi Shome:
See under Vito Tanzi and Parthasarathi Shome

Parthasarathi Shome and Julio Escolano:
The State of Tax Policy in the Central Asian and Transcaucasian Newly Independent States 159

Veerinderjeet Singh:
The 1994 Budget and Recent Developments – The Path to Sustainable Growth 94

Paul Sleurink, Hans Decleir and Veronique Sway:
Holding Companies 271

Arnold J. van der Smeede:
Towards a Gradual Abolition of Capital Tax?

Andrew M.C. Smith:
Taxation of Non-Resident Equity Investment in New Zealand: Unilateral Extension of Domestic Imputation Regime to Non-Resident Portfolio Investors 59

Martin A. Smith:
An Overview of the Accrual Provisions and Issues Arising Thereunder 218

Robert M. Spevack:
See under Peter J. Connors and Robert M. Spevack

Veronique Sway:
See under Paul Sleurink, Hans Decleir and Veronique Sway

Peter Nanyenya Takirambudde:
Double Corporate tax: Untangling the Undergrowth of Company and Shareholder Tax Rules 82

Lin Mei Tan and Stuart Tooley:
Tax Simplification: Progress to Date 236

Vito Tanzi and Parthasarathi Shome:
A Primer on Tax Evasion 328

Seth E. Terkper:
Improving the Accountancy Content of Tax Reform in Developing Countries 21

Katherine A. Thiessen:
See under Blair P. Dwyer and Katherine A. Thiessen

James J. Tobin and William R. Seto:
Hybrid Entities 315

Dr Thomas Töben:
Holding Companies 285

Stuart Tooley:
See under Lin Mei Tan and Stuart Tooley

Jefferson P. VanderWolk:
Recent Developments Regarding the Source of Profits 138

Gary J. Webb:
Structuring International Joint Ventures: Canadian Tax Issues to Consider 448

Stef van Weeghel:
Recent Case Law 637

Bruce Zagaris:
Financing Participation in Caribbean Basin Investments and Trade in the Aftermath of Reduced Section 936 567

© 1994 International Bureau of Fiscal Documentation