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GOODBYE MR BACHMANN, WELCOME MR WIELOCKX

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I. INTRODUCTION

On 11 August 1995, the EC Court of Justice (the EC Court) held in the *Wielockx* case[1], that the Dutch regime of the fiscal pension reserve (Fiscale Oudedags Reserve or FPR) discriminates between resident and non-resident taxpayers and is therefore contrary to Article 52 of the EC Treaty. This article examines the judgement given by the EC Court and explores its implications for Member States.

II. AN OVERVIEW

Mr Wielockx was a Belgian national who resided in Belgium. He worked as a physiotherapist in a partnership in the Netherlands. All his activities were performed, and his income earned in that country. Under the Belgium–Netherlands Treaty the taxing right in respect of the income he received as a physiotherapist had been allocated to the Netherlands.[2]

For the purposes of the Dutch Individual Income Tax Act 1964 (IITA) Mr Wielockx was a non-resident taxpayer. In the 1987 tax year he wished to claim a deduction of NLG 5,145 being a contribution to the FPR. Mr Wielockx was refused the deduction as according to the IITA only resident taxpayers were entitled to claim the deduction. Mr Wielockx appealed against this refusal to the Dutch Court of Appeal of 's-Hertogenbosch.

The Court of Appeal subsequently submitted the following three questions to the EC Court.

1. Does Article 52 of the Treaty establishing the EEC or any other provision of that Treaty, preclude a Member State, such as the Netherlands, from levying a tax on the income of natural persons whereby taxable persons receiving profits from a business enterprise are accorded the right to constitute a pension reserve, thereby reducing gross income (see Article 3(3)(a), in conjunction with Article 44d to 44l inclusive, of the IITA 1964 in the version in force for the year in question), if that right is not granted to a taxable person who is a national of, and resident in, another Member State who receives profits from a business enterprise in the first-mentioned Member State on which he is liable to pay the above mentioned tax?
2. In this context, is it relevant that on the basis of Chapter III of the IITA 1964 (Taxable Amount in the Case of Foreign Taxable Persons) sums withdrawn from the pension reserve do not form part of the taxable Dutch income of the foreign taxable person? Thus under the current Dutch tax regime, the connection between the deductibility of contributions to the pension reserve and the taxability of receipts derived therefrom is broken in the case of non-resident taxable persons.
3. Does the fact that the foreign taxable person earns all or almost all of his income through activities performed in the first-mentioned Member State have a bearing on the issue?

The Court examined the three questions together and ruled in answer to them as follows.

A rule laid down by a Member State which allows its residents to deduct from their taxable income business profits which they allocate to form a pension reserve but denies that benefit to Community nationals liable to pay tax who, although resident in another Member State, receive all or almost all their income in the first state, cannot be justified by the fact that the periodic pension payments subsequently drawn out of the pension reserve by the non-resident taxpayer are not taxed in the first State but in the State of residence – with which the first State has concluded a double taxation convention – even if, under the tax system in force in the first State, a strict correspondence between the deductibility of the amounts added to the pension reserve and the liability to tax of the amounts drawn out of it cannot be achieved by generalizing the benefit. Such discrimination is therefore contrary to Article 52 of the EC Treaty.

III. THE FPR

The Dutch legislator introduced the scheme of the FPR to enable self-employed persons to save for their old age. The FPR constitutes a mathematical quantity that represents a portion of income on which tax has not yet been paid. Under the scheme a self-employed person may annually deduct an amount, depending on profits, from his gross income. This

1. C-80/94.
2. The referring Court of Appeal of 's-Hertogenbosch and the Advocate General (point 10 and note 10 of the Opinion) believe that the activities of Mr Wielockx fall under Art. 7 of the Belgium–Netherlands Tax Treaty (business profits), while the EC Court (para.14) and the Commission (point 10 and note 10 of the Opinion) hold that the activities of Mr Wielockx fall under Art. 14 (income from independent personal services). In the Report for the Hearing, point 7, reference is also only made to Art. 14 of the Treaty.

deduction constitutes the *deductible contribution* to the FPR. On the occasion of *inter alia* termination of the business activities of the self-employed person, his/her no longer being a resident taxpayer or, at that time, reaching the age of 65, income tax must be paid on the total amount of the FPR. These events constitute *taxable withdrawals* from the FPR. The charge to tax may be avoided by purchasing an annuity (for instance from an insurance company) to the amount of the FPR. This is called: *conversion* of the FPR. This conversion is tax-free, but the later periodic payments from the annuity are taxed at the progressive rate being, at the time of the *Wielockx* case, a maximum of 72%.

The legislator has explicitly wished to disconnect the FPR from the source "business profits" in order to emphasize the personal nature of the FPR.[3] That is why the contribution to the FPR is deducted from the gross income and not from the profit calculation.[4]

IV. FREEDOM OF ESTABLISHMENT

The EC Court first examined whether it was a matter of discrimination, overt[5] or covert[6], by reason of nationality. In its case law the EC Court gives a very wide interpretation to this prohibition to discriminate. The residence criterion may produce discrimination according to nationality, if this operates mainly to the disadvantage of nationals of other Member States. After all, the non-residents are often foreigners.[7]

Discrimination occurs in the event of the application of different rules to comparable situations or the application of the same rule to different situations.[8]

A. Comparable cases

As in the *Schumacker* case[9] the EC Court held that in the field of direct taxes the situation of resident and non-resident taxpayers is generally not comparable. There are objective differences between the two situations; the sources of income may be different, there may also be a divergence in the way in which the relevant states take into account the person's ability to pay the tax or their personal and family circumstances (paragraph 18). If the non-resident taxpayer receives all or almost all of his income in the state where he works, this non-resident taxpayer is objectively in the same situation as the resident taxpayer who does the same work there. Both are taxed on the same taxable income in that state alone (paragraph 20).

The EC Court explicitly limits the application of the principle of equal treatment to the situation in which the non-resident taxpayer receives all or almost all of his income in the state where he works. This is in line with the views of the Advocate General (AG) who regards as decisive the question as to whether the non-resident taxpayer receives (almost) all of his income in the state where he works or not (point 27 of the AG's Opinion). The third question of the Court of Appeal is therefore answered in the affirmative. In the *Schumacker* case, in which the income of the wife also played a part, the EC Court was less restrictive in its formulation. The EC Court referred to "the major part of his taxable income" (paragraph 36) "the major part of his income and almost all his family income" (paragraph 38) and "obtains his income entirely or almost exclusively from work performed in the first State" (paragraph 47).

This inconsistent terminology and the opinion of the AG in the *Schumacker* case[10], which on the one hand mentioned the standard from the Commission Recommendation (75% threshold)[11] and on the other hand the standard from the Treaty between Germany and the Netherlands (90% threshold)[12] gave rise to the supposition that the EC Court had not yet made up its mind as to which threshold should be used. However the *Wielockx* judgment, and the clear conclusion of the AG on this point, indicates that the court may well have come down in favour of the criterion that all or almost all the income must have been derived from the state where the work is performed. Although the Court, as in the *Schumacker* case, does not mention any quantitative criterion, it does seem to want to abandon the 75% threshold from the Recommendation of the Commission. In our view "almost all" seems to point more in the direction of a 90% than 75% threshold.[13]

We would like to emphasize that the EC Court regards the deductible contribution, under the FPR, as a deduction related to the personal circumstances of the taxpayer (see also under III, last paragraph, especially note 3). For that reason the EC Court applies its *Schumacker* ruling, using the all, or almost all, income criterion. The question arises whether the EC Court would also use this criterion with respect to deductions and allowances that do not relate to the person or his family, but to the profits (self-employed individual) or (salary) income (employed individual). From paragraphs 19 and 20 of the *Avoir Fiscal* case, one could conclude that if the

3. See also Report for the Hearing, *Wielockx* case, point 5 and 23. From point 23 it is clear that the Dutch Government took the position that the deductions under the FPR are personal allowances.
4. In his Opinion in the *Wielockx* case Advocate General Léger wrongly presumes that the contributions to the FPR are deducted from the taxable income instead of from the gross income (see point 25 and point 46). The same error is made by the EC Court in para. 21. See also Report for the Hearing, point 4.
5. Para. 18, 270/83 (*Avoir Fiscal*).
6. Para. 11, 152/73 (*Sotgiu*); para. 13, C-175/88 (*Biehl*); para. 14, C-330/91 (*Commerzbank*); para. 15, C-1/93 (*Halliburton*); para. 9, 22/80 (*Boussac*); para. 23, 41/84 (*Pinna*); para. 10, C-111/91 (*Commission/Luxembourg*); para. 32, C-221/89 (*Factorame II*); para. 42, C-279/89 (*Commission/UK*); para. 14, C-389/92 (*Mund*).
7. Opinion of the Advocate General, point 20; see also para. 28, C-279/93 (*Schumacker*).
8. See para. 17, *Wielockx* case; para. 30, C-279/93 (*Schumacker*); para. 30, C-281/82 (*Unifrex*); para. 16, 810/79 (*Überschär*); para. 7, 283/83 (*Racke*); para. 29, 84/87 (*Erpelding*); para. 37, C-271/91 (*Spain/Commission*); para. 21, C-85/90 (*Dowling*).
9. C-279/93.
10. Para. 15 of C-279/93 shows that Mr Schumacker worked in Germany from 15 May 1988 up to and including 31 December 1989 while he resided in Belgium. During 1988 Mrs Schumacker received unemployment benefit in Belgium.
11. Commission recommendation of 21 December 1993, on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident (94/97/EC). *Official Journal L 39*, 10 February 1994.
12. The Frontier Workers Regulation.
13. In C-107/94, (*Asscher*), a ruling on the extent of the threshold could be expected.

profits or the (salary) income of the resident and non-resident taxpayer are treated in the same way for income tax purposes, no (additional) all, or almost all, income criterion would be required for equal treatment. However, new case law is required to determine whether this preliminary conclusion will be upheld by the EC Court.

B. Self-employed or employed person

In paragraph 20 the EC Court describes in which circumstances the non-resident taxpayer is objectively in the same situation as the resident taxpayer. As far as the non-resident taxpayer is concerned the EC Court refers to the "employed or self-employed person".

Given that Mr Wielockx is self-employed the reference to "employed or self-employed person" indicates that the EC Court wanted to give a more general rule applying both to employed and self-employed persons. This view is further reinforced by the references (paragraphs 16 and 18) of the EC Court to the *Schumacker* case, as Schumacker was an employee.[14]

We therefore believe that when considering the question of discrimination of taxation treatment on the basis of nationality the EC Court does not wish to distinguish between employed and self-employed persons; at least in cases in which the national legislation distinguishes between resident and non-resident taxpayers. It seems plausible to us that this should also apply to cases in which schemes/facilities available to a Member State's own nationals are normally denied to nationals of other Member States. We refer to the cases of *Biehl*[15] (no refund of excessive wage tax deducted, upheld in the *Schumacker* case), *Bachmann*[16] (deductibility of voluntary sickness and invalidity insurance and life insurance contributions) and the *Commission versus Belgium*[17] (group pension plan contributions).

Herzig/Dautzenberg[18] argue that the discrimination prohibition for employed persons (Article 48 of the EC Treaty) differs from that for self-employed persons (Article 52 EC Treaty) in the sense that Article 48 of the EC Treaty also prescribes equal treatment of nationals of other Member States while Article 52 of the EC Treaty only prescribes equal treatment in comparison with their own nationals. Although the EC Court in the *Wielockx* case did not consider the issue of the most favoured nation clause it seems unlikely to us that the EC Court would want to treat employed and self-employed persons any differently on this point[19]. The fact that in paragraph 20 of the *Wielockx* case the EC Court speaks both of employed and self-employed persons and equates them completely tends to confirm our view.

V. JUSTIFICATION

A. General

If a tax regime has been held to discriminate, the next question that must be answered is whether that discrimination may be justified. As in the *Bachmann* case[20] and the *Schumacker* case[21] the principle of fiscal cohesion was advanced in the *Wielockx* case in order to attempt to justify the discrimination.

In paragraph 23 of the *Wielockx* case the EC Court formulates the reliance on cohesion as follows:

In order to justify the fiscal disadvantage suffered in this respect by non-resident taxpayers, the Dutch Government relies on the principle of fiscal cohesion laid down in C-204/90 *Bachmann v. Belgium* [1992] ECR I-249, according to which there must be a correlation between the sums which are deducted from this taxable income and the sums which are subject to tax. If a non-resident could set up a pension reserve in the Netherlands and thus secure a right to a pension, that pension would not be taxed in the Netherlands since, by virtue of the double-taxation convention between Belgium and the Netherlands referred to above, such income is taxed in the State of residence.

B. The impact of tax treaties

The criticism of the cohesion principle advanced in the *Bachmann* case[22] was *inter alia* that the EC Court misjudged the operation of tax treaties.[23] This misjudgment relates to the fact that in the event of payment of pension premiums to a Belgian insurance company there is no guarantee that the later pension payments will be taxed in Belgium. After all,

14. In the same sense A.J. Rädler, An analysis of the European Court of Justice's Schumacker Decision. *Tax Notes International*, 15 May 1995, at 1685 and J. Wouters in his annotation under the Halliburton Case, *TRV*, 1995, at 406.
15. C-175/88
N.B. Also in the *Biehl* case there was a requirement of residency. Sec. 154(6) of the Luxemburg *Loi sur l'impôt sur le revenu* provided that the excessive wage tax deducted could not be reclaimed if an employed person was only a resident taxpayer of Luxembourg for part of the year because he settled there in the course of the year or left Luxembourg. Mr Biehl moved from Luxembourg to Germany in the course of the year and could for that reason not reclaim the excessive wage tax deducted from his salary earned in Luxembourg.
16. C-204/90.
17. C-300/90. C-204/90 and C-300/90, both ruled on 28 January 1992 will be quoted by us as the *Bachmann* case.
18. N. Herzig and N. Dautzenberg, Der EWG-Vertrag und die Doppelbesteuerungsabkommen, *Der Betrieb* 1992, Heft 50, 11 Dezember 1992.
19. In the same sense M. Gammie and G. Brannan, "EC Law strikes at the UK Corporation Tax. The Death Knell of UK Imputation?" *Intertax*, 1995, at 402 and 403. In their contribution these authors *inter alia* discuss a complaint by a German company with a subsidiary in the UK (Hoechst AG) and an Italian company with a subsidiary in the UK (Pirelli Spa) from which two actions result against the UK Inland Revenue concerning the ACT system applicable there. According to the authors these companies may also rely on the fact that the UK-Netherlands Treaty does grant a tax credit to Dutch investors where as the treaties with Germany and Italy do not allow a credit to Italian and German investors. In that case the Court may at last express itself explicitly and finally on the most favoured nation clause.
20. C-204/90 and C-300/90.
21. C-279/93.
22. C-204/90 and C-300/90.
23. See B. Knobbe-Keuk, "Restrictions on the fundamental freedoms enshrined in the EC Treaty by discriminatory tax provisions", *EC Tax Review*, 1994, at 80 and 81; Hinnekens/Schelpe, *EC Tax Review*, 1992, at 58; H.J. Kamphuis and F.P.G. Pötgens "Schumacker ofwel onder welke omstandigheden wordt de buitenlands belastingplichtige behandeld als een binnenlands belastingplichtige?", *Weekblad voor Fiscaal Recht*, 1995, at 654; M. Dassesse, L' Arrêt Bachmann et la loi du 28 décembre 1992: une Victoire à la Pyrrhus?, *J.D.F.* 1992, at 323, 324 and 334.

most treaties concluded by Belgium follow Articles 18 and 21 of the OECD Model Convention 1992-1994 as a result of which the power to levy tax subsists with the state of residence.

In paragraph 26 of the *Avoir Fiscal* case[24] the EC Court held that a tax treaty cannot justify an infringement of community law (see also point 67 of the Opinion of the AG in the *Wielockx* case)[25]. A treaty that is contrary to the EC Treaty must remain inoperative. This follows from the precedence of the EC Treaty over other tax treaties.[26]

In the *Schumacker* case, particularly in paragraphs 16 and 32, the EC Court also takes the OECD Model Convention as a starting point for the distinction between resident and non-resident taxpayers. In the *Wielockx* case moreover the operation of tax treaties, which followed the OECD Model Convention, was even considered decisive for rejecting the cohesion of a national tax system as grounds for justification. After all, owing to the operation of tax treaties the Netherlands may tax all pensions received by its residents, irrespective of the state in which the premiums have been paid. On the other hand the Netherlands waives the right to tax pension payments that are received abroad even if the premiums for these pension payments were deducted in the Netherlands (paragraph 24). The AG (point 54) and the Court (paragraph 25) reach the conclusion that the cohesion is achieved at another level, namely that of a treaty concluded with another Member State.

C. Distinguishing *Bachmann*

In view of the above we believe that the EC Court disassociates itself from or gives a finer specification of the cohesion principle than that originally formulated in the *Bachmann* case. It should be pointed out that the AG in his Opinion on the *Wielockx* case bore in mind paragraph 26 from the *Bachmann* case and therefore proceeded very cautiously. The EC Court stated:

It is true that bilateral Conventions exist between certain Member States allowing the deduction for tax purposes of contributions paid in a State other than the one in which the advantage is granted, and recognizing the power of a single State to tax sums payable by the insurers under the contracts concluded with them. However, such a solution is possible, only by means of such Conventions or by the adoption by the Council of the necessary coordination or harmonization measures.

In paragraph 26 of the *Bachmann* judgment the EC Court took the position that tax treaties must be interpreted with due caution and that it was not possible to conclude from the relevant treaty that the state where work was performed had abandoned the cohesion principle (point 56 of the Opinion of the AG in the *Wielockx* case).

From the above it is apparent that in the *Bachmann* case the Court demanded cohesion at a national level while in the *Wielockx* case cohesion at the tax treaty level prevented the Dutch Government from relying on cohesion at a national level. In our view the different stance taken by the court cannot be explained by the fact that while Bachmann was a resident taxpayer, Wielockx was not. After all, in both cases the Court found that discrimination on the basis of nationality had occurred. We believe that if the EC Court had to reconsider the *Bachmann* case, it would now give a very different judgement.

D. Proportionality

In view of paragraph 26 of the Bachmann case the AG remarked in the *Wielockx* case that the discrimination could not be justified. According to the AG the reason for this was that, unlike the *Bachmann* case, in the *Wielockx* case the Netherlands could guarantee its ability to levy taxes because the debtor of the pension payments, namely the enterprise, was established in the Netherlands.[27] A commitment of the enterprise to pay the tax on the pension payments therefore forms a sufficient guarantee (proportionality test). In the *Wielockx* case the debtor (the insurance company) was established in the same Member State as the party relying on the cohesion (the Netherlands).[28] In the *Bachmann* case, however, the relevant insurance company was established in a different Member State (Germany) to the one relying on cohesion (Belgium).

From this it follows that in the absence of cohesion at convention level[29] one must determine in which Member State the insurance company is established. In the event of establishment in the state where the work is done the reliance on cohesion may perhaps not be possible because of the proportionality test.[30] (see also E paragraph three, last sentence).

E. The second question

The EC Court's interpretation of the second question was remarkable. In this question the Dutch Court of Appeal referred to cohesion at a national level. This appears from the reference to "Chapter III of the IITA 1964 (Taxable Amount in the Case of Foreign Taxable Persons)" and the cohesion between deductibility and tax liability "in the prevailing Dutch taxation system" (paragraph 12). The EC Court ignored this, however, and referred directly to the Belgium-Netherlands Treaty, on the basis of which the right to levy tax is due to Belgium and not to the Netherlands (paragraph 14). Question two is answered in paragraph 27 (Judgement) and reiterated in the operative part of the judgement.

24. 270/83.
25. See also the Opinion of AG, M. Darmon in the *Commerzbank* Case, C-330/91, points 19 to 23.
26. Art(s). 5 and 234 of the EC Treaty; see Opinion of AG Mancini in the *Avoir Fiscal* Case, 270/83, point 7; 235/87 (*Matteucci*).
27. The enterprise is not, for that matter, the debtor of the pension payment. In our view this does not detract from the validity of the AG's arguments.
28. For that matter the AG is wrong to assume that the FPR belongs to the capital of the enterprise (point 61).
29. For instance because in a treaty a right to levy tax is allocated in full or in part to the state where the work is done. See *intra* V.E. and Art. 18(2) of the UK–Netherlands Treaty.
30. Please note the EC Court did not rule on this point.

Also noteworthy is the fact that the Dutch Court of Appeal sees cohesion between "the deductibility of contributions to the pension reserve and the liability to taxation of sums removed therefrom" (paragraph 12) while the EC Court refers to the "periodic pension payments subsequently drawn out of a pension reserve by the non-resident taxpayer" (paragraph 14).

We would point out that by the term "periodic pension payments subsequently drawn out of a pension reserve by the non-resident taxpayer" the EC Court must have had in mind the situation where the pension reserve is converted (untaxed) into an annuity. When reading the *Wielockx* case it should be taken into account that the EC Court did not consider the question of taxable withdrawals from the FPR when reaching its judgment. This is the more surprising because under paragraph 6 it discusses the taxable liquidation of the FPR when the age of 65 is reached. Is it not obvious to compare such taxable withdrawals to the lump sum payment of a pension? It is Dutch convention policy to allocate the right to levy tax on the lump sum payment of pensions in full or in part to the state where the work is done. Recent examples are Article 18(2) of the treaties with the United States and Canada. Deblauwe remarks that within the OECD framework it is even being considered to allocate the right to tax private pensions payments unconditionally to the state where the work is done.[31] In those cases the state where the work is done does not waive its right to levy tax. If this occurs there will be no cohesion at treaty level, although owing to the retained right to levy tax there is no reason to deprive the non-resident taxpayer of the FPR. After all, national cohesion is guaranteed, by virtue of the right, to levy tax on the pension payments.

See annex for an overview of the right to levy tax on lump sum pension payments in the respective treaties between the Member States of the European Communities.

VI. THE TAX VACUUM

In spite of the fact that in the *Wielockx* case the EC Court disassociates itself from the cohesion of the national tax system in respect of pension (and in our opinion also annuity) payments, the judgement is not entirely satisfactory. After all in this case, the withdrawals from the FPR have been allocated to Belgium.[32] It is unlikely that Belgium will levy any tax on the withdrawals from the FPR since we believe that it will probably treat the FPR as an individual provision.[33] This means that the withdrawals from the FPR in Belgium will be tax free.[34] In this connection it must be noted, however, that the tax free status of the pension receipts results from the operation of the tax treaty and the difference in national tax systems. The fact that this creates a more favourable position for the non-resident taxpayer Mr Wielockx is not relevant, EC case law is consistent on this point.[35]

It is important for the Member States that sums do not escape tax simply because of the divergent tax treatment that exists between them. The free traffic of employees and the rights of free establishment of self-employed persons must not be impeded by fiscal legislation. In this connection the refusal of a deduction is no more appropriate than a levy vacuum. It could be argued that cohesion is therefore necessary at a European Union level: deduction in one Member State and tax levy in the same or in another Member State. We believe that such a cohesive fiscal system at an European Union level could only be reached by means of legislation. In this regard the Commission's Recommendation is a good first step.

VII. TREATY CHARACTERIZATION OF THE FPR

The question that arises is how the withdrawals from the FPR are to be characterized under the Belgium–Netherlands Treaty.

In the action before the Dutch Court of Appeal Mr Wielockx took the position that by virtue of Article 25(4)[36] of the Treaty he was also entitled to application of the FPR because the FPR was supposed to concern the tax levy of the permanent establishment in the Netherlands. The Dutch Court of Appeal held, also in view of the provisions of Article 3(2) of the Treaty[37], that under Dutch tax law the FPR does not refer to the tax levied on the permanent establishment. This decision also applied for the purposes of the Treaty.

Owing to the personal nature of the FPR and the manner in which the Dutch legislator has substantiated this, namely deduction from the gross income and not from profit, we support the decision of the Dutch Court of Appeal. This means that in our opinion withdrawals from the FPR do not qualify *vis-à-vis* Article 7 of the Belgium–Netherlands Treaty. In our view this conclusion would not be altered if the activities of Mr Wielockx had been taxable under Article 14 of the Treaty (income from independent personal services). The OECD Commentary to Article 14 shows that its application should be linked to Article 7 in so far as possible because the articles are based on the same principles.[38]

31. R. Deblauwe,"Internationale Belasting op Pensioenen", *Internationaal Fiscaal Praktijkboek*, Kluwer, 1994, at 91.
32. See P.H.J. Essers and O.A.W.J. Janssen, "Fiscale grensvergelijkingen" Kluwer, 1994, at 56; see also the Dutch Government in the Report for the Hearing of point 24.
33. See P. Kavelaars "Belastingvlucht naar België" *Gouda Quint*, 1992, at 33, which reaches the same result in connection with the comparable and meanwhile discontinued Art(s). 19 and 32 (rights to periodic payments).
34. In this connection we characterize the withdrawals as lump sum payments.
35. See Commerzbank, C-330/91, para. 13; Avoir Fiscal, 270/83, para. 19; Biehl, 175/88, para. 15; see also Keller C-27/71.
36. Art. 25, para. 4 of the Belgium–Netherlands Treaty provides:
"The taxation on a permanent establishment which an enterprise of one of the States has in the other State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities."
(No official translation; translation of IBFD).
37. Art. 3, para. 2 of the Belgium–Netherlands Treaty states the following:
"As regards the application of the Convention by either of the States, any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that State relating to the taxes which are the subject of this Convention." (No official translation; translation of IBFD).
38. Commentary on the OECD Model Tax Convention 1992-1994, Art. 14, para. 3.

The fact that in Article 14 the personal nature of the independent labour is more prominent than in Article 7 does not alter the conclusion that the FPR is not source-bound and must therefore not be linked to the income that follows from independent personal services.

Owing to the absence of a specific provision we believe the withdrawals from the FPR qualify under Article 21 of the Treaty (the other income article).[39] We therefore find it curious that both the AG (points 52 and 53 of his opinion) and the EC Court (paragraphs 8, 23 and 24) consider Article 18 applies to such withdrawals. Article 18 is not relevant because this Article refers to pensions and other similar remuneration, paid in consideration of past employment, whilst the FPR relates solely to the individual taxpayer[40]. The fact that the FPR is intended to enable the self-employed to build up pension provisions does not of itself alter this.

The question arises as to why the EC Court itself interpreted (and applied) the tax treaty, in imitation of the AG. The EC Court could just as well have left this matter to the referring national judge. In answering the preliminary question the EC Court could suffice with an explanation of its nuanced *Bachmann* version, namely, that an appeal to the coherence principle from the Bachmann judgements is not applicable, if the right to levy tax in the treaty has been surrendered. However, it is possible that the EC Court consciously elected to interpret the Treaty. Indeed, if it was left to the national judges of the various Member States to interpret the relevant treaties, *vis-à-vis* the scope of the Community law (coherence principle), an uniformed explanation of Community law would by no means be guaranteed. Possibly, the EC Court had foreseen this problem and perhaps for that reason elected to interpret the Treaty itself. If this is the case the interpretation of the treaties, as far as such interpretation is significant for the explanation of Community law, would be withdrawn from the competence of the national judges.

39. In Belgium pensions for self-employed persons also fall under the other income art. See for the above Deblauwe, loc. cit. at 103; L. de Broe "Dubbelbelastingverdragen", *Fiscaal Compendium*, part 18, no. 3.1. and part 21 no. 3.1.2; The general comment of the Belgian Tax Administration on the agreements to prevent double taxation, Art. 18 no. 31.

40. There is no question that the FPR relates to employment income.

Annex

Overview of the right to levy tax on lump sum pension payments in the Tax Treaties as concluded between the EU Member States

	NL	B	DK	D	E	F	IRE	I	L	P	UK	SF	S	A	GR
NL															
B	R														
DK	R	R													
D	R	R	R												
E	R	R	R	R											
F	R	R	R*	R	R										
IRE	R	R	S	R	R	R									
I	S	R	R	R	R	R	R								
L	R	R	R	R	R	R*	R	R							
P	NTT	R	R	R	R	R	R	R	NTT						
UK	S	R	R	R	R	R	R	R	R	R					
SF	R	R	R*	R	R	R	R	R	R	R	R				
S	S	R	R	R	R	R	R	R	R & S*	NTT	S	R*			
A	R	R	R	R	R	R	R	R	R	R	NTT	R	R		
GR	S	R	S*	R	NTT	R	NTT	R	R	NTT	R	R	R	R	

R = state of residence
S = state of source
NTT = no tax treaty
* other income article

NL = Netherlands, B = Belgium, DK = Denmark, D = Germany, E = Spain, F = France, IRE = Ireland, I = Italy, L = Luxembourg, P = Portugal, UK = United Kingdom, SF = Finland, S = Sweden, A = Austria, GR = Greece

MADAGASCAR

Overview of the Tax System and Recent Reforms

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I. INTRODUCTION

Madagascar, the world's fourth largest island, is located 430 kilometres off the coast of southern Africa. With a per capita national product of 200 US dollars (1992 est.), the country is one of the poorest nations in the world. Over three quarters of the labour force is engaged in subsistence agriculture, while agriculture accounts for approximately 30 percent of GDP and 70 percent of all exports. The country's main exports are coffee, vanilla and cloves. The Malagasy Franc (FMG), the national currency, is exchanged at a rate of approximately FMG 2,000 for one US dollar.

Madagascar's tax system faces a fundamental crisis. Tax revenues are less than adequate to finance basic public sector services. Tax revenues as a percentage of GDP have declined in recent years. The current tax structure is overly complex and distortional. It is also fragmented, and contains a large number of taxes that are obsolete and raise very little revenue. Tax administration is antiquated in structure and programmes, and lacks computerization. As a consequence, tax evasion is widespread and appears to have worsened in recent years.

Because of the dual nature of the economy with a modern and mostly urban sector and a traditional and informal sector, most taxes fall on a relatively small number of taxpayers in the formal sector. This has induced a host of problems. Taxpayers have sought relief by putting on political pressure and lobbying for a generous and discretionary system of fiscal incentives. At the same time, the high tax pressure on narrow bases has been a factor contributing to tax evasion.

This article provides a summary of the tax structure in Madagascar. Due to the highly fragmentary nature of the tax system, only the most important taxes will be discussed in detail. Changes in direct and indirect taxation introduced by the *Loi de Finances pour 1995* and the *Loi Rectificative à la Loi de Finances pour 1995* have been included in this overview.

II. TAXES ON INCOME AND PROFITS

Taxes on personal income and corporate profits accounted for approximately 17 percent of total tax revenues in 1993. The budget changes for 1994 involve a reduction of their contribution to about 12 percent. Table 1 reports tax revenues for 1994 by economic category, in nominal as well as in percentage terms. The relative decrease in importance of taxes on incomes, profits and capital is partly a reflection of the increased emphasis on indirect taxation. Although it is hard to estimate the impact, collections from income taxes suffer from a higher than normal lack of compliance and from a very generous and poorly controlled package of tax incentives.

A. Corporate profit taxation

By and large, the most important of the income taxes is the corporate income tax or IBS (*impôt sur les bénéfices des sociétés*). Madagascar's corporate income tax is in many ways a fairly standard corporate income tax. However, in some aspects it becomes a complex and highly distortional tax compared to similar taxes found in many other countries. Given the current structure of the corporate income tax, it is highly likely that the effective marginal rate of taxation of a standard investment will differ very considerably by sectors and even by type of asset, ranging from almost confiscatory rates to heavy subsidies. This pattern of taxation, of course, leads to a very uneven playing field and therefore to significant economic distortions.

Coverage

The corporate income tax follows the territorial principle. All net income derived in Madagascar by national or foreign companies is subject to tax. Excluded from tax are different forms of interest income from Treasury bills and savings deposits. Capital gains from the sale of buildings are exempt from the IBS, but are covered by a separate tax. The determination of the tax base is conventional with respect to the inclusion of revenues and costs of production.

All taxes except for the IBS are deductible. However, taxes paid on income derived from capital under the IRCM (*impôt sur les revenus de capitaux mobiliers*) are credited.

Adjustments and timing of income issues

The law is silent about the valuation of inventories for tax purposes, does not allow for depletion allowances, and leaves it to ministerial order to establish the regime for depreciation allowances. The most frequently allowed depreciation schedule is the straight line method calculated by reference to the historical cost or book value of the asset. The Ministry of Finance rarely allows the use of more generous methods such as double declining or accelerated depreciation.

The IBS allows a general carry-forward of losses for three years and there is no provision for carry-back. The net operating losses realized during the first two years of new companies in agriculture, mining, industry, and hotel services can be carried forward for two years. The maximum loss offset in any year cannot exceed 75 percent of the enterprise's capital or 2 percent of total receipts in the year.

There is no provision for indexation for inflation. Of course, the lack of indexation tends to inflate profits artificially because depreciation allowances and inventory valuation adjustments do not incorporate the actual cost of replacement for these items. It should be noted, however, that this effect may be counterbalanced when interest payments constitute a significant expense item. This is because the deduction for interest costs does not get adjusted for that component of interest payments that is simply a compensation for keeping the principal constant in real terms. Of course this lack of indexation tends to understate profits. The advantage of being able to deduct nominal interest charges is enhanced by the fact that a large portion of the interest income received by the firms is free of tax.

Investment incentives

The IBS legislation provides for very generous investment credits and it discriminates among different types of activities. Enterprises in agriculture, mining, industry, transportation, and hotel services are allowed an investment tax credit of 50 percent. The investment tax credit for all other sectors is 25 percent. However, any enterprise that in the judgement of the Minister of Finance is contributing to the goals of the Economic Plan, may be granted an investment tax credit of 100 percent. The tax credit is limited to 50 percent of the tax liability due in any one year. All investment credits can be carried forward for five years, subject to the annual overall limitation of 50 percent of the tax liability.

The investment incentives in the income tax legislation are in addition to those granted in the Investment Code. The Investment Code grants investment credits and tax holidays to qualifying investment projects, it also provides these projects with exemptions from the customs tariff and indirect taxes. To qualify, the projects must be in agriculture, mining, industry, transport or hotel services. The Government is currently working on the reform of the Investment Code. The main goal of the reform is to rationalize the set of fiscal incentives and make the awarding of these incentives more objective and ex-post.

Filing

Enterprises have to file an information return every year before 1 March. If the enterprise fails to present the information return, the tax administration is authorized to proceed to the assessment of tax based on their knowledge of similar enterprises. Similar provisions exist to control the diversion of net profits, through transfer pricing or extraordinary charges, or *vis-à-vis* holding companies also operating abroad.

For all enterprises which close their accounts at dates other than 30 June or 31 December, any tax that is due will be grossed upward by 50 percent. This applies whether the firms are domiciled in Madagascar or abroad. This rule prevents three or more companies with different accounting dates from colluding in shifting expenses or revenues from one company to another during the course of the year to minimize taxable profits. However, this rule also discriminates against local subsidiaries of foreign corporations which apply the practice of worldwide uniformity of accounting date.

Tax rates

The tax rates structure is complex and discriminatory. The general tax rate is 45 percent, but it is reduced to 35 percent for enterprises in agriculture, mining, industry, transportation and hotel services. Those companies operating in more than one sector can claim the lower rate of 35 percent if at least 75 percent of their gross receipts originate in the lower-rate sectors. In addition, foreign enterprises operating in Madagascar pay a surtax of 50 percent, in effect putting the nominal rates for these enterprises to the extraordinarily high levels of 67.5 percent or 52.5 percent. The surtax does not apply to those foreign companies that are involved in joint ventures with local enterprises, or who are working under a contractual arrangement with local enterprises.

Oil companies are subject to a separate income tax regime (*impôt direct sur les hydrocarbures*) with a different rate structure. These companies pay a rate of 45 percent when their profitability does not exceed 15 percent, with profitability determined on a net cash-flow basis. For rates of return above 15 percent they pay a graduated surtax as follows: 25 percent for rates of return between 15 percent and 20 percent, 33.3 percent for rates of return between 20 percent and 25 percent, and 50 percent for rates of return over 25 percent.

The horizontal equity and economic impact of the corporate income tax gets further complicated because the Minister of Finance can at his discretion lower the tax rates to either 30 percent, 20 percent or 10 percent for those enterprises deemed to be contributing to the Economic Plan.

Minimum tax

All enterprises are subject to a minimum tax. For enterprises in agriculture, industry, mining, petroleum, tourism or transport, the minimum tax is FMG 200,000 plus 5 per mille of the turnover (*chiffre d'affaires de l'exercise*). For all other enterprises the minimum tax is FMG 800,000 plus 5 per mille of turnover. The fiscal minimum tax does not apply to new enterprises during a start-up period of one year. New enterprises in agriculture, mining, industry, transport and hotel services are exempt from the minimum tax for the first three years of operation.

B. Personal income taxation

The general personal income tax or IGR (*impôt général sur les revenus des personnes physiques*) follows the corporate income tax in terms of revenue collections. The IGR is the result of the recent consolidation of two schedular taxes, one falling on wage and salary income previously known as IRSA (*impôt sur les revenus salariaux et assimilés*) and the other falling on professional and business income previously known as IRNS (*impôt sur les revenus non-salariaux*). In fact, this consolidation was more nominal than effective because the two sources of income continue to be taxed under two different regimes. The schedular nature of the system of personal income taxation is also revealed by the fact that income from capital is taxed independently under the IRCM (*impôt sur les revenus des capitaux mobiliers*) as are capital gains under the TPI (*taxe sur la plus-value immobilière*). However, there is some measure of integration in that taxpayers with both salary and non-salary income get their taxes calculated on total income.

Salary income

The most important feature of the income tax on salaries is that it is a final withholding tax on wages. Employers withhold the tax from the monthly pay cheques and transfer the payments to the tax authorities. Employees have no obligation to file an annual return, so there is no adjustment or adding up of incomes from different sources. This practice contrasts with a conventional global income tax using a withholding or PAYE (pay-as-you-earn) system in which taxpayers still have the obligation to file an annual return especially if they hold more than one job.

The tax rate schedule for salary income was modified by the *Loi Rectificative à la Loi de Finances pour 1995*, providing a zero rate for monthly incomes less than FMG 125,000. The schedule continues to be steeply progressive, incorporating eight separate tax bands (including the zero rate bracket). Marginal tax rates range from 5 percent for monthly incomes over FMG 126,000 but less than FMG 200,000 rising fast to 35 percent for monthly incomes in excess of FMG 1,000,000 (the equivalent of approximately USD 500).

Some of the progressiveness is negated by the fact that salary incomes from holding several jobs never get aggregated and that employees can claim a minimum exempt allowance in each of the separate jobs. Of course, this loophole is a source of horizontal inequities among salaried workers. Another problem associated with the lack of an annual return is that the withholding agents, the employers, have little incentive to check the accuracy of the personal and family allowance claims made by their employees. There are no special deductions or allowances from the tax base. Instead there is a credit of FMG 500 per month per dependent.

Non-salary income

This is one of the most difficult areas of taxation from the viewpoint of enforcement. In Madagascar, as in other tax systems, there appears to be a large number of professionals and individual businessmen that either escape income taxation altogether or grossly underreport their true earnings.

The reform of 1990 that introduced the IGR made great strides to cast the tax net wide to include non-compliant taxpayers. The law provides three different taxation regimes for taxpayers with non-salary incomes: the regular regime based on actual incomes, the regime for small enterprises, and the regime of *forfait*. Taxpayers with professional or business income are supposed to file an information return before 1 March with information on their incomes and professional or business costs for the previous year. Firms subject to the other two regimes also have to report domicile and other basic information by 1 March. Based on this information, tax officials do the actual calculation of the tax and in September the notification of taxes due are sent out to taxpayers. When no information return is filed, tax inspectors are authorized to calculate the tax due based on objective criteria including the external signs of the taxpayer's purchasing power. Tax inspectors also can adjust income upwards according to external signs of the purchasing power of taxpayers as signalled by the ownership of housing, cars, servants, trips abroad, and transfers of foreign exchange abroad. Despite these innovations there appears to be a large number of evaders.

The tax rate schedule for non-salary income is different than that which applies to salary income, with a minimum tax component of FMG 5,000 for monthly net incomes under FMG 250,000. For net incomes between FMG 251,000 and 500,000 the tax rate is 5 percent and rises by 5 percentage points along seven more brackets. The marginal highest rate is 45 percent for incomes over FMG 5 million. Although the progressive rates for non-salary reach a top rate of 45 percent, compared with 35 percent for salary income, the average effective rate for taxpayers earning the same income tends to be considerably lower for non-salary income due to the differences in tax bands. The only exception is for low non-salary incomes, because regardless of how low the income is the taxpayer still owes FMG 5,000. Taxpayers with only non-salary income are also entitled to a dependent tax credit of FMG 6,000 (per dependent) each year.

There is a set of very generous credits for investment and savings under the IGR tax. This supposedly could apply to those taxpayers with either salary or non-salary income. But the lack of annual returns for those taxpayers with only salary income de facto precludes the application of the investment and savings credits to this type of income. The investment credit mirrors to a large extent the investment tax credits available under the corporate income tax regime, but is actually more generous in its coverage. The investment credit is granted for 50 percent of the acquisition cost of new equipment, the construction of buildings or the construction of new residential housing for the taxpayer. This credit has a limit of 50 percent of the income tax liability for the year. The excess credit can be carried forward for four years, subject to the same limitation of 50 percent of the tax liability in any one year. The savings credit is granted for savings deposits at designed financial institutions and for the purchase of Treasury bills. The actual credit is 25 percent of total savings during the year. The limit in any one year is 50 percent of the tax liability and this limit has to be computed together with the investment tax credit. That is, the combined offset cannot exceed 50 percent of the tax liability. For the savings tax credit the law refers to savings during the year rather than net savings.

Capital income

Capital income from financial assets is taxed through the IRCM (*impôt sur les capitaux mobiliers*). This tax also operates as a withholding tax retained either by the institution paying interest, or the company distributing dividends. The general tax rate is 25 percent, but rates of 8, 35 and 45 percent are applied to exceptions specified in the law. The rate is 40 percent if the taxpayers receiving the income are not known to the tax administration. The IRCM tax paid is creditable against the general income tax, IGR.

However, the taxation of income from financial assets is less than even. While one form of income derived from capital, dividends, is subject to double taxation, another form, namely interest, is tax free. At the present time, the following types of interest income are tax free: interest earned on time deposits (deposits blocked for one year) in approved financial institutions, interest earned on one-year loans, interest earned on savings accounts blocked for at least 6 months, and interest earned on Treasury bonds.

In addition to the taxation of some capital income through the IRCM, some capital gains, such as those from the sale of land and buildings, are taxed through the TPI (*taxe sur la plus-value immobilière*) which has a graduated rate schedule. There are four rates (5, 10, 20, and 30 percent) depending on the size of the capital gains. The highest rate of 30 percent applies to capital gains of FMG 1 million or higher. Capital gains from the sale of financial assets or mobile goods are not subject to the TPI. All income transfers to foreigners not subject to tax under the different income taxes are subject to a transfer tax, the TFT (*taxe forfaitaire sur les transferts*). This is a final tax withheld by the payee at a rate of 15 percent.

III. INDIRECT TAXATION

On paper, the current structure of indirect taxation in Madagascar has the three main components of a modern system of indirect taxation; a broad base general tax on consumption, the excise taxation of several commodities including petroleum products, and the customs tariff for international transactions. An additional source of indirect tax revenue arises because of the existence of state monopolies in the production and marketing of tobacco, alcoholic beverages and matches.

A. General consumption taxes

Prior to January 1994, the main instrument of indirect taxation in Madagascar was the TUT (*taxe unique sur les transactions*), a form of the usual tax credit or invoice type value added tax. The TUT rate was 15 percent and it was applied to manufacturers, wholesalers and importers. Although the TUT was introduced in the 1960s, Madagascar's tax administration did not prepare enough to administer this type of tax properly. The main difficulty was the inability to control fraudulent credit claims which over time led to the suspension of all types of refunds.

By January 1994, the time the TUT was abandoned, the Ministry of Finance owed taxpayers 50 billion FMG in past credits. These arrears were owed to taxpayers who had claimed deductions for TUT paid on inputs but were not able to offset them against the TUT liabilities arising from their own production or sales. Domestically, those taxpayers that were not able to get a refund were in effect obliged to cascade the TUT tax payments. The problem was particularly acute for exporters who naturally had fewer domestic sales against which they could offset the credit.

In January 1994, the TUT was replaced with the TST (*taxe sur les transactions*). This was a general sales tax levied at the same rate of 15 percent. Because no credits were granted for the tax paid in previous stages of production, the TST had the potential of becoming a cascading turnover type tax. To avoid the perverse cascading effects complicated measures were devised. However, these measures made the new tax basically unmanageable. Thus, the Government of Madagascar decided to abolish the TST only 6 months after its introduction.

However, the TST was not completely abolished. The *Loi Rectificative à la Loi de Finances pour 1994* which introduced the new *taxe sur la valeur ajoutée* (TVA) also legislated a 5 percent TST completely assigned to local governments. Its revenue raising capacity is significantly limited by the fact that the law exempts from this local TST all commodities paying TVA and all petroleum products.

In July 1994, the Government of Madagascar introduced the TVA to replace the short-lived national TST. The TVA was introduced with little preparation, despite the fact that the lack of adequate enforcement had been the main reason for the dismissal of the previous value-added tax. Also perpetuating old traditions, the 1994 law empowered the Ministry of Finance to grant exemption status, partially or fully, from the VAT without approval of the tax expenditures by Congress. This was amended in the *Loi Rectificative à la Loi de Finances pour 1995*, restricting discretionary exemptions only to cases of natural disasters or national emergency. The Government appears to have decided not to let firms use the arrears of unpaid credits from the previous consumption tax (the TUT) as credits against the new tax.

The structure of the new TVA is similar to that of the old TUT. There are, however, several significant differences. First, the new TVA is levied at the much higher general rate of 25 percent. Second, the utilization of credits for the tax paid for inputs of production, is much more restrictive than under the TUT.

No refund is possible under the new tax. This was also the case under the TUT. However, credits did not have a limited life under the TUT; i.e. they could be carried forward to future years. Under the new TVA these credits lapse after a specified period of time.

The new law allows on a regular basis a credit for taxes paid within the two months prior to the bimonthly TVA declaration. However, all taxpayers are given a grace period and are allowed to claim credits within the next 6 months. Credits are not allowed for the following purchases, among others: buildings other than the plant necessary for production, motor vehicles unless they are exclusively used for paid transportation services, any type of furniture or office equipment, and telecommunications. Depreciable capital goods are not subject to the 6-month time limit for credits. Instead, the amount of the tax that is creditable is limited to the share of the good that is depreciated in any particular fiscal period.

As was also the case under the TUT, exporters are allowed to transfer credits to other taxpayers in excess of what they can claim in their bimonthly declaration. However, the amount of transfer credit is reduced *pro rata* to 80 percent of the volume of exports. To transfer credits, exporters must provide the tax office with detailed information on how the tax was generated and on the enterprise receiving the credit. Other significant features of the TVA are reviewed in the following paragraphs.

The coverage of the new tax is wide and includes the production and importation of most kinds of goods and services. It is particularly notable that the activities of insurance companies, financial transactions by banks and other financial institutions are covered by the TVA. However, *La Banque Centrale, La Caisse d'Epargne* and the *Centres de cheques postaux* are exempt. This contrasts with the practice of many other countries which exempt all financial institutions from VAT, because of the difficulty of defining value added in financial transactions. The TVA also taxes many transport and all construction activities.

The list of activities not covered by the TVA includes agriculture, cattle ranching, education, health services, group insurance, the provision of water and electricity to households, schools and hospitals, newspapers and magazines except for the sale of space for publicity. The list of exempt goods is similar to that under the TUT and it includes food products, school materials, health products, postage and fiscal stamps, stamped paper and banknotes, and petroleum products.

Importantly, the law defines all exports as exempt rather than making them, as is customary in most other countries, zero rated. Of course, the difference between the exempt status and zero rating is that under the latter the taxpayer has a right to a refund for the taxes paid in the different stages of production while under the former he does not. However, the TVA law passed in 1994 confuses zero rating with exemption of goods. As a result, the list of exempted goods is de facto treated as if it were a list of zero rated goods.

B. Excise taxes

Prior to July 1994, the system of indirect taxation included a wide array of excise taxes under the TC (*taxe de la consommation*). The TC was levied on 300 products, including many inputs, at multiple rates – some as high as 500 percent but most at 5 and 10 percent. The largest revenue producers were tobacco and alcohol products. The TC system of excises was replaced by the MTVA (*majorée TVA*) in July 1994, while the MTVA in turn was abandoned in favour of the *droit d'accises* (DA) in January 1995. Petroleum is subject to a separate excise tax.

The DA was introduced by the *Loi de Finances pour 1995*, replacing the short lived MTVA. The MTVA was a special value added tax falling on certain commodities, levied at different rates (usually higher than the 25 percent rate of the TVA). The DA properly integrates all commodities into the value added tax at the single TVA rate, while levying an *ad valorem* excise tax at the producer or import levels on specific groups of commodities.

Besides the traditional excisable commodities that impose negative externalities such as alcohol and tobacco products, the current regime of excises also taxes regular goods, such as fabrics and edible oils, as well as a group of commodities that can be categorized as luxury goods, such as precious stones and metals, automobiles and domestic appliances. The *ad valorem* tax ranges from 5 percent to 120 percent. The typical *ad valorem* rate on tobacco products is 30 percent, rates on alcoholic beverages vary from 20 percent on beer to 100 percent on sparkling wines. Most of the precious stones and metals are taxed at 100 percent, vehicles at 15 percent and domestic appliances at 20 percent.

Petroleum tax

Until 1993 petroleum taxes played a minor role in Madagascar's public finances. There were many reasons, including the use of specific rates that lagged behind inflation and the use of an overvalued official exchange rate for conversion of international prices into FMG prices. Because all petroleum products are imported, the excise taxes are in effect a tax on imports. The impact of the tax on economic activity and income distribution have to be understood in light of the fact that petroleum marketing is carried out through a state monopoly, SOLIMA, at prices set by the government.

In 1994 the government raised the tax rates on petroleum products (*nouveau taux TUPP*). The tax remains a specific tax with the following rates for 1994: FMG 1,000 per litre for super gasoline, FMG 800 per litre for regular gasoline, FMG 250 per litre for *gasoil*, and no tax for kerosene. After taking into account the cost to the monopoly company and the actual prices (tax inclusive) charged to consumers, the effective tax in June 1994 on consumers per unit was 161 percent for super gasoline and 67 percent for regular. However, *gasoil* users received a subsidy of 11 percent and kerosene users, 36 percent. In effect, the combined pricing and new taxes scheme have amounted to a cross-subsidization programme leaving the government with little net tax revenue.

C. Custom tariffs

Import taxes

Throughout 1994 the Government undertook significant policy changes in the foreign trade regime. The most significant change was the liberalization of foreign trade. In July 1994 the Parliament approved a revision of the Customs Tariff which introduced a maximum rate of 30 percent when the two components of the tariffs, the *droits de douane* (DD) and the *taxe sur les importations* (TI), are aggregated. This reduction in rates was a continuation of previous reforms which over the past years reduced the maximum tariff rate and the rate of dispersion. The Government has also proceeded to eliminate most of the non-tariff barriers to trade. The liberalization of international trade has been accompanied by partial liberalization in the international finance and foreign exchange markets and this has helped to reduce distortions in trade. These measures include the possibility of opening bank accounts in foreign currency and the flotation of the FMG. There has also been partial liberalization in the regulation on the repatriation of foreign earnings. Now exporters are allowed to keep 10 percent of foreign earnings. The other 90 percent still has to be converted in the foreign exchange market within 90 days from the date of shipment.

Export taxes

This form of taxation on international trade has also seen radical changes in recent times. In 1987 all export taxes were eliminated with the important exceptions of those on vanilla, coffee, pepper and cloves. In addition, the marketing of agricultural exports, previously controlled by marketing boards, was liberalized except again for vanilla. Additional reforms followed. After 1994 the only commodity subject to export tax is vanilla. The current export tax on vanilla is composed of a "permanent" export tax of 15 percent and a "temporary" tax of 11 percent. Certification for exports and quality controls were also reduced in 1994 to four groups of commodities: vanilla, seafood, coffee, and meat products. There are still some other rules affecting exporters, such as the repatriation of proceeds within a specified period of time and rules concerning the surrendering of foreign exchange.

As a consequence of these changes, collections from export taxes fell from a high of 17.8 of total tax receipts in 1987 to 1.7 percent in 1993. However, export taxes for 1994 were forecast to amount to 2.5 percent of total tax revenues.

D. Fiscal state monopolies

The state revenues from the fiscal monopolies (RMMF) arise mainly from the production and marketing of tobacco, alcoholic beverages and matches (Article 04-01-01 of *Code Général des Impôts* (CGI)). The transfers to the government are the operating profits of the monopolies and these profits are defined as net of all taxes and duties levied on the products. The profits of the RMMF naturally arise from its pricing of the commodities. Prices are regulated by the Ministry of Finance and are set to cover production costs or import prices plus a mark-up that determines the profit margin. Manufacturers and approved wholesalers may operate as private entities under the control and supervision of the RMMF. The monopoly power granted to the RMMF by the Government, in effect, constitutes an additional tax similar to indirect taxes such as the customs tariff or the TC (*Taxe de la Consommation*). Of course, the monopoly powers of the RMMF practically eliminate competition in the importation, production, and distribution of the commodities at present falling under the remit of the RMMF.

The revenue raised by fiscal state monopolies forms a substantial part of the Central Government's total tax revenues. For example, in 1992 the net income from the fiscal state monopolies exceeded the corporate income tax and also the revenues from TC.

IV. OTHER TAXES

A. The professional tax

In spite of its name, the professional tax (TP) is a general licence tax covering practically all self-employed individuals and companies engaged in a market activity. Indeed there are few exemptions from the tax. Farmers selling their crops in the same area where they grow them and partners in limited partnerships are exempt. Revenues from the tax are assigned to the regional governments (*faritany*) and just a small part (*les centimes additionnels*) are earmarked for local governments. Most of the taxpayers are engaged, and over two thirds of the revenues are generated, in commercial activities. The less visible group of professionals represent a very small percentage (under 2 percent) of collections from the tax. Penalties for failing to comply with the tax include confiscation of merchandise, or an administrative order of closure of the business. But these penalties affect commercial activities more than professional activities.

The enforcement of the professional tax is aided by the fact that proof that the tax has been paid, (a letter issued by the Direct Taxes Service) is demanded prior to the payment of bills by any public institution.

The determination of the professional tax is quite complex. The tax is composed of a fixed tariff and a variable tariff. The fixed tariff depends on the nature of the registered activity, the population of the community, and the number of employees. The variable tariff is determined on the basis of the taxpayer's fixed assets and turnover.

The fixed tariff is determined through a matrix of charges last updated in January 1994. The matrix has nine rows relating to population agglomerations of descending size. The top row (called category 1) sets out the tariff amounts for different occupations in agglomerations with 75,000 inhabitants or more. The last row lists the tariff amounts for the same occupations but in localities with populations of 500 or less.

Economic activities are classified in five categories: commercial, industrial, crafts, production of services, and liberal professions. Each of these is taxed according to different criteria. About 500 different types of professions, industries, crafts or trades are listed. Within each type of occupation there are often numerous sub-groups. For example, a transporter will fall in different tax classes depending upon the size of his vehicle(s), tonnage, or passenger capacity, or number of vehicles he owns. A person who transports both goods and people is treated as carrying out separate activities and is taxed independently in respect of each activity by reference to the locations in which he operates. Some of the different activities are taxed separately and added together at 100 percent of the tax for each activity, but other taxes are applied cumulatively according to a decreasing scale. After five cumulative activities no tax is charged in respect of additional activities.

The variable component of the TP is calculated on the basis of the rental value of the premises (or of the equipment used including raw materials and transport equipment) and the number of employees. Individuals belonging to certain categories, or occupations without a fixed place of business, have to pay triple the amount otherwise due, as a tax-in-advance of income they may earn during the year. These tax payments are creditable against the income tax subsequently assessed.

B. Taxes on real estate

There are three main real estate taxes with their revenues assigned entirely to local government. These are the land tax (*impôt foncier sur les terrains*), the real estate tax (*impôt foncier sur les propriétés bâties*), and the surtax on the real estate tax (*taxe annexe sur les propriétés bâties*). In addition, there are several registration taxes payable in respect of the transfer of ownership of real estate. Real estate taxation is therefore more fragmented than is usually the case.

The problems with property taxes on real estate in Madagascar are the ones normally associated with this type of taxation. Property values for assessment purposes have lagged behind market values. In particular, the system of land and property registration appears to be quite incomplete and out of date. Real estate taxes are among the most unpopular forms of taxation. An often used explanation is that property taxes are disconnected from ability to pay *per se*, since they tax holdings of assets rather than income or expenditure flows.

The land tax is based on the presumed rental value of the property as of 1 January of the fiscal year, but actually in most cases the tax is determined by applying a statutory rate. There are six different tax rate groups depending on the economic use of the land. Exemption from the land tax can be allowed for arable land in case of natural disasters such as floods, cyclones, or landslides. The actual tax rates are determined locally within certain maximum and minimum limits for each grouping.

The highest rate applies to plantations of traditional crops (cocoa, coffee, sugar, coconut, cotton, cloves, oil palms, essential oils, pepper, sisal and vanilla). The rate for the first category is between FMG 500 and FMG 1,000 per hectare (*CGI*, Section VII, Article 01-07-07). The second category consisting of forests, lakes, and swamps, is generally taxed at about 80 percent of the tax per hectare applying to the first category. The third category consisting of vegetable, rice and other plantations, is taxed at about one third of the rate applicable to the first category. The fourth category consists of grazing areas, land that cannot be economically used, or which is resting (in a crop cycle). The tax rates for the fourth category are about one tenth of those for the first category. The fifth category carries a penalty rate of about double that of the first category. It applies to idle land that has potential use. The sixth category consists of non-agricultural land within urban areas. The land tax here corresponds to 1 percent of the market value of the land.

Market values are determined either by reference to recent transactions or by comparison with reference values set by an administrative commission. Owners or occupiers of taxable land have the obligation to report to the local tax office *(bureau des Contributions directes territorialement compétent)* the locations, surface by crop or other use, the names of tenants and the amount of rent. Representatives of the tax authorities can visit and evaluate and verify the land in question.

The second property tax, the Real Estate Tax on Built-up Land is based on the actual or presumed rental income of the property. Machinery and equipment which become physically incorporated into the structure of an industrial or commercial building also become subject to the built-up-property tax. The rates for this tax generally run within the limits of 3 percent to 10 percent. The actual rates differ between residential and non-residential uses and by whether or not they are owner occupied.

In addition to the regular tax, there is an additional tax (CGI Article 01.09.05) amounting to 2 percent for properties in the smaller decentralized jurisdictions and 3 percent to 6 percent for the larger jurisdictions referred to as ex-CU (*ex-Communes Urbaines*). There is an additional charge, referred to as *centimes additionnels*, of 15 percent of the basic real estate tax, assigned for the improvement of the infrastructure of the *ex-Communes Urbaines*. Thus, the tax on built-up property can range from about 5 percent to about 18.5 percent of actual or presumed rental income.

Enterprises that include real estate properties in their balance sheets can use the real estate tax as a credit against their income tax liability. In addition, new construction is exempt from built-up-property tax for a period of ten years. A property which is built up gradually, becomes taxable *pari passu* as units of the construction become habitable or functional. Temporary tax exemptions can run to different dates for different components of the property. The tax exemptions are personal and are lost upon change of ownership (except for succession in the event of death).

The third real property tax is actually another surtax on the real estate tax on built-up property (*taxe annexe sur les propriétés bâties* or TAFB). This surtax is levied on the same base of actual or presumed rental income of property at rates between 2 and 6 percent. The collections are earmarked to pay for the cost of regular municipal services such as street lighting and cleaning.

The transfer taxes for real estate accrue to the central Government. They are levied at 2 percent for the transfer of ownership of buildings to be used as a home and at 4 percent for other uses. When the buildings are sold for profit there is a registration fee of 12 percent in addition to other charges that exceed another 4 percent.

The reassessment of property values at the local level has lagged behind now for many years despite the fact that there have been, at least in some areas, significant increases in property values.

V. CONCLUSION

The Government of Madagascar is currently involved in a series of ambitious reforms in many areas of economic policy. But success in many of these areas will depend crucially on the existence of a sound tax system. This tax system should produce an adequate level of revenues, whilst keeping the level of economic distortion to a minimum. Regard must also be had to maintaining a desirable distribution of income in the country.

The present tax system is partly anchored in obsolete tax institutions sometimes dating back to colonial times. Some other parts of the tax system have been continuously reformed in the last two decades. However, many of the changes introduced have been made without reference to other aspects of the tax system and often without adequate preparation on the tax administration side. As in many other developing countries, tax reform in Madagascar has been driven by short term revenue pressures. This has resulted in a tax system that is overly complex and with serious shortcomings. There is a clear need to undertake a comprehensive overhaul of the tax system.

TABLE 1

Tax Revenues in Madagascar, By Economic Category, 1994 (Projected)

	Billions of FMG	As Percent of Total Revenue
Direct Taxes:	97.2	12.2
Pers. Income: Salaries	23.0	2.9
Pers. Income: Non-Salaries	8.0	1.0
Corporate Income (IBS)	54.1	6.8
Other	12.1	1.5
Indirect Taxes:	662.2	82.9**
Consumption Taxes	150.5	18.9
Excise Taxes	6.7	0.8
Taxes on Internat'l Trade:		
– Imports*	446.7	55.9
– Exports	20.3	2.5
Fiscal State Monopolies	38.0	4.7
Other Revenues:	39.0	4.9
Real Estate Taxes	8.7	1.1
Other	30.3	3.8
Total:	798.4	100.00

Source: Ministry of Finance.

* Including all consumption and excise taxes on imports.
** Percentages do not add up due to rounding.

MALAYSIA

THE MALAYSIAN INTEREST RESTRICTION

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I. INTRODUCTION

The Inland Revenue Department (IRD) issued a guideline on 16 July 1990, relating to the restriction on the deductibility of interest imposed by Section 33(2) of the Income Tax Act 1967 (ITA). Under this guideline, the computation of the interest restriction can be very complicated and time consuming, particularly where the company has a large investment portfolio (e.g. shares, land and buildings, deposits and advances to subsidiaries etc.). This is because the guideline expressly requires the investment sources (rental, shares, deposits etc.) to be broken down into income producing and non-income producing sources. In addition, each income producing source is then further broken down into various subgroups. Indeed certain tax assessment branches took the very aggressive position that each individual investment must be treated as a separate source, interest being allocated at the level of the individual investment.

Although the guideline has no statutory authority, the majority of taxpayers have faithfully followed it in order to get their tax computations agreed. Another reason why companies followed the guideline was to achieve agreement of the exempt income account so that exempt dividends could be declared. The guideline imposes substantial compliance costs both in terms of the documentation required and the complex time-consuming reconciliation of the interest balances it necessitates. This heavy compliance burden has increased the cost of doing business in Malaysia especially for investment holding companies.

On 21 July 1994, a Special Commissioners' case *P Securities Sdn Bhd v. DGIR* (1995)(2 MSTC 2256) held that there is only one investment source for each category of investment income and that the tax authorities were therefore not entitled to split that source into income producing and non-income producing components.

This article will examine the computation of the Section 33(2) interest restriction prior to the *P Securities* case. The impact of the case on the computation of the restriction will also be examined.

II. THE POSITION UNDER THE ITA

An interest expense will only be allowed as a deduction if the expense was wholly and exclusively incurred on money borrowed and employed in the production of gross income or laid out on the purchase of assets used, or held, for the production of gross income. (Section 33(1)(a))

Section 33(2) restricts the interest deduction available under Section 33(1)(a), where a company has used a portion of the loan, which has been borrowed for business purposes for relending or investment in movable or immovable properties. The restriction applies for the purpose of determining the taxable business profit or loss.

The interest restriction is calculated using the formula :

$$\text{Interest restriction} = \frac{\text{Total investment}}{\text{Total borrowings}} \times \text{Monthly interest expense}$$

The restriction is calculated by reference to month end balances. For this purpose the interest expense is deemed to accrue evenly over the period. (Section 33(2)(a))

III. THE IRD GUIDELINE ISSUED ON 16 JULY 1990

The IRD guideline provides as follows:

A. Non-applicability of interest restriction

Where interest on borrowed money charged to the business account does not exceed RM 10,000 for companies and RM 6,000 for individuals, Section 33(2) will not apply and the full interest expense will be allowed against the business income.

B. Formula under Section 33(2)

The interest restriction is computed for investments not exceeding RM 500,000 by reference to the year end balances. However, in cases where the investments exceed RM 500,000 the month end balances must be used.

C. Allocation of the *restricted* interest against investment income

The amount of interest not eligible to be set off in determining the business income will be available for set-off against investment income. However, under the guideline the interest to be allowed against investment income is subject to further restrictions:

1. Loans

Investments in respect of loans will be split into *income producing* and *non-income producing* groups and the interest expense allocated to the income producing investments will be deducted against interest derived from those investments.

No tax deduction is available for the interest expense allocated to the non-interest bearing loans. This is because a loss arising in respect of a source of investment income may not be set off against any other source of income, nor may it be carried forward.

2. Shares

Share portfolios (excluding shareholdings in subsidiaries and associates) should be divided into *income producing* and *non-income producing* elements. The interest allocated to the income producing investments may then be set off against the dividend income produced by those investments.

No deduction is available for the interest expense allocated to the non-income producing investments.

Each investment in a subsidiary or associate is to be treated as a separate source. If the subsidiary/associate does not yield dividend income, no relief will be available for the interest expense allocated to it.

3. Real estate

Properties are to be grouped according to their usage i.e. shops, factories and business premises form a single source whilst residential properties, e.g. houses and flats, constitute a separate source.

The guideline specifies that the company is required to account for the monthly balances of the interest expense account, as well as to keep track of the subdivision of the investment source. Imagine the complex computation necessary where a listed company, has 10 subsidiaries, 20 associate companies and several properties and has borrowed from various sources and advanced loans (some being interest-free) to its subsidiaries/associated companies.[1]

In the more complicated scenarios the calculation may become a nightmare, the company's staff, its tax advisors and the tax authorities, spending days tracing the transaction trail and verifying the computations.

IV. *P SECURITIES SDN BHD V. DGIR* (1995) 2 MSTC 2256

In this case the taxpayer, an investment company, held various shareholdings as investments. Some of the shareholdings produced income in the form of dividends each year while others did not. In order to acquire the shareholdings the taxpayer borrowed money from financial institutions and interest was incurred by the company during the periods under consideration. It was not disputed that the interest was incurred in order to produce income. For the relevant periods, the company was assessed to income tax on dividends received on the grounds that each of its shareholdings constituted a separate source of income. Consequently, the interest deduction was apportioned between those shareholdings that produced income and those that did not.

The company appealed arguing that all the shareholdings held as investments by the company constituted a single source of income. Therefore, the whole of the interest payable on borrowings used to acquire those investments should be set off against the share investment income for the relevant periods, irrespective of the fact that some of the shareholdings did not produce dividend income in those periods.

The issue to be determined by the Special Commissioners of income tax was whether each shareholding held by the company in its capacity as an investment holding company, constituted a single or separate source of income within the meaning of Section 33(1) ITA, read together with Section 4(c) for the purpose of ascertaining the adjusted income of the company.

The determination of one source or separate source is an important issue because this would affect:

(a) *the extensiveness of documentation to be kept by the company*

If separate categories are required, then the company has to keep track between income producing shareholdings and non-income producing shareholdings for each of its investments. The fact that the status of the various shareholdings could vary from year to year would further add to the complexity.

(b) *the computation of the interest expense*

The interest expense to be set off against investment income may fluctuate from year to year depending on whether the shareholding is income producing or non-income producing during the year in question. The amount of tax payable by the company is correspondingly affected.

Example 1

Tan Lee Mey Bhd is an investment holding company, holding shares in listed companies, each of its investments constituting less than 20 per cent of the issued share capital of the investee company. The total investment is as follows:

Share portfolio	Investment	Dividend received (grossed)
	RM	RM
Income producing	6m	300,000
Non-income producing	4m	–

1. This is a relatively simple scenario. The issues would be further complicated if the status of the company's investments changed. For example a simple investment becoming an associated company or an associated company turning into a subsidiary.

All investment is financed through borrowings from Hong Leong Bank. The total interest expense incurred during the year amounting to RM 120,000. Assuming the interest expense is allocated using year end balances[2], then the interest allocation would be as follows:

Share portfolio	Investment	Interest allocated
	RM	RM
Income producing	6m	72,000
Non-income producing	4m	48,000

The tax computation

	Investments divided into income producing and non-income producing shareholdings	All sharehold ings treated as a single source
Dividend income	300,000	300,000
Less: interest	(72,000)*	(120,000)
Adjusted income	228,000	180,000
Tax payable @30%	68,400	54,000

* Restricted

If all shareholdings held as an investment were treated as a single source, it would result in a tax saving of RM 14,400. In addition to that, tax compliance costs would be considerably reduced.

Returning to the case of *P Securities*, the company also argued that Section 4(c) requires dividends to be treated as derived from one source and not broken down into income producing and non-income producing components; i.e. if Section 4(c) had intended to permit the categorization stipulated in the guideline, it would have been worded akin to Section 43 where references to "business" can refer to several sources.

The Special Commissioners held that:
(1) On the true and proper construction of Section 33(1) and for the purpose of Section 4(c) ITA, each holding of shares as an investment does not constitute a separate source of income; and
(2) pursuant to that as the dividend income was the company's only source of income it was wrong of the tax authorities to apportion the interest payable on the loan to acquire the share portfolio between the shareholdings that produced the dividend income and the shareholdings that did not.

The decision of the case follows the *ratio decidendi* by Rowlatt J in the UK case of *Merrifield v. The Wallpaper Manufacturing Ltd.* (1931) 16 TC 40. The case concerned the question as to whether the interest from two different securities, i.e. National War Bonds and War Loan Stock, should be treated as income from one source or from separate sources for the purposes of Case III, Schedule D of the UK Income Tax Act 1918. Rowlatt J decided that they constituted a single source.

> ....The Income Tax Acts are a tax upon the yearly profits and gains of the subject, and among the yearly profits and gains, upon interest on money, and the whole field of yearly profits and gains is split up and sub-divided for the purposes of different methods of charging, different methods of assessment, and so on; but it seems to me that, the tax being in the first instance upon profits and gains, one ought not to disintegrate the groupings of the profits and gains according to sources, further than the Acts affirmatively require.......

V. THE POSITION AFTER *P SECURITIES SDN BHD V. DGIR*

At the point of writing, the IRD had stated in its Dialogue with the MIA, MACPA, MIT and MATA[3] held on 25 February 1995, that the *P Securities* case is currently under appeal and until the outcome is known, the existing guideline should be followed.

It should be reiterated that the IRD guideline has no statutory force and since there is a precedent case which has held against the guideline, the guideline should now no longer be followed. The tax authorities should give due respect to the *P Securities* decision until the High Court has considered the matter.

This is in line with the tax authorities practice that a tax should always be paid first, irrespective of the fact that a case is appealed to the Special Commissioners or to the Court. The tax authorities rarely allow a postponement of tax even in situations where the question of law is debatable. Likewise, the "players" of the game (i.e. the tax authorities and the taxpayer) should always adhere to the decision of the Special Commissioners until it is overruled. This is the unwritten "rule" of the game.

VI. CONCLUSION

Since losses arising in respect of sources of investment income (e.g. rental, dividends and interest) cannot be set off against other sources of income or carried forward, it is not fair to sub-divide each investment source into income producing and non-income producing groups. Indeed it would appear that the ITA does not allow for this sub-division. In the words of Rowlatt J "one ought not to disintegrate the groupings of the profits and gains according to sources, further than the Acts affirmatively require". The tax authorities should therefore face up to the realization that the treatment imposed by the guideline, quite apart from being unfair and placing an unreasonably heavy burden on taxpayers, is simply not permitted by the legislation. A fresh approach is called for!

2. In an actual calculation, the IRD would require the interest restriction to be determined based on month end balances
3. Malaysian Institute of Accountants (MIA), Malaysian Association of Certified Public Accountants (MACPA), Malaysian Institute of Taxation (MIT).

UNITED STATES

LIMITATION ON BENEFITS AND THE COMPETENT AUTHORITY DETERMINATION

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I. INTRODUCTION

Treaty shopping is, and has been, a favourite pastime for tax planners. It is only relatively recently, however, that treaty shopping has become subjected to intense scrutiny. At the heart of the treaty shopping problem lies the question as to when efforts made to legally minimize taxes become unacceptable. This question is interesting because it requires a distinction to be made between impermissible or inappropriate tax avoidance motives and mere tax minimization motives. Domestic US Jurisprudence confirms that "[A]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes..."[1] Considering the measures being taken by the US Treasury Department and Internal Revenue Service (IRS) to curb treaty shopping, the question arises as to whether this statement continues to apply to international affairs.

At its narrowest, treaty shopping consists of the use of a host treaty country[2] to receive income at minimum tax cost when the country of residence of the ultimate beneficiary of the income does not have a treaty with the country where the income originates. Here, a third country resident establishes an entity in a host treaty country allegedly for the sole purpose of obtaining the benefits of the host country's treaty with its treaty partner. This fact pattern is disfavoured for several reasons. Firstly, it allows for (indirect) treaty benefits to residents of the third country without reciprocal benefits for residents of the treaty partner of the host country. Secondly, to the extent that third country residents have ample opportunity to use a host country's treaty network, the third country has no incentive to enter into treaties with the treaty partners of the host whose treaty is "shopped." Thirdly, residents of the third country escape scrutiny by not being subject to exchange of information mechanisms and mutual enforcement mechanisms that tax treaties may provide. This therefore increases the likelihood that criminal and other illegal activities go undetected.

A broad interpretation of treaty shopping includes the fact pattern where the ultimate beneficiary resides in a third (treaty) country,[3] and establishes an entity in a host country which has a treaty with the country from which income is derived if there is base erosion (or earnings stripping) or because the intermediary country has more favourable tax rates or treaty rates with the source country. Investors from countries with treaties in which source country taxation is not as limited as in other treaties may prefer to use and "shop" another treaty to secure a lower rate of tax.[4] Here, the concerns listed earlier appear less relevant. Arguments to disallow this type of treaty shopping are mainly revenue oriented. Base erosion implies the reduction of taxable income through deductible payments. A base erosion test limits the resident of a treaty country to use only a certain amount of its gross income to pay interest or royalties to residents of third countries. If its deductible payments exceed a certain percentage of its gross income, there is base erosion. Due to base erosion taxable income will be reduced, which is not favourable from the revenue perspective of the country of residence. Therefore, to grant treaty benefits (i.e. reduced rates) to payments that erode the tax base would be disfavourable as well. Similarly, granting treaty benefits to payments that do not necessarily erode the tax base but that constitute untaxed or low-taxed income in the country of the recipient/beneficiary will be deemed disfavourable. Particularly if the income is merely deposited in the country of the recipient/beneficiary to avoid further taxation.

Reasonable people can disagree about which tax avoidance interpretation constitutes mere tax minimization and which interpretation rises to the level of impermissible tax avoidance. Nevertheless, it appears that the broad definition of treaty shopping currently is the governing definition. This article briefly reviews the US position on treaty shopping. It

* This article expresses the author's personal opinions and does not necessarily represent the views of the IRS, the Treas.Dept. or Stibbe Simont Monahan Duhot.

1. *Helvering v. Gregory* 69 F.2d 809 (2d Cir. 1934), aff'd. 293 US 465 (1935).
2. The term "host country" is used as meaning "a country with a treaty for the avoidance of double taxation".
3. This third country does have treaties with regular treaty provisions and rates.
4. Under a treaty, the country of source will generally levy a tax at a reduced rate or will have the exclusive right to tax the income.

then goes on to analyze the use of a limitation on benefits provision, particularly with respect to the new US–Netherlands Treaty and the discretionary authority of the competent authority to grant treaty benefits.

II. BACKGROUND

Treaty shopping was attacked initially by the IRS through application of the sham transaction doctrine and subsequently through the application of the conduit doctrine.[5] The most often cited successful example in this area is the 1971 Tax Court case *Aiken Industries*.[6]

In 1976, a Treasury Department report to the Congress on foreign portfolio investment in the United States observed that "Treaties providing for reduced withholding rates induce foreign investors of countries without treaties with the United States to form either personal holding companies or trusts in the foreign treaty jurisdiction in order to have their investments in the United States receive favourable withholding tax treatment. These entities are then afforded the benefit of treaty tax rates applicable to the jurisdiction in which they are operating."[7] However, one year later, in 1977 a letter ruling involving a Netherlands finance company approved the use of the treaty to reduce US withholding tax to five percent while it reiterated that "The Netherlands was selected for incorporation because it is a financial centre that imposes no withholding tax on interest paid by a Dutch entity to foreigners, and because of its favourable internal income tax structure and extensive network of tax treaties providing for favourable treatment of interest income paid to Dutch entities."[8] This indicates that the IRS initially supported a narrow interpretation of treaty shopping.

Section 342 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required the IRS to establish procedures limiting reduced withholding rates under income tax treaties solely to those persons legitimately entitled to such benefits. The Conference Report referred to earlier hearings that "have demonstrated that substantial amounts of passive income, which would be tax free in the hands of foreigners, finds its way into the hands of US persons and residents of non-treaty countries who should be paying tax on it. They have also shown concern about the use of treaties by those not justifiably entitled to their benefits (so-called "treaty shopping")." Proposed regulations were issued in 1984 but were not made final.

Two revenue rulings issued in 1984 based on *Aiken Industries* effectively promulgated the IRS's disapproval of treaty shopping and, in the absence of regulations or legislative actions, were the main vehicles to directly attack treaty shopping. They rely on the conduit doctrine to disallow treaty benefits.[9]

The 1986 Tax Reform Act contains several provisions designed to prevent treaty shopping. With the imposition of the branch profits tax, Congress expressed its concern that foreign investors resident in one country would attempt to use another country's tax treaty with the United States to

5. Under the conduit doctrine transactions lacking in economic substance or reality will be disregarded for tax purposes. The fountainhead of this approach is *Gregory v. Helvering*, 293 US 465 (1935). In this case the Supreme Court stated:

> "When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to business of either, as plainly is the case here. Putting aside then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate organization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner... The whole undertaking, though conducted according to the terms of [the statute], was in fact an elaborate and devious form of conveyance, masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

6. *Aiken Industries v. Commissioner*, 50 TC 595 (1968). In this case, a US corporation, (MPI) borrowed funds from its Bahamian parent (ECL). MPI borrowed funds in year 1 from ECL and issued a four percent sinking fund promissory note in recognition of the debt. In year 2, ECL assigned the notes of MPI to a newly incorporated subsidiary in Honduras (Industrias). In exchange, Industrias provided ECL nine of its own notes, adding up to the same principal amount and interest as the funds MPI borrowed from ECL. After the transfer, MPI paid interest directly to Industrias and Industrias paid interest to ECL on account of its own notes owned by ECL. There was virtually no spread for Industrias on the transaction. Art. XI of the at that time effective US–Honduras Income Tax Convention provided that the interest paid by a US corporation to a Honduran corporation not having a permanent establishment in the United States was exempt from US tax. Pursuant to the Convention, MPI claimed exemption from the withholding provisions applicable to the US source income paid to Industrias. The Tax Court found that Industrias, a valid Honduras company, was merely a conduit for the passage of interest payments from MPI to ECL. The interest payments in question were not "received by" the Honduran corporation within the meaning of Art. XI of the Convention. The words "received by" contemplates dominion and control over the funds without the obligation to transmit it to another. The Convention required more than a mere exchange of paper between related corporations to come within the exemption from taxation granted by Art. XI of the Convention. Aiken Industries failed to demonstrate that a substantive indebtedness existed between MPI and Industrias and the Tax Court could not find that the transaction had any valid economic or business purpose. The transfer of the MPI notes from ECL to Industrias in exchange for the notes of Industrias left Industrias with the same inflow and outflow of funds. In addition, MPI, ECL, and Industrias were all members of the same corporate family and in fact, MPI was paying the interest to ECL.

7. Report to the Congress on Foreign Portfolio Investment in the United States 42, *US Treasury Department*, Washington, D.C. (1976).

8. PLR 7723035. The letter ruling relied on Rev. Rul. 75-118, 1975-1 C.B. 390 (declared obsolete in 1987!) which dealt with a US subsidiary corporation paying dividends to its Dutch parent company. The Rev. Rul. allowed the application of the reduced withholding rate provided under the Netherlands–US Treaty.

9. In Rev. Rul. 84-152 P, a Swiss corporation, owned all of the stock of S, a Netherlands Antilles corporation. P also owned all of the stock of R, a US corporation. To satisfy R's requirements for additional working capital, P agreed to lend funds to S, which in turn loaned a similar amount to R. Neither R nor S were thinly capitalized. Relying on *Aiken Industries*, the Revenue Ruling holds that the interest payments made by R are not "derived by" S for purposes of the interest provisions of the US–Netherlands Income Tax Convention as extended to the Netherlands Antilles, even though S is a valid Netherlands Antilles corporation. Rev. Rul. 84-153 basically applies the same analysis to a Netherlands Antilles finance subsidiary (S) of a US parent corporation (P) that issues Eurodollar bonds and reloans the proceeds to a US affiliate (R). The bottom-line rationale for denial of treaty benefits here is that S, while a valid Antilles corporation, never had such dominion and control over R's interest payments, but rather was a mere conduit for the passage of R's interest payments to the foreign bondholders. Even though it can be demonstrated that the transaction may serve some business or economic purpose, the use of S lacks sufficient business or economic purpose to overcome the conduit nature of the transaction.

avoid branch profits tax and branch level interest tax.[10] The branch profits tax of 30 percent may be reduced by a US income tax treaty in certain cases. To limit treaty benefits in treaty shopping situations, the branch profits tax is to yield to treaties only in specific situations.[11]

Another measure designed to prevent treaty shopping was recently issued in the form of regulations regarding conduit financing arrangements.[12] The regulations address multiple party financing when one of the principal purposes is the reduction of withholding tax under a treaty or under the law. The regulations allow the IRS to disregard the intermediary and to re-characterize the arrangement as one single transaction, i.e. basically codifying the doctrine of substance over form.

Limitation On Benefits (LOB) provisions are one of several measures that attempt to limit abusive claims for treaty benefits. Although nothing new, LOB provisions have gained increased popularity as an effective measure to alert taxpayers that treaty shopping will not be condoned. This, once again, became apparent most recently with an amendment to the Budget Reconciliation bill (HR 2491) proposed by Senator Herb Kohl (D-Wis). Kohl's amendment introduced a LOB provision that, if it had been accepted, would have had serious treaty override consequences.

One of the ancestors of the current LOB provision stems from 1945, and consisted of a reference in Article VI of the first United States–United Kingdom Treaty regarding dividends to the fact that "the reduction of the rate to five percent shall not apply if the relationship between corporations has been arranged or is maintained primarily with the intention to secure reduced tax rates". The immediate forerunners of the LOB provision are the Investment or Holding Company article and the Associated Enterprises article contained respectively in the 1977 and 1981 proposed US Model treaties.

To better monitor claims for treaty benefits, the withholding regulations are in the process of being revised. Section 1.1441-6(a) of the current withholding regulations provides that the withholding rate of thirty percent shall be reduced as may be provided by an income tax treaty with any country. Withholding agents must determine the applicable withholding rate pursuant to the appropriate tax treaty and the regulations issued thereunder. In the absence of regulations, withholding agents may, in general, rely on an owner's address of record in determining whether they may withhold tax on US source dividends at the reduced treaty rate applying to the non-resident alien individual owner. See Treas. Reg. Section 1.1441-(b)(3). To currently secure the reduced rate of, or exemption from, US income tax at source in the cases of items of income specified in Treas. Reg. Section 1.1441-2 other than coupon bond interest and dividends, the recipient must, if entitled to such treatment pursuant to a tax convention, file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent. In the case of dividend income, the withholding agent may rely on the country of residence and address of record supplied by each participant for the purpose of determining the appropriate withholding rate, absent actual knowledge or reason to know otherwise. In light of the strict "qualified resident" requirements imposed under the LOB regime and branch profits regime this "address" system appears primitive and outdated. Proposed regulations issued pursuant to Section 342 of TEFRA intended to amend Section 1.1441-6 and have Form 1001 apply to dividend income as well.[13] A Certification of Residence Form was introduced. Non-resident alien individuals were required to file this form in order to obtain a reduced withholding rate under a treaty. However, these proposed regulations where not made final. A new proposal to curb treaty shopping is being considered and would require foreigners who invest in US securities to obtain taxpayer identification numbers.[14] Currently foreign persons are not required to have an Alien Taxpayer Identification Number (ATIN).

III. LIMITATION ON BENEFITS

Whereas tax treaties generally have as one of their main functions the avoidance of discriminatory tax treatment of residents of the respective contracting states, the LOB provision is a discriminatory provision *per se*. By including a LOB provision in a treaty, the treaty partners agree that certain residents will *not* be eligible for treaty benefits.

A LOB article is a sophisticated legal contraption that limits the Personal Scope article of a treaty. The Personal Scope article usually provides that the treaty applies to persons who are residents of one or both of the treaty countries, "except as otherwise provided." The treaty subsequently will define "persons" and "residents." It is these definitions that are at the heart of the LOB article. The LOB provision caters to the "except otherwise provided" clause in the Personal Scope article. By not meeting the secondary requirements added by the LOB provision to the "person" or "resident" definitions, the threshold for application of either some or all of the operational provisions of the treaty has not been met. Thus, by creating a distinction between ordinary residents and quali-

10. See General Explanation of The Tax Reform Act of 1986, *Joint Committee Report*, at 1038.

11. The first case is where a foreign corporation is a "qualified resident" of a treaty country and the treaty prohibits the branch profits tax. "Qualified resident" status means that the foreign corporation is not treaty shopping. The second case is where a foreign corporation resides in a country whose treaty permits the United States to impose its withholding tax on dividends paid by the corporation but otherwise prohibits the branch profits tax. The Act provides tests to determine whether a foreign corporation is treaty shopping.

12. See Notice of Proposed Rule making and Notice of Public Hearing regarding the Conduit Arrangements Regulations, *I.R.B.* 1994-44, at 24.

13. Sec. 342 of the Bill (Withholding of tax on non-resident aliens and foreign corporations) provides:

> Not later than 2 years after the date of enactment of this Act, the Secretary of the Treasury or his delegate shall prescribe regulations establishing certification procedures, refund procedures, or other procedures to ensure that any benefit of any treaty relating to withholding of tax under Sec(s). 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefit.

The Conference Agreement emphasizes that the address system of withholding of tax on US source dividends is particularly vulnerable to abuse and mentions a number of alternatives to the present enforcement system such as a refund system or a certification system to limit treaty benefits to those persons entitled to them.

14. See Wall Street Journal of 7 November 1994 and the proposed regulations (IL-24-94) under Sec. 6109 that provide procedures for requesting a taxpayer identification number (TIN) for certain alien individuals.

fied residents, LOB provisions effectuate that only qualified residents are eligible for treaty benefits.

Article 16 of the 1977 US Model treaty stipulated that certain treaty benefits do not apply: (1) If 25 percent or more of the capital of a company resident in a Contracting State was owned directly or indirectly by individuals who were not residents of that State and (2) if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State was substantially less than the tax generally imposed by the first mentioned State on corporate business profits. Where this occurs then, notwithstanding the provisions in the Dividend, Interest and Royalty articles, that other State could tax such dividends, interest and royalties. Thus, in this type of LOB article a person resident in a Contracting State is disqualified from receiving treaty benefits by reason of a combination of two facts: i.e. its capital being owned as to 25 percent or more by non-residents *and* its income being taxed at a substantially lower rate than generally is imposed by the Contracting State.

Rather than a combination of tests, Article 16 of the 1981 Proposed US Model treaty imposed alternative threshold tests. Similar to the 1977 Model, this article requires that (A) more than 75 percent of the beneficial interest in a person resident in a Contracting State must be owned, directly or indirectly, by one or more individual(s) resident in that Contracting State. However, the article adds a base erosion test and states that the income of such a person ought not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States. Alternatively, (B) a determination can be made that the acquisition or maintenance of such a person and the conduct of its operations did not have as their principal purpose obtaining benefits under the Convention. This type of LOB article maintains that (C) if income is being taxed at a substantially lower rate than generally is imposed by a Contracting State, any relief from tax provided by the other Contracting State to the resident of the first Contracting State shall be inapplicable.

The newest, more sophisticated, LOB articles limit treaty benefits to treaty country residents with "sufficient nexus" to a treaty country. To determine the proper level of nexus, these new LOB provisions impose several "safe harbour" objective tests such as a qualified shareholder and base erosion test, a publicly traded test, an activity test, a derivative benefits test and possibly other special rules. In the event none of the tests are satisfied, a discretionary relief provision creates a last resort mechanism to obtain treaty benefits. However, the "principle purpose" test contained in both the earlier LOB provisions and in the new LOB provisions is not an easy test to administer since it requires a subjective analysis rather than an objective analysis. To determine whether the acquisition or maintenance of a person and the conduct of its operations did not have as its principal purpose the obtaining of benefits under the Convention it may be useful to look at the "qualified resident" regime imposed under the US branch profits tax rules in 1987. The technical explanation and Memorandum Of Understanding (MOU) of recent treaties may also provide guidance as to how the subjective tests operate.

Many treaties have LOB provisions. For example, Australia, Barbados, Belgium, Bermuda, China, Egypt, Finland, Germany, Iceland, India, Indonesia, Israel, Italy, Korea, Luxembourg, Malta, Mexico, Morocco, Netherlands, New Zealand, Norway, Russia, Spain and Trinidad & Tobago all have a provision following either the 1977 US Model Treaty, the 1981 Proposed US Model Treaty or a version of the more sophisticated LOB format as displayed in the German Treaty. The treaties that are recently renegotiated or currently in the process of being (re)negotiated (Canada, France, Sweden, Portugal, Ukraine, and Kazakstan) all (will) include a LOB provision.

IV. UNITED STATES–NETHERLANDS TREATY

The first income tax treaty between the United States and the Netherlands was signed in 1948, effective 1 January 1947. The first Treaty was modified by two protocols[15] and a supplementary convention. Neither the Articles of the first Treaty nor the subsequent protocols and other amendments to it contained a LOB provision. The new Treaty, signed on 18 December 1992, with an effective date of 1 January 1994, includes an extensive LOB article.[16] It may be of some comfort to note that few LOB provisions are, or will be, as sophisticated as the one contained in this Treaty. In fact, the technical explanation to the LOB article contained in the Netherlands Treaty acknowledges that this provision is unprecedented among US treaties in its level of detail.

Under Article 26 of the Netherlands Treaty, a series of objective and subjective tests apply to determine whether a company qualifies for treaty benefits.[17] The tests all serve the purpose of identifying taxpayers that have a business purpose for residing in the Netherlands and holding their US investments through a Dutch entity. The tests seek to determine whether sufficient nexus to the Netherlands exists and whether the business purpose outweighs any purpose to obtain the benefits of the Treaty. Satisfaction of one of the four primary objective qualification tests of Article 26 will automatically qualify a company for treaty benefits. These

15. The first Dutch Treaty was amended by a protocol on 10 November 1955 to facilitate its extension to the Netherlands Antilles. On 28 September 1963, the first protocol was modified and supplemented by a second protocol relating to Netherlands Antilles companies. A supplementary convention signed on 8 July 1966 again modified the Treaty, but did not apply to the Netherlands Antilles. The primary purposes of the supplementary convention were to enable the Netherlands to impose withholding tax on dividends derived from sources within the Netherlands by US residents and corporations, to modernize the first Dutch Treaty and to more closely conform it to the proposed OECD Model Treaty. Effective 1 January 1988, the US substantially terminated the extension of the original Dutch Treaty to the Netherlands Antilles. A new treaty was signed with the Netherlands Antilles at that time and is pending ratification.

16. However, a delayed effective date of 1 January 1995 is provided and assumed unless the taxpayer elects to apply the new Dutch Treaty. See Notice 94-1, 1994-2 C.B at 24

17. However, the objective tests enumerated in the Dutch Treaty are more comprehensive than the US Model Treaty provisions.

tests function as safe harbour tests and are effectively used as surrogates for identifying actual intent. They are included in the Treaty to identify cases where it is reasonably likely that the taxpayer has a purpose other than treaty shopping for the structure it adopted. However, these are mechanical tests and it is possible that a taxpayer may fail to satisfy these, even though he is not engaged in treaty shopping. Therefore, if the objective tests can not be met, secondary subjective qualification tests may be applied to determine "good" intent. If these "fall-back" tests are satisfied, a company may still qualify for treaty benefits, although it should be noted that satisfaction of these subjective tests will not necessarily result in an automatic qualification for treaty benefits. It is important to note that the technical explanation of the Treaty is not clear on this issue. The technical explanation provides that:

> "it is not necessary, however, for a taxpayer to obtain an advance determination under Paragraph 7 of Article 26 in order to obtain the benefits of the Convention. A taxpayer confident of its ability to present a convincing case under Paragraph 7 could refrain from obtaining an advance determination from the competent authority and wait to present a case to the competent authority until requested to do so by the competent authority. A person pursuing this strategy will have no assurance (apart from its confidence in its position) that the competent authority will determine that benefits of the Convention should be granted, unless that position is based on further guidance provided by the competent authorities with respect to the application of Paragraph 7."

It is safe to assume that the IRS position is that, in the event that the objective tests are not satisfied, one can *not* claim benefits under Paragraph 7 of Article 26 of the Treaty without a favourable determination having been received. Therefore, although the technical explanation provides that a determination by the competent authority may be issued retroactively to the time of entry into force of the Treaty provision or the establishment of the structure in question, whichever is later, taxpayers are advised to request a determination early on, if it is certain that none of the objective tests can be satisfied.

A. Objective (safe harbour) tests

The objective tests in Article 26 of the Dutch Treaty that result in automatic qualification are the (1) Publicly Traded test, the Indirect Publicly Traded test and the Shareholder test in Paragraph 1 of Article 26; (2) Active Trade or Business test in Paragraph 2 of Article 26; (3) Headquarters test in Paragraph 3 of Article 26; and (4) EC Shareholder test in Paragraph 4 of Article 26. An exception to the listed tests is contained in Paragraph 1 of Article 26 for persons deriving shipping and air transportation income.

1. Publicly traded test
Indirect publicly traded test
Shareholder test

Generally, this test requires the relevant company to either be publicly held or have a lesser level of public ownership but demonstrate through a base reduction test that payments to the company are not substantially channelled to persons not qualifying for treaty benefits. If a company's shares are regularly and substantially traded on a registered stock exchange, there is a presumption that the company is owned by residents of the State where the stock exchange is located and that, even if residents of non-treaty countries are the ultimate shareholders of the company, treaty shopping is not the principle purpose of the company's organization. A similar test applies in the branch profits tax area.

A company is considered to be entitled to treaty benefits if:

(I) the principal class of its shares are:
- (A) listed on a recognized stock exchange in either the US or the Netherlands, *and*
- (B) regularly and substantially traded on any recognized exchange.[18]

(II) (A) more than 50 percent of the company's shares (both in terms of voting rights and value) are directly or indirectly owned by five or fewer companies resident in either the US or the Netherlands that meet the requirements under (I)[19] *and*
- (B) (i) the company is not a conduit company[20] *or*
  - (ii) the company satisfies a base reduction test.[21]

(III) the company is a resident of the Netherlands *and*
- (A) at least 30 percent of its shares are owned by five or fewer resident Dutch companies which meet the requirements under (I) *and*
- (B) at least 70 percent of its shares are owned by five or fewer US or EC resident companies[22] listed and traded on a recognized stock exchange *and*
- (C) (i) the company is not a conduit company *or*
  - (ii) the company satisfies a base reduction test.

(IV) (A) a majority of the company's shares are owned by persons which satisfy I-II above, *and*
- (B) the company satisfies a base reduction test *or*

(V) the company is a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its state of residence *and*
the majority of its beneficiaries, members or participants are persons which satisfy (I)-(II) above or are US citizens.

18. The Memorandum of Understanding indicates that the London, Paris and Frankfurt Exchanges qualify as recognized stock exchanges. The competent authorities may designate additional third country exchanges that qualify.
19. Art. 26(8)(k) provides that the reference to "shares owned directly or indirectly" shall mean that all companies in the chain of ownership that are used to satisfy the ownership requirements must meet the residence requirements in that clause.
20. The term conduit company is defined by Art. 26 Para. 8(m) of the Treaty as a company which makes deductible payments (i.e. interest, royalties) equal to 90% or more of its aggregate receipt of such items in the same taxable year.
21. The base reduction test is satisfied if deductible payments (i.e. interest, royalties) to persons not entitled to benefits under the Treaty are less than 50% of the company's prior year gross receipts.
22. A member of the EU is a qualified member of the EU if both the Netherlands and the United States have a comprehensive income tax treaty with that particular member of the EU.

2. Active trade or business test

The assumption underlying this test is that a third country resident that derives income from a certain activity in the United States would not incur the expense of establishing a substantial Netherlands trade or business involving a similar activity primarily to avail itself of the benefits of the Treaty. In these instances, it is therefore presumed that the investor has a valid business purpose for investing in the Netherlands.

To satisfy this test, a Netherlands company has to:
(I) be engaged in the active conduct of a trade or business in the Netherlands *and either*:
(II) (A) (i) the income for which benefits are claimed is derived in connection with the trade or business in the Netherlands *and*
(ii) the trade or business of the Dutch income recipient is substantial in relation to the US income producing activities; *or*
(B) the income derived from the US is incidental to the Dutch trade or business.[23]

This test has a group qualification component as well. Income is derived "in connection with" a trade or business if the income producing activity in the United States is a line of business that "forms a part of" or "is complementary to" the trade or business conducted in the Netherlands (the state of residence). The Treasury Explanation interprets "forms a part of" as meaning "the design, manufacture or sale of the same products or type of products, or the provision of similar services." The technical explanation further states that "complementary" does not require the activities to relate to the same type of products or services, but "they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure of the other."

The "substantial" requirement has a safe harbour. Dutch activities will be considered substantial if the assets, gross income and payroll expenses of the Dutch trade or business exceed certain threshold percentages as compared to each of these items for the similarly connected US trade or business from which payments are received.

Income derived from a State is "incidental" to a trade or business conducted in the other State if the income is not "derived in connection with" a trade or business and if the production of such income facilitates the conduct of a trade or business in the other State (for example, the investment of the working capital of such trade or business).

Certain attribution rules apply to determine whether a company is engaged in the active conduct of a trade or business in the Netherlands, and may facilitate meeting that threshold test.

3. Headquarters test

A Netherlands company will be entitled to benefits if it is considered to function as a headquarters company for a multinational group. To qualify as a headquarters company, each of seven sub-tests listed in the Treaty need to be met. These sub-tests serve to demonstrate a business purpose for being established in the Netherlands. The headquarters company must provide a substantial portion of the overall supervision and administration of the group.[24]

4. EC Shareholder test

Passing the EC shareholder test provides for the application of the benefits of the Dividend, Branch tax, Interest and Royalty articles of the Treaty only. The EC shareholder test consists of (I) an ownership test and (II) a base reduction test.

(I) To meet the EC shareholder test, the company must be:
(A) a resident of the Netherlands *and*
(B) at least 30 percent of the aggregate voting rights and value of its shares must be owned by five or fewer resident Dutch companies which meet the requirements under the Publicly Traded test *and*
(C) at least 70 percent of its shares must be owned by five or fewer US or EC resident companies[25] listed and traded on a recognized stock exchange *and*
(D) (i) the company is not a conduit company *or*
(ii) the company satisfies a base reduction test.[26]

(II) (A) a majority of the company's shares must be owned by persons which satisfy the publicly traded test, *and*
(B) the company satisfies a base reduction test.

B. Subjective test

The Treaty provides that companies who fail to meet one of the primary objective tests can seek competent authority relief by requesting a determination from the competent authority that the taxpayer qualifies for treaty benefits. Article 26, Paragraph 7 provides:

> "A person resident of one of the States, who is not entitled to treaty benefits of this Convention because of the foregoing paragraphs, may nevertheless, be granted benefits of this convention if the competent authority of the State in which the income in question arises so determines. In making such determination, the competent authority shall take into account as its guidelines whether the establishment, acquisition, or maintenance of such person or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under this Convention."

The Treaty mandates a guideline for the competent authority in determining whether a company qualifies for treaty benefits. The given guideline is that obtaining benefits under the new Treaty was not a "principal purpose" of the arrangement. The primary consideration under Paragraph 7 is the taxpayer's motive in establishing itself in the Netherlands, and whether residence in the Netherlands can be explained by factors other than the motive of deriving treaty benefits. If the US competent authority determines that obtaining benefits

23. Be aware though that this alternative test can have the effect of disqualifying a company from the zero withholding regime on interest in Art. 12(8).
24. Specific headquarters functions are enumerated in the MOU.
25. *Supra* note 22.
26. The base reduction test is satisfied if its payments of tax deductible interest and royalties to companies not entitled to the benefits of the Treaty are less than 50 percent of its gross income.

under the Treaty was not a "principal purpose" of the arrangement, an entity qualifies for discretionary relief and may be entitled to treaty benefits.

Establishing that obtaining treaty benefits was not the principal purpose of the arrangement is done through review and measurement of indicia of intent. Paragraph XIX of the MOU to the Treaty enumerates six subjective factors which may be considered by the competent authority in applying the principal purpose test. The six factors serve as indicia of intent and are intended to assist in determining whether the principal purpose test is met. However, unlike the primary objective tests under Article 26, satisfaction of one of the intent factors of the principal purpose test will not automatically qualify a company for treaty benefits. The Senate Foreign Relations Committee Report states that the purpose of Article 26(7) is to provide a "safety valve" for a treaty country resident that has not established that it meets one of the objective tests, "but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty".

C. The six intent factors

The six factors listed in the MOU that help in determining if the principal purpose test is met are examined below:

1. The company's date of incorporation in relation to the date that the new Treaty entered into force

This requires chronological ordering of the date of incorporation of the entity relative to the date of entry into force of the new Treaty. Technically, the LOB provision only applies to the new Treaty, but since the date of incorporation merely serves as indicia of intent and not as a test, a date of incorporation preceding the effective date of the Treaty may be considered. Unfortunately, it can not be logically concluded that the earlier the date of an entity's incorporation and its placement within the overall structure of the taxpayer group, the less likely it is that tax avoidance was a principal purpose for including the entity. An entity incorporated under the former Treaty may very well have had as its principle purpose the obtaining of benefits under the former Treaty. Therefore, being incorporated in the Netherlands before the ratification of the new Treaty does not necessarily assist in eradicating "bad" intent. However, the fact that an entity was incorporated prior to the entry into force of the former Treaty (1947) and employed as part of the company structure prior to that date can possibly assist in disproving "bad" intent.

2. The continuity of the historical business and ownership of the corporation

In many cases, companies operating in the Netherlands were formed before the new Treaty entered into force and have never changed hands. Therefore, factor (2) is relatively easy to meet and may assist in establishing "good" intent. Further, the fact that a company's shares have always been held directly or indirectly by the original founder or direct descendants of the founder, may be viewed positively. Mere shifting of ownership within a taxpayer group due to business evolvement will generally be respected. This factor aims primarily at exposing the practice of purchasing shell companies or holding companies in the Netherlands for the purpose of reducing the overall tax liability and obtaining specific treaty benefits.

3. The business reasons for the corporation residing in its State of residence

This factor examines the business reasons for a company residing in the Netherlands. In addition, this factor allows the competent authority to consider, as a separate factor, the business reasons for locating outside of a particular country. To meet the business reasons factor, a company must not only be able to show its business reasons for locating in the Netherlands, but specifically, why the company prefers operating in the Netherlands as opposed to another country. The typical assertion of the favourable Dutch treaty network and favourable Dutch tax system are not necessarily persuasive in this context. Arguments focusing on the Dutch infrastructure and hospitable business environment may weigh in the decision to locate in the Netherlands, but these too are not necessarily persuasive. Many of these benefits could have been obtained by locating in another country. Therefore, it will be helpful to emphasize the business reasons for not residing in another country as well as the business reasons for residing in the Netherlands.

4. The extent to which the corporation is claiming special tax benefits in its country of residence

This requirement has been part of LOB provisions for a long time.[27] Unfortunately there is not much guidance as to what would be considered to constitute a "special" tax benefit. In general, part of the reason companies are formed in the Netherlands is because of the favourable Dutch treaty network and favourable Dutch tax system. However, most companies receive no more favourable tax treatment than any other company formed in the Netherlands. Therefore, a negative result when applying this factor is hardly decisive. To properly apply this factor, a distinction must be drawn between tax benefits granted under the Dutch tax code such as the participation exemption or the absence of withholding on interest and royalties, and special tax benefits available on a case by case basis through the Dutch ruling practice. A complicating factor is that a US determination of "bad" intent where a Dutch company is granted specific tax benefits by the Dutch tax authorities would indicate great scepticism as to the integrity of the Dutch tax authorities by the US competent authority. By default therefore, this factor can serve to look at treaty benefits obtained under the treaty between the Netherlands and the country where the foreign parent company is incorporated or where the ultimate shareholders reside. Further, this factor allows the competent authorities to look at the effective tax rate applying to the income rather than mere-

27. For example, see Art. 16 of the 1967 US–Brazil Treaty (which never entered into force).

ly at whether the Dutch entity receives "special treatment" as compared to other Dutch entities.

5. The extent to which the corporation's business activity in the other State is dependent on capital, assets, or personnel of the corporation in its State of residence

This test may assist in determining the role of the corporation resident in the Netherlands. Financing companies, which, like holding companies, typically conduct little or no business in the Netherlands, may be able to present a compelling argument by reference to this factor. Financing companies typically have as their main function the access of capital markets through debt offerings to portfolio investors. They fund loans to related entities through the issuance of Euromarket bond loans or through note loans to institutional lenders. Although failure of this test by itself will not be too decisive, satisfying this test may tip the scales towards a favourable determination.

6. The extent to which the corporation would be entitled to treaty benefits comparable to those offered by the convention if it had been incorporated in the country of residence of the majority of its shareholders

A common argument used to help substantiate that the principal purpose of incorporation in the Netherlands was not to obtain treaty benefits under the US–Netherlands Treaty is that the taxpayer would have enjoyed the same treaty benefits under the treaty between the US and a third country where the Parent company is located. For example, if the withholding rate under the US–Netherlands Treaty and the relevant US–third country treaty for a particular type of income is the same, then the Dutch entity was not incorporated in the Netherlands for the principal purpose of obtaining benefits under the US–Netherlands Treaty. Satisfaction of the comparable benefits test by itself will usually not be considered conclusive.[28] While it may be appropriate in certain cases to grant discretionary relief to such entities, it normally would be required to demonstrate favourable indicia of intent in addition to the derivative benefits argument. This is because if the derivative benefits argument were to be paramount, the competent authority could effectively modify the shareholder test by allowing derivative benefits to any 100 percent foreign owned company. This was clearly not the intention of the negotiators. Also, such a conclusion would narrow the treaty-shopping analysis significantly, and ignore third party use of treaty countries that impose a very low level of tax. In general, a low to very low effective tax rate in the treaty country will be taken into consideration by the competent authority when determining whether the third country was chosen for treaty shopping purposes (albeit in a broad sense). In such a situation, a look-through to the ultimate shareholders will assist in determining whether income is merely being accumulated in the treaty country and not further distributed to the ultimate beneficiaries so as to avoid and minimize taxes. Therefore this factor is interpreted as allowing the competent authority to determine whether the majority shareholder of the Dutch resident company is a "qualified owner" and whether the ultimate owners of the Dutch company were in fact treaty shopping.

These six factors are construed to assist in determining a taxpayer's "principal purpose" and solely serve as indicators of the taxpayer's intent. The factors are not accorded equal weight and not all are necessarily relevant in a particular case. The competent authority is entitled to take into account other considerations and indicia of intent in making its determination as to the taxpayer's principal purpose.

D. The EC factor

In addition to these six factors, Paragraph XXI of the MOU provides that the legal requirements for the free flow of capital and persons within the European Union, together with the differing internal tax systems, tax incentive regimes, and existing tax treaty policies among the EU Member States, should be taken into account (the EC factor). No reference in the Treaty, the technical explanation or the MOU indicates that this factor in and of itself will suffice to qualify for treaty benefits. In fact, Paragraph 4 of Article 26 of the Treaty already allows for significant EU ownership in exchange for reduced Dutch ownership. Therefore, one can not easily conclude that the EC factor will be a coercive factor. However, in specific situations this factor may certainly assist in presenting a sympathetic case where a Dutch company is wholly owned by EU owners, and other subjective tests are satisfied.

E. The changed circumstances factor

Paragraph XIX of the MOU expressly allows the competent authority to grant relief pursuant to Paragraph 7 of Article 26 to a company which formerly qualified under Article 26 but, due to a change in circumstances, no longer qualifies, so long as a tax avoidance motive did not precipitate the new circumstances:

> "The competent authority may determine under a given set of facts, that a change in circumstances that would cause a company to cease to qualify for treaty benefits under Paragraphs 1 and 2 of Article 26 (limitation on benefits) need not necessarily result in a denial of benefits. Such changes in circumstances may include a change in the state of residence of a major shareholder of a company, the sale of part of the stock of a Netherlands company to a person resident in another member state of the European communities, or an expansion of a company's activities in other member states of the European Communities, all under ordinary business conditions. The competent authority will consider these changed circumstances (in addition to other relevant factors normally considered under Paragraph 7 of Article 26) in determining whether such a company will remain qualified for treaty benefits with respect to income received from United States sources. If these changed circumstances are not attributable to tax avoidance motives, this also will be considered by the competent authority to be a factor weighing in favour of continued qualification under Paragraph 7 of Article 26."

28. See the derivative benefits rule in the proposed protocol to the US–Canada Treaty.

Paragraph XXI provides that the competent authority may determine that a change in circumstances causing a company to no longer qualify for benefits under the publicly traded test, the active trade or business test or the exempt organizations test (Article 26 Paragraphs 1 and 2) of the Treaty, will not necessarily result in the denial of benefits, if these changed circumstances are not attributable to tax avoidance motives. The changed circumstances factor only applies to the aforementioned objective tests.

F. The narrow margin factor

The Treasury's Technical Explanation states that the fact that a corporation failed to satisfy one of the tests by a narrow margin should also be considered as a favourable factor. Narrow failure to meet one of the objective tests is, by itself, not sufficient reason to grant discretionary relief. However, it will be a favourable factor that, together with other factors demonstrating the lack of a treaty shopping motive, may warrant discretionary relief. It is important to note that narrow failure of the ownership percentages in Article 26 is not likely to be a persuasive argument for a favourable determination under Paragraph 7 of Article 26. Since the spirit of the LOB provision is to limit the granting of treaty benefits that are effectively enuring to the benefit of third country residents, the ownership percentages can be deemed critical components of the tests enumerated in Article 26.

The factors and tests set out in the MOU and the Technical Explanation are not intended to be an exhaustive list of what may be considered in deciding whether to grant benefits. The MOU merely identifies examples of indicia of a taxpayer's intent to establish itself in the Netherlands. All relevant factors may be considered by the competent authority when analysing a case. Also, the presence or absence of any one factor will not be considered conclusive in deciding whether or not to grant discretionary relief. Therefore, it does not necessarily matter how many factors a taxpayer satisfies. Consistent with the guideline stated in Paragraph 7 of Article 26, the purpose of applying the factors and subjective tests is to determine if one of the principal purposes of forming a company in the Netherlands is to obtain the benefits of the Treaty, i.e. whether "the establishment, acquisition, or maintenance of such person or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under this convention".

G. Requests for discretionary relief

Article 26(7) of the new Treaty provides that companies who fail to meet the four primary objective tests can seek competent authority relief. The procedure for requesting US competent authority assistance is explained in Rev. Proc. 91-23, 1991-1 C.B. 534 as amended by Announcement 95-9, 1995-7 I.R.B. 57. Requests for assistance in limitation on benefits cases should comply with Announcement 95-9. The new Treaty does not provide additional specific procedures for requests for competent authority assistance and no other additional procedures have yet been issued.

In general, only requests by US persons, as defined under Section 7701(a)(3) of the IRC, will be considered by the US competent authority. However, Notice 94-1 clarifies that for the purposes of the US–Netherlands Treaty, non-US persons may present their initial request for assistance directly to the US competent authority. The US competent authority will not issue determinations regarding a taxpayer's status under the prescribed requirements in the LOB provision. The competent authority may determine the availability of treaty benefits only when the prescribed requirements are not met. Determination requests regarding whether a Dutch taxpayer is entitled to the benefits of the Treaty based on the tests enumerated in Paragraphs (1) through (6) of Article 26 shall not be considered, because of the inherently factual nature of these questions.[29] Further, no determination requests shall be considered with respect to hypothetical situations.

Although a request for competent authority assistance generally must be filed after an action occurs which would give rise to a claim for competent authority assistance, taxpayers have discretion over the time for filing such a request. However, as stated earlier, in the absence of a favourable competent authority determination, a conservative taxpayer is advised not to claim benefits under Paragraph 7 of Article 26. Thus treaty benefits should only be claimed if a Dutch taxpayer has already obtained a favourable determination, or if it is confident of the fact that it satisfies one of the objective tests enumerated in Article 26. If the IRS has initiated an examination in which the validity of a Dutch taxpayer's claim for treaty benefits under the tests enumerated in Article 26 is at issue, a determination request could only be made with the permission of the Director of the District office which has jurisdiction over the examination. In such instances, the District Director will consult with the US competent authority in deciding whether to grant a Dutch taxpayer permission to request a determination. However, a favourable determination may be granted retroactively to the beginning of the taxable year in which the request was filed.[30] The determination generally will be valid for the taxable year in which the determination is requested and for the succeeding two taxable years assuming that there are no material changes in the Dutch taxpayer's facts and circumstances. If during the three year validation period a material change occurs in any fact that formed the basis for the determination, the Dutch taxpayer must notify the US competent authority of such change and submit a new request for a determination, explaining the change.[31]

29. See Notice 94-1, 1994-2 *I.R.B.* at 24, Rev. Proc. 94-7 Sec. 3.01 2., 1994-1 *I.R.B.* at 174.

30. The Technical Explanation to the Treaty provides that "...it is also expected that if the competent authority determines that benefits are allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later".

31. See MOU Paragraph X.

V. CONCLUSION

LOB provisions are here to stay, and their potential impact on the treaty shopping game should not be underestimated. The objective (and subjective) LOB tests, if carefully applied and enforced, are an effective measure to obtain the disclosure of information necessary to determine whether treaty benefit claims are warranted and to subsequently weed out those that are not. However, the effectiveness of and compliance with LOB provisions will ultimately depend on the extent to which they will be enforced from an audit perspective and to what extent the US competent authority will be provided with adequate resources to respond to the request for LOB determinations.

A significant ancillary factor is to what extent withholding agents will be held responsible for ascertaining whether foreign beneficiaries are qualified residents for purposes of the respective LOB provisions. In this context, the "actual knowledge or reason to know" test applicable with regard to the duty of a withholding agent is hard to enforce. Without a competent authority determination, it is questionable whether an unrelated withholding agent will ever be able to have actual knowledge or reason to know whether a beneficiary does or does not qualify for treaty benefits pursuant to the relevant LOB provisions. Withholding agents, caught between the proverbial rock and a hard place consisting of the reason to know standard and the under withholding penalty provisions, are advised to move with great caution.[32] Form IB 93 USA is helpful, but considering its limited scope, not determinative in resolving the dilemma.[33] In this regard the re-introduction of the Certification of Residence Form as initially proposed pursuant to Section 342 of TEFRA would greatly assist withholding agents.

32. For the reason to know standard is a subjective standard, developed mainly in connection with the innocent spouse doctrine. *See Sanders v. United States*, 509 F.2d 162, 167 (5th Cir. 1975; *Guth v. C.I.R.*, 897 F.2d 441 (1990); Stevens, 872 F.2d 1499.

33. See Notice 94-85, 1994-35 *I.R.B.* at 20.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

JANUARY 1996

Principles of international taxation, Amsterdam, 22-26 January 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Taxation of Italian employees working abroad, Milan, 29-30 January 1996 (Italian/English):

Assoservizi Srl, Via Chiaravalle 8, 20122 Milan, Tel.: 39-2-5830 4888, Fax: 39-5830 4507.

MARCH 1996

Application of tax treaties, Amsterdam, 4-6 March 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Meeting of the International Tax Planning Association, Budapest, 7-8 March 1996 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

APRIL 1996

International tax planning techniques, Amsterdam, 11-12 April 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

SWITZERLAND

Income Tax Incentives for Corporations

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I. INTRODUCTION

The Swiss tax system is made up of a network of different taxing jurisdictions. Although federal tax is common to all Swiss companies, each of the 26 cantons has its own tax system, which is usually further subdivided between numerous communes. Until recently, there have been significant differences between the different taxing jurisdictions which has led to some interesting tax planning opportunities through the use of "canton shopping". However, these differences shall be greatly reduced before the end of the century.

Switzerland is currently undergoing a total reform of its corporate income tax system with a view to harmonizing federal, cantonal and communal tax law. Firstly, a new Direct Tax Law[2] (hereafter: DTL) entered into force on 1 January 1995. Secondly, a tax harmonization law[3] (hereafter: THL) was introduced on 1 January 1993 which lays down the foundations of a new tax system upon which all cantons must be based before the end of the year 2000.[4] Although the general principles of taxation shall be similar throughout Switzerland, there are still possibilities for "canton shopping" since each canton is free to interpret the THL in its own way and, more interestingly, cantons are still able to apply competitive tax rates.

These laws introduce many important changes to the method of assessing Swiss corporations to income tax. However, Switzerland remains a competitive location when seeking international tax planning opportunities. The following is a brief survey of the more common tax incentives still available for corporations.

II. RELIEF FOR QUALIFYING DIVIDEND INCOME

In Switzerland the classical system of taxation applies to corporate profits. This implies that a company is charged to tax on its profits and that its shareholders are taxed separately on the dividends paid out of these same profits. There are no rules to allow the shareholders a credit for the tax paid by the company.[5]

Following from the above, where a corporation is interposed between an operating company and its shareholders, there would normally be an economic triple taxation. The economic double taxation imposed by the classical system may be acceptable, economic triple taxation certainly is not. Therefore, in order to avoid the additional layers of taxation on corporate profits, Switzerland has adopted a system whereby a company receiving dividends derived from qualifying holdings may file for tax relief. Tax relief comes in the form of a reduction of federal and cantonal taxes. It is computed based on the ratio that the net qualifying dividend income bears to the total net profits of the recipient company.

A. Legislation

The following articles are applicable for Swiss federal tax purposes. Similar rules are also to be found in the THL.[6]

Article 69 DTL

> Should a joint-stock company or cooperative hold more than 20 percent of the share capital of another company or a participation with a current market value of more than CHF 2 million, income tax shall be reduced by reference to the ratio between the net earnings generated by these participations and total net profit.

Article 70 DTL

> 1. Net earnings on participations pursuant to Article 69 correspond to the earnings on these participations less the financing costs related thereto, and an amount of 5 percent which covers administrative costs. Financing costs are defined as interest on loans and other costs which are economically equivalent thereto.
>
> 2. The following are not considered as earnings on participations:
> (a) repayments of capital;
> (b) earnings which represent commercially justified expenditures for the paying joint-stock company or cooperative;

1. The author wishes to thank Dr Xavier Oberson, Professor of Taxation and Administrative Law at Geneva University, for his valuable suggestions.
2. Loi fédérale du 14 décembre 1990 sur l'impôt fédéral direct, *RS* 642.11.
3. Loi fédérale du 14 décembre 1990 sur l'harmonisation des impôts directs des cantons et des communes, *RS* 642.14.
4. Art. 72 para. 1 THL.
5. Swiss resident shareholders may obtain relief for taxes paid by corporations in states which apply the tax credit mechanism if granted by a double tax convention. (This concerns distributions from entities resident in Great Britain, France and Ireland).
6. Art. 28, para. 1 THL is exactly the same as Art(s). 69 & 70 para. 1(1) DTL.

(c) capital gains on participations and gains on the revaluation of participations, including proceeds from the sale of priority subscription rights.

3. Earnings on participations shall only be taken into account in calculating the reduction when a distribution of earnings has not lead to a depreciation of the corresponding participations which reduces taxable net profits.

B. Companies for which relief is available

Qualifying dividend relief is available to joint-stock companies and cooperatives. The former include Swiss corporations, limited liability companies, and corporations with unlimited partners.[7] It is also available to foreign companies of a similar nature if the foreign company maintains a permanent establishment in Switzerland and the dividends are directly linked to the Swiss operations.[8] All these entities may qualify for relief on dividend income regardless of the nature of their activities and regardless of the country in which the shareholders are resident.

C. Dividend income for which relief is available

To qualify for relief on dividend income, a Swiss company must own at least 20 percent of the registered capital of another company, or a participation the value of which exceeds CHF 2 million.

Participations include shares or any other interests which grant the right to a dividend or similar income (e.g.: participation certificates, profit sharing certificates and founders certificates.[9]) Participations do not include bonds and other loan certificates held by shareholders.[10] Participations must be held directly by the Swiss beneficiary at the time the dividends are due. They may not be held on a fiduciary basis nor be subject to usufruct.

Earnings generated from participations include ordinary dividend distributions as well as any other attribution of income to shareholders such as hidden dividend distributions, liquidation proceeds, bonus shares etc. The term does not include repayments of capital, income for which a deduction is granted to the distributing entity[11], capital gains and revaluation gains.

Earnings on participations shall only be granted relief to the extent that a distribution of earnings does not lead to a subsequent tax deductible depreciation of the shares in the distributing company.[12] Indeed, it is not possible to obtain the relief for qualifying dividend income as well as a tax deduction resulting from the corresponding depreciation of the shares.

D. Calculation of tax relief

Companies with qualifying dividend income may reduce their corporate income tax by reference to the ratio between net earnings on such participations and total net profit. The following formula must be applied in each tax period to determine the amount of the tax relief available:

$$\text{Tax Relief} = \text{Corporate income tax} \times \frac{\text{Net qualifying dividend income}}{\text{Total net profit}}$$

(1) Corporate income tax
This is the ordinary tax levied on Swiss resident corporations. It is calculated by applying ordinary Swiss tax rates to the total net profit as determined hereafter.

(2) Total net profit
This is the net taxable profit which is used as a basis to determine the corporate income tax as per Swiss tax law. It includes the qualifying dividend income. There are special rules to take into account the situation where Swiss companies may also obtain relief for permanent establishments or real estate situated abroad.[13]

(3) Net qualifying dividend income
The following formula must be applied to determine the amount of net qualifying dividend income:
gross qualifying dividend income less financing costs; less administrative costs* ; and less other costs.
* (5 percent of gross qualifying dividend income)

Gross qualifying dividend income is the total amount of the dividend. It includes unrecoverable foreign tax at source as well as any tax credit which may be available on dividends received from companies resident in Great Britain, France or Ireland.

Financing costs are defined as interest on loans and other costs which are economically equivalent thereto. They are generally attributed to qualifying dividend income by reference to the ratio between the book value of the qualifying participations and total assets. This is however not the only method of attribution. Any other justifiable method may also be taken into consideration.

Administrative costs incurred due to the management of participations may be difficult to determine. To avoid any time-consuming complications, a fixed 5 percent deduction is allowed without justification. The deduction does not apply to pure holding companies whose only income is qualifying dividend income.[14]

7. Société anonyme, Société à responsabilité limitée, Société en commandite par actions.
8. Art. 49 para. 3 DTL, Art. 24 OECD Model tax convention on income and on capital (non-discrimination). Permanent establishments of foreign companies do not qualify for treaty relief on dividends received from abroad.
9. Bons de participation, bons de jouissance, Parts de fondateurs.
10. Except if the loan is economically considered as share-capital and the interest received is not allowed as a deductible expense in the hands of the distributing company (see Art(s). 65 & 75 DTL, Art(s). 24 para. 1(c) & 29 para. 3 THL).
11. Due to payment of interest, royalties, commissions, management fees, R & D etc.
12. Art. 70, para. 3 DTL.
13. Circular No. 5 "Relation existant entre la réduction pour participations de l'article 59 AIFD et les réductions pour établissements stables et immeubles à l'étranger selon l'article 55 AIFD", *Federal Tax Administration*, 21 January 1985.
14. If the net qualifying dividend income is artificially reduced by 5 percent, a pure holding company whose only income is qualifying dividend income, would not be totally exempt since the net qualifying dividend income would be lower than the total net profit.

Other costs incurred by qualifying participations include non- recoverable foreign tax at source.

III. HOLDING COMPANIES

Holding companies may obtain relief on qualifying dividend income for Swiss federal tax purposes (see above). Consequently, a pure holding company (i.e. a company whose income is entirely generated by qualifying dividend income) is totally exempt from Swiss federal taxes. However, relief for qualifying dividend income only applies to Swiss companies which hold minimum interests of 20 percent (or CHF 2 million) in other companies. In addition, the relief does not apply to capital gains, nor to interest on loans to affiliates.

In an attempt to attract both foreign and domestic investment, cantonal tax laws have the possibility of offering much more generous relief to holding companies. Indeed, companies which qualify for holding company status are completely tax exempt.[15]

A. Legislation

Article 28 paragraph 2 THL

> Joint-stock companies and cooperatives whose main purpose (according to their charter of incorporation) is the long term management of participations, and which do not have any commercial activity in Switzerland, do not pay corporate income tax for as long as the participations (or the income derived therefrom) represent more than two thirds of the total assets (or income). Income generated by these companies from Swiss real estate is taxable at ordinary rates, after taking into account any deductions for usual mortgage costs.

Those cantons which have already adjusted their legislation to comply with the THL have often simply incorporated this article into their own cantonal tax legislation.[16]

B. Criteria to qualify for Holding company status

Holding company status is granted to the same types of company as the relief for dividend income (see above). The additional conditions are as follows:

(1) the main purpose of the Holding company (as per its charter of incorporation) must be the management of long-term financial investments in affiliated companies;
(2) at least two thirds of the assets (or income) must be derived from long term participations; and
(3) a Holding company may not be actively engaged in commercial activity in Switzerland.

Main purpose

The main purpose of the company must be the holding of long term investments. This must not only be mentioned in its charter of incorporation but must also be true in reality.

Long term participations

More than two thirds of the assets or income of the Swiss Holding company must be generated by long term participations. In determining the ratio of long term participation to total assets, it is market values (rather than book values) which should be taken into consideration.

Participations is not defined by the THL. Cantons are therefore free to interpret this term. They are not limited by the 20 percent rule which is necessary for relief on qualifying dividend income (see above).[17] The Geneva Cantonal Tax Administration has interpreted this term to include financial participations as well as long term loans to affiliates.[18] Financial participations are defined as shares in the capital of joint-stock companies and cooperatives as well as any other interests which give the right to a dividend or similar payment. There is no minimum participation requirement. Affiliates are companies which are owned, or own, at least 20 percent of the Holding company.

Participations must be *long term*. Indeed, if there is a regular turnover of share holdings, the Swiss company shall be considered to be a share dealing company and lose its Holding company status. However, the THL does not define what is considered as "long term". Again, Cantonal Tax Administrations may provide their own interpretation.

Income from long term participations is not defined by the THL. Cantonal tax practice may therefore consider that such income does not only include dividend distributions, but also other income such as capital gains or interest income.

Absence of commercial activity in Switzerland

Holding companies may receive income from sources other than long term participations as long as such income does not exceed one third of total income. However, Article 28 paragraph 2 clearly mentions that there can be no commercial activity in Switzerland. This may be interpreted as no "commercial (or industrial) activity on the Swiss open market".[19] There must therefore be no construction, manufacturing or trading of goods or services with Swiss clients. However, other activities are tolerated. These include management and administration of the company itself as well as the participations it holds. It also includes financing, management of intellectual property or investment and management of the company's working capital.

C. Taxation of holding companies

Holding companies are exempt from corporate income tax.[20] This is the case irrespective of whether the income is derived

15. There is an exception with regards to income from real estate situated in the canton as well as income for which a Holding company wishes to obtain relief by virtue of a double taxation convention.
16. E.g.: Art. 22 Geneva Corporate Tax Law (hereafter: CTL-GE) = Loi du 23 septembre 1994 sur l'imposition des personnes morales (D 3 1.3).
17. See also Art. 665(a) para. 3 Swiss Code of Obligations.
18. Information No. 4/94, "Imposition des sociétés holding et des sociétés auxiliaires: Nouvelles règles applicables dès le 1er janvier 1995", *Geneva Tax Administration*, 12 December 1994.
19. Walter Ryser, "La réduction pour participations, les sociétés holding et de domicile", *Archives*, vol. 61, at 394.
20. There is complete exemption on income from dividends, interest, royalties, capital gains etc.

from long term investments or otherwise, or whether the income is generated abroad or in Switzerland.

This general rule suffers a few exceptions. Holding companies may own real estate in Switzerland, however, any income or capital gains generated from such real estate is subject to ordinary taxation.[21] Income for which treaty relief is obtained must be subject to ordinary taxation if required by the relevant tax treaty.[22] In Geneva, income earned from services rendered to Geneva based affiliates is also subject to ordinary taxation.[23]

IV. DOMICILIARY COMPANIES

Domiciliary companies are those which have administrative activities in Switzerland but which are exclusively engaged in commercial activities abroad. They can range from small letter-box companies with no personnel or infrastructure of any kind, to the large operational headquarters of multinational companies. Although Swiss federal tax law does not provide any particular relief for Domiciliary companies, there are special rules for cantonal and communal income tax purposes. These rules have been designed to attract foreign investors interested in sales, financing, intellectual property or other operations outside Switzerland.

Companies which qualify for Domiciliary company status are completely exempt from tax on income from dividends and capital gains from their financial participations. In addition, profits from trading outside Switzerland are taxed at substantially reduced rates.

A. Legislation

Article 28, paragraph 3 THL

> Joint-stock companies, cooperatives and foundations which have an administrative activity in Switzerland, but no commercial activity, pay corporate income tax as follows:
> (1) income from qualifying participations, capital gains and gains on the revaluation of such participations are tax exempt;
> (2) other Swiss source income is taxed at the normal rates; and
> (3) other foreign source income is taxed at normal rates, to the extent it can be attributed to the management activities of the Domiciliary company.

Most cantons have incorporated this article into their own cantonal tax legislation.[24]

B. Criteria to qualify for Domiciliary company status

Domiciliary company status is granted to the same types of company as the relief for dividend income (see above). In addition, it is also granted to foundations. It is not necessary for the Swiss company to be held by foreign interests.

There may be administrative activity in Switzerland, however any form of commercial activity in Switzerland disqualifies the Swiss company from obtaining Domiciliary company status.[25]

C. Taxation of Domiciliary companies

Each canton has its own particular interpretation of Article 28 paragraph 3 THL. The following relates to the situation in the canton of Geneva.[26]

(1) Income from qualifying participations[27]
  - Dividend income: tax exempt.
  - Capital gains realized on the disposal of long-term investments: tax exempt (provided the gain does not arise on the sale of a real estate company which owns real estate in Geneva). Capital gains are however taken into consideration to determine the tax rate. Capital gains include gains from the sale, exchange, and re-evaluation of participations and exchange rate gains etc. It follows that any capital loss incurred on the disposal of long-term investments is not tax deductible, but can be taken into consideration for the purpose of determining the tax rate.

(2) Other Swiss source income
  - Other Swiss source income is taxed at ordinary rates.

(3) Other foreign source income
  - Foreign interest income from group companies[28]: 2.5 percent of such income is taxed at ordinary rates;
  - Other foreign interest income: 15 percent of such income is taxed at ordinary rates;
  - Other foreign source income: 20 percent of such income is taxed at ordinary rates.

  Foreign source income includes income derived from the purchase and sale of goods and services abroad, income derived from the use of intangible property abroad (license fees, royalties, etc.), income for services rendered abroad[29], commissions from fiduciary transactions carried out with foreign parties as well as commissions on transactions related to foreign real estate.

Income for which treaty relief is obtained must be subject to ordinary taxation if required by the relevant tax treaty.[30] Separate accounts must be held for each category of income from which the costs directly attributable to each category must be deducted.[31] If it is not possible to attribute costs to any particular category of income, financial costs may be allocated in proportion to the ratio between the book value of qualifying participations and total assets. Other general expenses are allocated by reference to the ratio between the Swiss source income and foreign source income.[32] Any losses suffered on

21. Interest paid on mortgage loans related to such real estate may be deducted from taxable income. Art. 28, para. 2 THL.
22. Art. 28, para. 5 THL.
23. Information No. 4/94, *supra* note 18.
24. Ex: Art. 23 CTL-GE.
25. See "Holding companies – Absence of commercial activity in Switzerland" mutatis mutandis.
26. See *supra* note 23.
27. Qualifying participations is explained under "Holding companies – criteria to qualify for Holding company status".
28. Group companies are those in the same "consolidated accounts" (this is to be defined by the competent tax authorities or case law).
29. See also: "Service companies."
30. Art. 28, para. 5 THL & Art. 24 CTL-GE.
31. Art. 23, para. 2 CTL-GE.
32. Art. 23, para. 3 CTL-GE.

participations or on the disposal of long-term investments may only be deducted from income generated by such assets.[33]

V. INTERNATIONAL SALES COMPANIES

International sales companies are set up in Switzerland for the specific aim of trading outside Switzerland. They are particularly interesting for re-invoicing and licensing companies. International sales companies often incur costs which are difficult to justify. To simplify matters, a Swiss company whose activities are managed from abroad and which has no commercial or technical organization in Switzerland may distribute 50 percent of its gross income without any form of substantiation.[34] This is the so-called "50 percent ruling". Although this special tax treatment has no legal basis, it is considered as generally accepted tax practice[35] and may be requested for Swiss federal, cantonal and communal income tax purposes.

A. Criteria to qualify for the 50 percent ruling

The following three conditions must be satisfied in order to qualify for the 50 percent ruling:
(1) independent commercial activity outside Switzerland;
(2) absence of any commercial or administrative organization in Switzerland; and
(3) activities of the Swiss company must be undertaken by shareholders and other individuals or corporations in a business relationship with the company.

B. Taxation under the 50 percent ruling

The 50 percent ruling is not strictly speaking a tax incentive. It is designed to minimize the number of litigious cases involving not only the question of deductibility of expenses but also the question of whether or not a constructive dividend is paid to the shareholders for the tasks which they accomplish on behalf of the company.

Under the 50 percent ruling, a company is entitled to deduct 50 percent of its gross profits in the form of a management fee or a royalty to a non-resident entity.[36] This percentage is deductible for corporate income tax purposes and is not re-characterized as a hidden dividend distribution. Hence it is not subject to Swiss withholding tax. Any payments made in excess of 50 percent of gross profits must be clearly justified, where justification is not possible, withholding tax is levied on all payments made to the shareholder (or to associates of that shareholder).[37]

From the remaining income, only administrative expenses limited to a maximum of CHF 10,000 to 12,000, and direct taxes may be deducted. The difference is usually taxable at ordinary tax rates. However, for cantonal and communal tax purposes, the 50 percent ruling may be combined with the rules applicable to Domiciliary companies (see above). In the canton of Geneva, this implies that the net taxable foreign source income is reduced by a further 80 percent (i.e. only 20 percent of taxable income is taxed at ordinary rates).

The following example illustrates the application of the 50 percent ruling applied in Geneva, where the company also takes advantage of the Domiciliary company rules:

	CHF
Gross profits:	100,000
50 % deduction:	(50,000)
Administrative expenses:	(10,000)
Net pre tax income	40,000
Tax : 15 % (Federal = 9 % and Cantonal and Communal = 6 %)	(5,217)*
Taxable income (taxes are deductible):	34,783
35% withholding tax on dividend distribution of 34,783 (treaty relief may be obtained)	(12,174)
Total tax liability	17,391
Effective tax rate on gross profits (in the absence of treaty relief)	17.4 %
Effective costs	27,391**

* Although the tax rate is 15% taxes are deductible. Therefore since 40,000 equals 115%, 100% equals 34,783, 34,783 x 15% = 5,217.

** The effective costs of 27,391 are calculated by adding the administrative expenses 10,000 to the income tax 5,217 and the withholding tax 12,174.

If any income is generated from an activity other than the foreign commercial activity, this is added to the taxable income. In other words, the 50 percent ruling does not apply to the income earned on any financial investments. These other items of income must be clearly separated in the accounts from the foreign commercial activity. The same is true for any costs directly linked to such other income.[38]

The Swiss Federal Tax Administration requires that any remaining income must be distributed in the form of a dividend. An exception is made for the amounts which are to be attributable to the legal reserve.[39]

VI. SERVICE COMPANIES

Service companies generally provide technical, administrative or scientific assistance including research and promo-

33. Art. 23, para. 4 CTL-GE..
34. Exceptionally, Tax Administrations have accepted a distribution of 80 percent of gross income (Supreme Court decision of 18 March 1991, *Archives* 60, 494 = *RDAF* 49, 81). This would not be possible if the re-invoicing or licensing company receives income for which treaty relief is requested. In this situation, the 1962 abuse decree (RO 1951 891 = *RS* 672.2) requires that no more than 50 percent of income for which tax relief is requested on the basis of a tax treaty may be used to satisfy contractual claims of persons not entitled to benefit from the treaty.
35. Supreme Court decision of 15 October 1993, *Archives* 63, 250.
36. Conrad Stockar "Aperçu des droits de timbre et de l'impôt anticipé – 3ème édition", *Lausanne* 1994, at 134.
37. See *supra* note 35.
38. The costs must be properly substantiated by relevant documentation.
39. Art. 671 Swiss Code of Obligations.

tional activities. When such services are provided to group companies, it is very difficult to determine the taxable income generated by the service company i.e. the extent of the contribution of the Swiss resident company to the total profits of the group. In order to limit the number of litigious cases, the Swiss Tax Administration commonly attributes to service companies a notional profit upon which tax is levied.[40]

This practice has no legal basis. It has however been officially confirmed by the Swiss Federal Tax Administration[41] as well as the Swiss Supreme Court.[42]

A. Criteria to qualify for service company status

A Swiss resident company must provide services to other companies within the same multinational group. Services to third parties do not qualify.

B. Taxation of service companies

The profit assessable in Switzerland is generally deemed to be at least 10 percent of total expenses incurred for the provision of the services to affiliates or one sixth of the total local payroll costs. Other income such as dividend, interest or licensing income must be added to the notional income.

The Service company ruling merely indicates the method of calculating the taxable income. For cantonal and communal tax purposes, it may be combined with the rules applicable to Domiciliary companies (see above). The following relates to the situation in the canton of Geneva.[43]

(1) Services provided in Switzerland are subject to ordinary taxation i.e. 10 percent of expenses are taxed at ordinary rates.
(2) In situations where a group service company employs non-resident personnel to provide services abroad to non-resident affiliates, 80 percent of the taxable expenses are exempt. The remaining 20 percent are subject to ordinary rates.
(3) Where Swiss resident personnel are employed to provide services abroad to non-resident affiliates, 50 percent of the taxable expenses are subject to the above mentioned preferential regime (i.e. 80 percent exemption). The remaining 50 percent is subject to ordinary rates.
(4) If Swiss resident employees work abroad for short periods of time, any expenses related to such activity are broken down between (1) and (3) in proportion to the number of days worked in Switzerland and abroad.

The Geneva Tax Administration has introduced a simplified method of calculating the corporate income taxes on Service companies which are primarily involved in rendering services abroad to group companies. Under this system, the company may choose to assess 30 percent of expenses at ordinary rates, and 20 percent of the remaining 70 percent of expenses at ordinary rates. Companies wishing to take advantage of this simplified method must request a prior ruling from the Geneva Cantonal Tax Administration.

VII. NEWLY ESTABLISHED ENTERPRISES

Newly established enterprises are not usually granted any particular relief for Swiss federal tax purposes. Nevertheless, the federal government does grant financial assistance on a case by case basis. This usually comes in the form of interest free loans or bank guarantees[44].

With regard to cantonal and communal income taxes, nearly all cantons encourage the establishment of new industries within their territories by granting tax privileges to new active business enterprises.[45]

A. Legislation

Article 23, paragraph 3 THL

> Cantons may introduce legislation which grants tax privileges to newly established enterprises which help the economic interests of the canton, for the year of foundation of the enterprise and for the nine following years. An important modification of the activity of an enterprise may be considered as a newly established enterprise.

B. Practical application

These privileges include exemptions from cantonal and communal taxes for a period of up to ten years after inception of the business. Enterprises not receiving the maximum relief can expect tax reductions of 30-50 percent over varying periods of up to 10 years or additional measures for anticipated amortization. These measures depend upon the type and amount of investment, the number of jobs created, regional economic planning aspects etc. In practice, they are primarily granted to enterprises engaged in manufacturing activities. However, recently even enterprises such as banks, insurance companies and accounting firms have exceptionally qualified. Requests for this relief must be submitted to the government of the canton in which the newly established enterprise is located.

40. Conrad Stockar, op. cit.
41. Circular No. 14, "Imposition des sociétés suisses qui exercent leur activité commerciale principalement à l'étranger", *Federal Tax Administration*, 29 June 1959.
42. Supreme Court decision of 25 January 1979, *Archives* 48, 207.
43. Information No. 8/95, "Imposition des sociétés dites de service", *Geneva Tax Administration*, 14 July 1995.
44. Financial assistance may be coupled with federal tax relief as per Art. 7, Arrêté fédéral instituant une aide financière en faveur des régions dont l'économie est menacée du 6 octobre 1978 (*RS* 951.931) and Ordonnance sur l'aide financière en faveur des régions dont l'économie est menacée du 21 février 1979 (*RS* 951.931).
45. Art. 1 Concordat intercantonal du 10 décembre 1948.

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 41-44 of the January 1996 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

ASIA & THE PACIFIC

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Papers prepared in conjunction with a series of seminars presented in Europe by Inter-Pacific Bar Association members during June 1995. The papers in this volume explore the practical aspects of joint ventures in China, Japan, Korea, Malaysia, the Philippines, Taiwan, Thailand, and Vietnam.
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Bangladesh

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INTERNATIONAL

Taxation and Foreign Direct Investment: The Experience of the Economies in Transition

David Holland and Jeffrey Owens[1]

I. INTRODUCTION

Foreign direct investment (FDI) has been identified by countries in transition towards market economies as an important element of that transition. This has led these countries to seek ways to attract FDI. In particular, a number of countries in the region have introduced tax incentives directed at attracting FDI. The use and effectiveness of such incentives in the context of the countries in transition have been the subject of a number of conferences sponsored by the OECD and others. This paper draws upon these discussions. Experience among OECD countries has suggested that tax incentives are not an effective way to promote or direct economic activity. This experience has led most observers from OECD countries to advise that the use of such incentives be avoided. In the context of advising the Economies in Transition, a number of questions and observations can be made.

The first question arises from the concern that the experience of OECD countries with developed product and capital markets may not be relevant to countries whose economies are in the first phase of the development of efficient markets. Therefore it is appropriate to ask, is there anything in the actual experience of those countries in the region who have used incentives to cause a reconsideration of the standard advice?

The second question is, what are the risks and potential benefits of different forms of incentives, if policy makers of the economies in transition decide to use incentives to accelerate the adjustments of their economies? In particular, if incentives are to be used, are there provisions to minimize the risks and enhance the achievement of the objectives?

In order to provide some insight into these questions, the OECD conducted a series of consultations with government officials, both tax policy makers and tax administrators, and private sector representatives in a sample of countries in the region viz. countries of the former socialist bloc of Eastern Europe and the former Soviet Union. The countries chosen had experience with the use of incentives which, it was hoped, could be usefully shared with other countries in the region. These consultations examined the more general factors that influence the decision to invest, the role of the tax system in the investment decisions of firms, the role of tax incentives in those decisions and the practical implications of the incentives on the functioning of the tax system. This article is based upon the report resulting from these consultations.[2] It builds upon the experience from OECD countries and draws conclusions based on the experiences of the countries in the region as revealed by the consultations. It generalizes from the experiences of specific countries to provide information which will be useful for policy makers throughout the region. It concentrates on the following issues: what are the important general features of the tax regimes from the point of view of potential foreign investors; what has been the experience from those countries that have provided special tax incentives to attract foreign investment; and, what are the practical consequences of the incentives on the administration of the tax system.

II. THE IMPORTANCE OF FOREIGN DIRECT INVESTMENT

Countries have identified a number of reasons for wishing to attract FDI. In general FDI is seen to be a way of compensating for existing deficiencies in the local markets and accelerating the transformation of the economies. The objectives of attracting FDI are:

Attraction of incremental investment capital

Local capital markets are often not well developed. They thus cannot meet the capital requirements for large investment projects. Moreover, access to the hard currency needed to purchase investment goods not available locally can be difficult. FDI solves both of these problems at once as it is a direct source of external capital. Foreign investors have access to foreign sources of capital and so are not constrained by the relative under-development of domestic capital markets or by the ability of the country to generate foreign cash flow from the export of domestic production.

1. Access to advanced technology

Relative to OECD production techniques, many firms in the region use out-dated equipment and techniques that can

1. The authors wish to thank Alex Easson who co-authored the original report and Richard Vann who made many useful comments. The views expressed are their own and do not commit the OECD or its Member governments.

2. A further discussion of these consultations can be found in "The Role of Tax Systems in Encouraging Foreign Direct Investment" OECD 1994.

reduce the productivity of workers and lead to the production of goods of a lower standard. This reduces the ability of the firms to compete abroad for export markets and contributes to the difficulty of the countries in the region to earn hard currencies. FDI is seen to address this problem as the investment goods are expected to embody advanced technology and the firms would bring in advanced know-how and production techniques. The alternative of purchasing the rights to the technology uses expensive foreign currency. It is also hoped that there would be spin-offs from the innovation process which would enhance the productivity of the local workforce and stimulate innovation among domestic firms.

2. Access to advanced management techniques

Foreign firms bring western management techniques with them when establishing operations. This provides an opportunity for locally engaged staff to acquire new techniques of operation. This transfer is of particular importance when existing firms are taken over and reorganized by foreign investors or when joint ventures are established with foreign investors. In the latter case, the foreign firm can benefit from the local knowledge and contacts of the domestic firm, and the domestic firm can benefit from new productivity enhancing management techniques.

3. Enhanced access to western markets

Western firms bring with them existing distribution channels and knowledge of the possibilities for sales to the global marketplace. The possibility for significant gains from trade would be opened up in a relatively costless manner. This would further the goal of export promotion as a source of foreign currency.

4. Facilitate privatization and restructuring

Certain types of privatization require large pools of capital and the ability to analyse the economic potential of an enterprise. Foreign firms can contribute in both of these areas. This can enhance the access to external sources of funds, as a source of capital when the assets are originally sold and when further investments are required to reorganize production and change product lines. The participation of foreign firms may also make the process more efficient by increasing the likelihood that the newly privatized enterprises would be able to realize their full potential.

Questions have been raised on the effectiveness of FDI in promoting a number of the above goals, e.g. technology transfer. Certainly not all FDI can be said to contribute to their achievement. Many of the projects attracted by the incentives offered have been short-term, profit-seeking ventures that have been of little lasting benefit to the country concerned and have been a drain on hard currency rather than a source. This suggests that, if the attraction of FDI is to be pursued for the above reasons, the instruments chosen must be critically evaluated to see if they are well targeted to the task.

III. NON-TAX FACTORS AFFECTING FDI

There are many factors other than the tax system that are relevant to the decision as to whether to invest in a country. Some of these factors are outside of the control of the government and relate to the comparative advantages of the country. These can be important in the policy process as the consultations have shown that the perception of relative disadvantages, say of location, is often used by policy makers to justify the provision of incentives to compensate for the disadvantages. Such policies are likely to be ineffective in improving the competitiveness of a country. The tax system can alter the private comparative advantages of firms on an after-tax basis and so has the potential to alter their behaviour. However it cannot change the relative advantages and disadvantages from a social point of view, that is, on a before tax basis. It merely divides the pie differently between the private sector and the government.

Other factors are within the control of, or at least can be influenced by, government policies. In many cases, these factors are seen by the private sector to be more important than the tax system, suggesting that these should be the areas the governments concentrate on.

It is not possible to assess the relative importance of the different factors in a quantitative manner. Certainly the ordering would be different for different sectors and circumstances. Some investors base their investment decisions on the economic opportunities and risks, with the tax consequences being worked out afterward. Naturally, an attempt is made to minimize the amount of taxes paid and so any incentives available were used. While this extreme view would certainly not hold in many cases, it underlines the fact that the tax system is probably not the most important factor in the FDI decision process.

Investment decisions are fundamentally driven by a comparison of the potential returns from an investment as compared to its risks. A number of non-tax factors are important in either contributing to the potential return or, often more importantly, reinforcing a perception of potential risk. These include:

A. Size of the market

The larger countries in the region provide substantial potential markets where the consumer demand for certain goods has been largely unfilled to date. This potential has been a draw for many of the initial foreign-owned operations in the region. In some cases these operations do not entail many, if any, of the benefits attributed to FDI. This is especially the case with short-term importation operations established to capture the economic rents available from satisfying the pent up demand for goods not previously available. In other cases, the establishment of a low cost marketing operation represents the first step by a multinational into the market of the country. This establishes a presence in the market and provides important insights into the ways of doing business and possible opportunities in the country.

B. Uncertainty

One of the greatest negative factors inhibiting FDI is the uncertainty that surrounds doing business in the region. To some extent, the uncertainty results from the fact that these markets have been closed to Western businesses in the past. It is for this reason that companies may establish small operations initially, in order to gather the necessary information for a full assessment of the risks and opportunities of doing business. In many countries the institutions of government are still evolving and there are unsettled political questions. This uncertainty is one of the major factors causing the somewhat disappointing FDI performance in the region. Companies are unwilling to contribute large amounts of capital into an environment where some of the basic political questions have not yet been resolved. Unfortunately, even countries that are relatively stable within themselves, suffer from the serious problems that are occurring in other parts of the region.

C. Legal and regulatory framework

The transition towards a market economy entails the establishment of a legal and regulatory framework that is compatible with private sector activities and the operation of foreign-owned companies. Much progress has been made in this area in many of the countries of the region. Areas of importance, such as protection of property rights, the ability to repatriate profits, and a free market for currency exchange have been established in many of the countries. For some, progress has been slower in some of these areas and this may inhibit FDI. It is important that these rules and their related administrative procedures be as transparent as possible. The drafting and enacting of legislation in these areas is a difficult process. In many cases, substantial changes were required from existing practice in the country. Thus the concepts were unfamiliar. In some cases the laws that have been drafted have been unclear. This has led to the need for substantial revisions to the initial laws and regulations. Frequent changes lead to uncertainty and make business planning difficult. The new rules also pose a challenge to the administrators in the country. This can lead to inconsistency of application which contributes to the sense of uncertainty.

D. Macroeconomic environment

Instability in the level of prices and the exchange rate makes business planning difficult and increases the level of uncertainty. This increases the perceived risk of making investments and so reduces FDI. Macroeconomic instability can also exacerbate other problems in the regulatory environment. For example, exchange rate fluctuations increase the costs to investors in situations where either the foreign exchange market is not totally free or where there are delays in receiving payments from the government that are not indexed to changes in currency values.

E. Access to basic inputs

Foreign direct investment can be attracted to the region by the availability of factors of production. Most countries in the region have highly educated and skilled labour forces that are of low cost compared to the wages paid in OECD countries. This provides an opportunity for foreign firms to make investments in the countries to supply the export market. In fact, there appears to have been relatively little of this investment. This may reflect the absence of some of the other basic features described here. It may also reflect the barriers to which such exports may be subject in overseas markets. Firms will also make investments to have access to raw materials such as oil and gas, minerals and forestry products. In some cases, even when the overall FDI performance has been low, there have been substantial investments in these sectors. In these circumstances a challenge for the countries has been to ensure that they receive an adequate return from the exploitation of their resources.

IV. GENERAL TAX FACTORS AFFECTING FDI

While the tax system is not the only, or even the most important, factor affecting the FDI decision, it clearly has an influence on investment decisions. However, tax incentives directed at attracting FDI are often secondary to the more general features of the tax law. In most cases, firms are concerned to have impediments to investment in the law or administration removed, rather than have incentive measures. Moreover, the concerns of firms often extended beyond the income tax to other taxes not related to the profits of the firm.

A. Level of tax

The overall level of the tax burden clearly has an impact on the attractiveness of a country for foreign investors. This includes all forms of taxes, not only the income tax. However, it is not appropriate to simply compare the burdens of taxation across different countries to determine their attractiveness (and in practice, such data are still not available). First, tax revenues are the ultimate source of funds for most government expenditures and have an obvious and crucial role in bringing expenditures and revenues into line. Thus, lower taxes, if they lead to a budget deficit that reduces the macroeconomic stability of the economy, can be counterproductive in achieving the goal of attracting investment and is a policy that few of the Economies in Transition have followed. Secondly, if the revenues are spent on purposes which reduce costs and enhance income generating activities, the expenditures effectively offset the negative impact of the taxation. Expenditures on health can reduce private health care costs and so be reflected in lower wage demand or reduced costs to business of employer-based health plans. Expenditures which enhance the transportation and public utility infrastructure of the country can reduce costs to companies and increase their profit-making potential. For these reasons, the overall level of taxation in the economy has not been a good indicator of relative economic performance among OECD countries.

B. Transparency of tax system

The concern raised most frequently by the private sector was its ability to predict the tax consequences of its investment and other decisions. This issue is particularly important for the long term, capital intensive investments that most governments in the region are attempting to attract. In most countries, it is difficult for firms to predict the tax outcome of their actions. The first problem stemmed from the law. In many instances it was seen as imprecise and vague. Even professional advisors find it difficult to provide confident interpretations of the law. Many of the provisions which are accepted as normal in the tax laws of OECD countries are not present in the laws in the region. Thus, for more complicated transactions such as reorganizations of corporations or thin capitalization, the law does not directly address the situation facing the tax payer and so the tax outcome is unclear.

This situation is exacerbated by the frequent, significant changes to the laws and regulations. While fine-tuning is inevitable in a statute as complex as a tax law, many of the changes have had a material impact on the amount of taxes to be paid on particular transactions. This reflects the constant evolution of the policy and legislation which is natural during a period of transition. A number of countries have tried to ameliorate this situation by providing protection to investments made before the change. In some cases the authorities modified the change on the basis of consultations with the private sector. While this dealt with the particular problem of the taxpayers affected, it further adds to the feeling of uncertainty. The reaction on the part of business parallels that expressed by businesses operating in OECD countries where the frequency of change contributes more to a sense that the tax system is complex, and difficult to plan and comply with, than do the provisions themselves.

The problems of the lack of transparency and stability of the law are often worsened by difficulties in the administration of the law. Tax administrators were subject to the same difficulties as private sector advisors in keeping up with the rapidly changing legislative environment. In addition, the tax administrations needed to cope with changes occurring in the taxpaying population. Previously there were a relatively limited number of taxpayers which were large state-owned companies. The relationship between the authorities and the taxpayers was close by western standards. In enforcing compliance, the tax authorities could rely on the budgeting cycle to which the firms were subject. The change toward a more market-oriented economy has added to the number of taxpayers. At the same time, the relationship of taxpayers to the government is changing; there is less information provided to the government and taxpayers have a greater incentive to attempt to minimize taxes payable. The effect of these stresses has been to reduce the ability of the tax authorities to provide timely interpretations of the law. Many private representatives voiced frustration that they were unable to receive the material on interpretation of the law and the advance rulings that are available in OECD countries. In addition, it is more difficult to maintain a consistency of interpretation both over time and across different tax offices. In some cases, sub-levels of government have authority in setting the rules or an influence over the administration of taxes. In these circumstances taxpayers can be unsure where to turn to find the answers to their questions. These issues of the administration of the law are raised as often as the rules themselves in discussions with the private sector. In many cases, deficient rules can be planned around. However, arbitrary or inconsistent administration can impose significant unanticipated costs on taxpayers. This situation increases the perception of risk for companies contemplating investments and emphasizes the need to develop tax laws that are easily administrable and so do not increase the pressures on the administrators during the difficult period of transition.

The general features of the tax system are important. They are important not only in determining the tax burden of the company, but also for their effect on how the company organizes its operations. These latter effects are often more important than the overall tax burden and were often cited during the private sector discussions.

C. Statutory tax rate

The statutory tax rate is clearly important in establishing the overall tax liability of an enterprise. However, the statutory tax rate does not, in itself, establish the ultimate tax burden on the activity. Equally important are the effects of the provisions which determine the tax base and the actions taken by firms to minimize their tax burden. Experience in OECD countries has shown that the statutory tax rate can be important in establishing the financial and tax planning strategies of a company. Corporations will generally respond to significant differences in statutory tax rates by streaming income toward the low tax jurisdiction and costs toward the higher tax rate jurisdiction. For example, other things being equal, a company would rather make its borrowings in a manner which places its interest deductions in the subsidiary which faces the highest statutory tax rate. As a result of such tax planning, a higher statutory tax rate does not always result in higher tax revenues, at least from those firms with operations in a number of countries. These concerns are particularly important for countries in the region which are still developing their capacity to respond to tax avoidance activity. In most cases the countries lack the provisions in the law which could be used; have limited access to data, both domestically and through exchange of information provisions in tax treaties; and, do not have personnel who are trained and experienced in the more complicated areas of tax auditing. The statutory tax rate can also influence certain marginal production decisions of firms and could have an influence in shut down situations where the treatment of capital costs is no longer relevant to the decision. On the other hand, lowering the rate reduces profit tax revenues from domestic activity. Profit taxes are often a more important source of government revenues in countries in the region than in OECD countries.

This puts a limit on the extent of any rate reduction, at least in so far as it is not matched by an offsetting widening of the tax base. This suggests that the statutory tax rate should remain within international norms of about 30 to 40 percent. This is the range of tax rates for most of the countries in the region.

D. The tax base

The calculation of taxable income is as important as the statutory tax rate in determining the burden of taxation. The features of its calculation can have a significant impact on the pattern of taxation across different companies. The treatment of different revenues and expenses can also have an influence on how a company arranges its affairs. In particular, the structure of the business, joint stock company, partnership, joint venture etc. will be influenced by the relative treatment of these forms of business operations. Financing decisions are also heavily influenced by the way the payments made with respect to the various financing instruments are treated for tax purposes. Finally, it is in the calculation of the tax base that many of the provisions that are the most complex for administration and compliance are found. For these reasons, most of the discussion with the private sector about the income tax revolved around questions that were either directly or indirectly linked to the calculation of taxable income.

In some countries in the region, a number of the features of the tax systems remain different from those of western economies. These differences generally are found in provisions that are rooted in the taxation regimes that existed under socialist economies. In the past, where the state was both the taxing authority and the owner of the enterprise, many of the issues which arise in determining the tax base where the taxpayer is privately owned do not arise. Therefore the tax system was often used as one of the means to control and influence the behaviour of enterprises. This led to a fundamentally different treatment of most of the important expenditures that are made by corporations. Countries in the region have made important changes to their regimes to bring them more into line with the appropriate treatment of private sector transactions. However in some countries, problems do remain.

In other cases, the tax systems are distinguished by what they lack. Western firms have evolved a very flexible array of arrangements and methods of organization. These methods of operation have necessitated the development of sophisticated and complicated provisions in the tax systems of OECD countries. For the most part, these provisions are not found in the laws of countries in the region. This can, at times, restrict the ability of firms to arrange their affairs in the most efficient manner. In other circumstances, it leaves the treatment of certain transactions ambiguous and impedes the tax and business planning of corporations. The lack of clear guidance in the law is also a problem for the tax administrations who, at the same time, are dealing with complicated business arrangements that are unfamiliar to them. The resulting lack of clarity increases the likelihood of disputes between tax payers and the tax services of the countries.

A number of specific elements of the tax system are the focus of particular attention:

– Depreciation regime. In many of the countries in the region the depreciation system is a remanent from the former taxation system. As compared to the depreciation systems offered in most OECD countries, it is detailed in its differentiation among different assets and industrial sectors and has low rates of depreciation. Such features reflect the different use for depreciation as part of the budgetary control mechanism under the former regime. This comment needs to be qualified in two important respects. First the persistence of significant inflation rates in a number of countries in the region makes simple comparisons of depreciation rates meaningless. Depreciation based upon historic cost is undervalued during inflationary times as the real cost of the depreciation of today's assets is underestimated when the asset base is measured in nominal dollars. A number of countries have allowed ad hoc adjustments to the asset cost bases to compensate for the underestimate of true depreciation in the face of inflation. However, such adjustments are not necessarily tied to the underlying changes in the value of the asset and their discretionary nature makes it difficult for firms to properly take them into account in their planning. The second qualification works in the opposite direction of the first. A number of countries allow general investment allowances to the extent that the amounts invested exceed accumulated depreciation. With stable prices, this effectively means that additional deductions, over and above depreciation, are allowed whenever the size of the total investment is increased. The value of this concession increases under inflationary conditions, where today's investments are compared to prior investments measured in nominal, not real dollars. Therefore, a benefit can be received even though there is no real growth in the size of the investment. This compensates to some extent for the underestimation of the depreciation.

– Treatment of expenses. A number of countries have restrictions on deductions for certain expenditures. In some cases these appear to be intended to improve the fairness of the tax system. In other cases, they are intended to facilitate control of the activities of state-owned enterprises. Some are implicit restrictions since expenses are generally not allowed unless explicitly noted. In this case, the list of expenses may simply have not kept up with the different ways of doing business under the evolving market economy. An important point is that the companies are often able to arrange their affairs to avoid the burden of the restriction. However, this requires using arrangements that are not efficient from a business point of view or that are somewhat artificial and potentially subject to audit examination.

  The restrictions that are most subject to criticism are the restrictions on the deductibility of wages and the limited deductions available for interest expenses in some jurisdictions. Deductions for wages are denied when the aggregate wage and salary bill exceeds some multiple of the minimum wage times the number of employees. In some jurisdictions, this was in effect accomplished by a payroll tax on the excess wages. These restrictions are used for two purposes. They are intended to reduce wage increases as part of an anti-inflation programme and to control the tendency of state-owned enterprises to grant excess wage increases rather than return funds to the state budget. While such restrictions may be appropriate for state-owned enterprises, they are not appropriate in the private sector where companies already have a significant incentive to keep wages to a minimum. The situation is potentially very damaging for foreign investors with expatriate staff who earned wages far in excess of the limits implied by the legislation, although in certain countries non-resident investors are excluded from this form of wage control. In fact, while these restrictions are annoying to foreign taxpayers, they are simple to plan around. Wages can be paid offshore and services provided by a service company or fringe benefits could be paid rather than wages and salaries. Stopping these mechanisms would be complicated legislatively and would put further pressure on the administrations.

Restrictions also historically existed for the deduction of interest. In some cases only bank interest could be deducted for tax purposes. This effectively denied the use of other financing instruments. This forces companies to either stream loans through conduit banks or to use more tax efficient lending mechanisms such as leasing. Again the result is that the restriction could be avoided at some cost in terms of flexibility. Effectively counteracting the tax planning would be complicated and counterproductive.

– Other features. Most of the countries in the region are still in the process of developing their tax systems and so they naturally do not have many of the more sophisticated provisions found in OECD tax systems that have been evolving over many decades. Features absent included rules to deal with reorganizations of businesses and rules to allow some form of consolidation of income and losses from companies that belonged to a commonly owned group of companies. In some cases, the relatively unsophisticated approach to accounting effectively deals with the problem as transfers are made at book rather than fair market value. There is one area that is particularly troubling to firms. In some countries losses may only be carried forward either for a very short period by OECD standards or are restricted in some other way. These restrictions originated in the previous regime where the state's role in funding the losses of corporations reduced the need to carry forward losses. However for private sector companies the ability to carry forward losses is critical in arriving at an accurate picture of income earned over a period of time. The restrictions are most harmful to companies looking to make long-term, capital-intensive investments. Such firms are likely to experience losses in the start-up phase of the investment. Naturally the firms would at least like to cover these losses with income before beginning to pay tax. Restrictions on the carry forward of losses can result in firms paying tax even when they are in a cumulative loss position.

E. Taxation of expatriates

Companies establishing operations will often wish to use foreign management personnel or technical experts. This is the principal way to transfer such expertise to the country. In some cases, the tax spent in the host country can significantly raise the cost of such expatriate personnel and so discourage FDI. The two areas where this occurs are social security tax and the personal income tax.

When looked at domestically, social security taxes are payments that are more or less directly reflected in benefits received by the employee. Thus, even though the taxes are for the most part levied on the employer, they are assumed to be reflected in the wages paid to the employee. The move by a number of countries to develop fully funded social security systems should enhance this connection. The existence of state pensions, medical care and unemployment insurance reduces the need for wages that are high enough to self-finance these costs. The taxes are not seen as a problem given the low level of wages in the region when compared to wages and salaries in OECD countries.

However, the application of the social security contributions to expatriate service providers in foreign-owned companies can lead to problems. In such cases, the wages paid to the expatriates are at western rates and certainly do not take into account the benefit side of the social security system. Moreover, the expatriates do not qualify for benefits under the system. In this case the taxes simply increased the cost of using the service providers. This acts effectively as an obstacle to the importation of know-how from the developed market economies. In recognition of this detrimental effect, a number of countries in the region have explicitly removed expatriate employees from both the contribution and benefit side of the domestic social security system. In other cases, companies have found ways of avoiding the payment of the contributions through devices similar to those employed to avoid the restricted deductions for wages and salaries under the profit taxes (e.g. paying part of the salary off-shore). Nevertheless, the potential liability for such charges remains a concern to foreign investors.

The personal income tax systems of the countries in the region have rate schedules linked to the level of wages in their country. As expatriate employees generally have higher levels of wages, they may face levels of tax much in excess of what they would pay in their home country. In addition their costs of living could likely exceed those of domestic taxpayers.

F. Customs duties on imported investment goods

Non-income taxes are also of concern to firms. They are concerned that the taxes are payable even when the firm is not profit-making and that they usually have the effect of increasing the cost of basic inputs. These taxes either increased the up-front risk of the investment or increased the operating cost of the company. The most prominent taxes are customs duties or general taxes on goods, that are applied to investment goods.

The application of duties on investment goods has some appeal to countries in need of enhanced revenue sources. Customs duties provide a direct and easy to administer source of revenue for the government. However, such taxes raise the cost of capital investments. This increases the risk of investing in a country and raises the required rate of return to make an investment profitable. Experience in countries in Asia suggests that the most important tax relief for firms examining potential investments is relief from customs duties on imported capital equipment. Customs duties on capital equipment act directly counter to the goals that are generally behind incentives to attract FDI. First, such taxes are most onerous on the long-term, capital-intensive projects that are required to modernize the industrial base in the region. Second, it is through the importation of modern equipment that much of the benefit of introducing advanced production technologies will be realized. For these reasons, most countries in the region provide at least partial exemptions from customs duties for own-use production equipment. However, these exemptions are sometimes linked to the initial capital contribution associated with the establishment of a new foreign-owned business and so may be of limited use for a company which makes its investment in stages. In other cases, a VAT is charged on the importation of the capital item, the normal treatment, but a delayed or incomplete refund is given. This approach nevertheless still effectively levies a tax on the capital item which would be inconsistent with any investment incentives that might be provided.

G. Tax treaties

Tax treaties provide a framework within which companies which operate across borders can plan their affairs. Their principal purpose is to coordinate the application of the tax systems of the home and host countries. Both countries have a legitimate claim to tax the revenues derived from cross border operations. The purpose of tax treaties is to provide the rules under which the tax pie is divided up to ensure that there is not double taxation of the income. They also provide a framework under which administrative issues that arise in the determination of the allocation of income between the two jurisdictions can be resolved.

H. Anti-avoidance rules

One final observation is important to put the foregoing discussion into context. It is not always disadvantageous to foreign firms that some of the features typical to the tax systems of OECD countries are missing or that the tax administrations in the region are not yet fully experienced in dealing with market-oriented business arrangements. A number of typical provisions to protect the tax base are often not in the tax systems of the countries in transition. For example, arm's length pricing rules and thin capitalization rules are generally missing. These are tools used by tax authorities to constrain the ability of firms to arrange their affairs to avoid taxation. Even with these rules, tax authorities have a substantial challenge in identifying and reversing tax avoidance. This is particularly challenging for the taxation authorities in the region who lack experience in dealing with market-based transactions and the methods of tax minimization routinely used by taxpayers in OECD countries. Therefore, foreign-owned firms can often arrange their affairs to eliminate their tax liability in the country. In such cases, tax incentives may be redundant.

V. COSTS AND BENEFITS OF TAX INCENTIVES

The classic argument raised against the use of incentives is that they distort economic activity. Incentives cause the after-tax pattern of returns to diverge from the before tax pattern and therefore lead to an allocation of resources that differs from the efficient equilibrium the market is assumed to generate. These results are generally valid for a developed market economy and are one of a number of powerful arguments that have led most OECD countries to curtail their use of incentives. However, clearly the conditions that are required for an efficient market have not yet developed in most of the countries of the region. Many firms remain under state control. Capital markets are rudimentary by the standards of developed market economies. Basic information on market possibilities and the way of doing business is imperfect, particularly from the perspective of foreign firms looking to invest in a country. The commercial and legal infrastructure that epitomizes market economies is still being developed. Many of the actors in the economy, managers and workers, are not yet familiar with the basic concepts of how markets work and so may not operate in an efficient manner. In these circumstances, there is an argument that, for the reasons noted in the introduction, FDI has benefits above and beyond the private return to the investment in creating markets and training domestic agents how to operate in a market environment. Under this argument, incentives could play a transitional role in creating a critical mass of market activity until capital markets in particular have been developed. In fact, one of the reasons for special tax treatment of foreign firms under the old system was that the tax system that applied to the domestic state-owned sector was not appropriate to foreign firms and so they needed a special regime to be able to operate. This reason could also apply during the transitional period of a country, before it has brought its tax system into line with the norm for a market economy.

Thus, there is an argument that certain forms of incentive could be justified in the situation in which the countries in the region find themselves. However, it is important in evaluating whether incentives, and in particular tax incentives, are justified to consider their costs relative to their assumed benefits.

A. Revenue cost

The most obvious cost of a tax incentive is the resulting foregone tax revenues. The hope would be a tax incentive would have a small revenue cost relative to the investment induced. That is, a small contribution of public money would induce a substantial increase in private sector funds for investment. Moreover, the investment being private would hopefully be more efficient than an investment by the government. However valid the latter point might be, there is little in the experience of OECD countries to suggest that the government would be the beneficiary of such a significant response to its foregone revenue.

In most econometric studies on the question, the foregone tax revenue has exceeded the increase in the desired investment. The reason is that the incentives are not targeted to incremental investment. Therefore, a substantial amount of the incentive is earned by investments that would have occurred in any event. From the point of view of the government, this is wasteful as it does not result in an increase in the desired activity. In the case of the economies in transition, there is the possibility that the investment, particularly if made by a footloose industry, would not have occurred without the incentive. In this case, it could be argued that there is no foregone revenue as the revenue would have been zero if the incentive had not induced the investment. There are a number of observations that can be made regarding this statement. First, if there are good investment opportunities, it is unlikely that no investments would be made without the incentive. If no investments, in fact, are being made, it is probably because some of the critical problems outlined above are present. As the experience to date in the region demonstrates, tax incentives alone cannot in themselves induce investment in such circumstances. Moreover, even if the type of investment receiving the incentive would not have occurred without the incentive, there is always some indirect substitution among investments. This substitution can occur in a number of ways. For example, the importation of capital for one project will increase the rate of exchange from what it would have been. This will act to depress economic activity by causing a shift away from domestically produced goods in the domestic market or making it harder to export goods.

Unfortunately the data necessary to perform econometric studies on the effectiveness of the tax incentives provided by the countries surveyed is not yet available. Still, the lack of substantial investments in many of these countries suggests that the incentives have not been effective in attracting investment to the region. Moreover for the most part the types of activities that have been attracted have not been the long-term projects envisaged by policy makers when they provided the incentive. Rather they have been short term quick profit ventures that would have occurred in any case. The tax incentives have merely succeeded in making a profitable venture more profitable.

B. Complexity of the tax system

One of the most serious problems with incentives is the complexity they introduce into the tax system. This complexity is manifested in a number of ways and imposes a variety of costs on the country. These costs must be taken into account in assessing the desirability of tax incentives.

Incentives require definitions of the eligible activities. This in itself complicates the tax legislation. The legislation must be sufficiently precise to allow taxpayers to accurately predict whether or not they qualify for the provision. If it is not, then taxpayers cannot plan their affairs on the assumption that they will receive the incentive. Its receipt is simply a windfall to them, with no positive impact on their behaviour. Moreover, rules are often required to deal with special situations, such as loss years or corporate reorganizations, in order for firms that undertake the desired activity to actually be able to make use of the incentives earned.

It is difficult to ensure that the firms which are intended to use the incentive are able to do so with any degree of confidence. But it is even more difficult, as many countries in the region have found, to ensure that taxpayers who are intended to be excluded are effectively debarred from taking advantage of the incentive. Taxpayers naturally try to arrange their affairs to qualify for the incentives. Anti-avoidance rules are often required. These rules are inevitably complicated and frequently work against the certainty that is required if there is to be any positive effect from the measure.

The tax planning by firms and the attendant reactions by the taxation authorities lead to frequent changes in both the legislation and the administration of the provisions. Frequent changes to the tax system have been identified by companies as the greatest single source of the impression that the tax system is complex.

This complexity imposes costs not only on the taxpayers, but also on the taxation authorities. They too must keep up with rule changes and time spent auditing incentive provisions reduces the time that can be spent on auditing other aspects of the income tax. This burden is particularly onerous on tax administrations which must cope with the transition to a market economy. Moreover the attempt to direct incentives to special classes of activities, such as "technology transfer", are subjective in nature and very hard to audit in practice as any tax authority in the OECD who has had to administer a tax incentive for research and development (R&D) has discovered.

C. Unintended results

As noted above, the windfall gains to investments that would have occurred in any event make tax incentives relatively cost-ineffective in many cases. This ineffectiveness is exacerbated to the extent that taxpayers who are not intended to benefit from the measures are able to plan their affairs so that they qualify. The experience in OECD countries is that this can make the amount of government tax revenues hard to predict. Tax incentives can be used by unintended beneficiaries and this can inflate the revenue costs significantly above predicted levels. This experience has been borne out in the economies in transition. This will be discussed in greater detail in the sections on the individual incentives. In many cases the bulk of the activity that has qualified for the incentives has been the result of tax planning rather than an increase in the desired activity. This experience has shown that it is difficult to target the incentive to the desired activity given the relatively simple tax systems in the region and the difficult circumstances under which the taxation authorities are working during the transition.

D. Precedent

The provision of even targeted tax incentives establishes the precedent for their wider use. Firms engaged in activities that do not qualify for the incentives will lobby for their extension to their activities or at least the provision of some form of incentive. This is a difficult argument for policy makers to counter as it involves making explicit choices between different activities which are both in some sense deserving. Moreover, whenever incentives are provided to one type of activity there will be other activities which are closely related to the preferred activity that do not qualify for the incentive. They will be able to argue that they are disadvantaged in competing with the firms which are in receipt of the incentive. The experience in OECD countries is that incentives once introduced have a tendency to spread to other activities. Accordingly the establishment of such incentives introduces a dynamic into the policy process that further undermines the revenue base of the government.

There is another aspect. The provision of an incentive often takes on the characteristics of an entitlement. Once given incentives are very hard to eliminate due to the lobbying by the constituency created by their existence. The recent experience of many OECD countries as they reformed their tax systems is instructive. Despite the fact that incentives were generally recognized to be ineffective, and thus many large incentives were eliminated, many smaller incentives remained which are of questionable economic or social benefit, but which are given to politically vocal groups.

VI. GENERAL TAX INCENTIVES

Tax incentives can be grouped into a number of categories; tax holidays, investment allowances and tax credits, timing differences, or reduced tax rates. Each of these types of incentives raises different design issues which must be resolved.

A. Tax holidays

This has been the typical form of tax incentive used by countries in the region. It is a tax incentive that is targeted at new firms, and is not available to existing operations. With a tax holiday, new firms are allowed a period of time free from the burden of income taxation. Sometimes, this initial period has been extended to a subsequent period of taxation at a reduced rate of tax.

One advantage of tax holidays that is sometimes cited is that they provide a simple regime for foreign investors at a time when the tax systems in the region are not yet fully developed since there is no need to calculate taxes in the early years of operation. This argument is certainly not valid for long-term investors. For them the tax treatment after the holiday has expired will be as important as the treatment during the holiday in determining the after-tax profitability of the investment. In addition, the tax treatment of the initial capital expenditures made before and during the holiday period must be determined so that appropriate records will be available for the calculation of depreciation when the holiday ends.

There are a number of technical issues that are important in determining the impact of a tax holiday on the return on investments. The first question is when does the holiday start? It could be when production starts, the first year in which the firm makes a profit or the first year that the firm achieves a positive cumulative profit on its operations. For large projects, in particular, losses are usually generated in the early years of production. These are typically the years of the highest capital costs, there are special costs that are linked to the start up period, the work force may need to be trained and there may be costs of developing the local market. For such projects, a tax holiday which starts when production occurs may actually increase the taxes paid over the life of the project and so act as a disincentive for investment. If losses are experienced during the holiday period they may not be allowed to be carried forward when the period ends. Thus the holiday may occur when no taxes would have been paid in any event and taxes may be increased following the holiday because no losses are available to offset against future profits. A similar situation can occur if the holiday starts when profits are first generated. Income may be sheltered that would have been eliminated in any case by the use of the tax losses. This may result in an overall increase in taxation in circumstances where the loss may only be carried forward for a short period or the use of the loss is otherwise restricted in some way. The laws in the region usually specify that the holiday commences when profits first occur. However, they are often ambiguous as to whether this means the first year that is in itself profitable or the first year that cumulative net profits are positive.

A related question is the treatment of depreciation during the holiday period – should it be deducted during the holiday period or can it be deferred until after the holiday has terminated. Depreciation represents a cost in the calculation of income and so its deduction is necessary to accurately measure the amount of income that should be subject to the holiday. Allowing a deferral of the deduction effectively overestimates the costs associated with the post-holiday period and so leads to a further reduction in tax which can lead to a very generous incentive. The issue is more complicated if some form of accelerated depreciation is also offered with respect to the investment. Forcing the use of the accelerated deductions during the holiday period at the least reduces their value and can actually lead to an increase in the level of taxation relative to the situation where no incentives are provided. A complete deferral of the deduction, however, can again lead to a very generous incentive and an effective tax holiday which is much longer than intended.

Another design question is the length of the holiday. Most of the holidays offered in the region have been of short duration.

As is discussed below, such holidays are of very little benefit to long-term capital intensive projects. Longer holidays would be of greater benefit and there is some evidence in Asia and Hungary that the longer holidays did succeed in attracting some long-term investment. However the longer the holiday the higher the revenue cost and the greater the vulnerability to tax planning schemes.

B. Investment allowances and tax credits

These are tax reliefs based upon the value of expenditures on qualifying investments. They provide tax benefits that are over and above the depreciation allowed for the asset. A tax allowance is used to reduce the taxable income of the firm. A tax credit is used to directly reduce the amount of taxes to be paid.

The major technical issues are the definition of the eligible expenditures, the choice of the rate of the allowance or credit, any restrictions on their use and the treatment of any amounts of incentive that cannot be used in the year that they are earned due to insufficient taxable income. The major problem with the determination of the eligible expenditures is achieving a precise definition that targets the incentive to the desired activity to minimize revenue leakage and, at the same time, provides the taxpayer with certainty as to the application of the incentive thus increasing the effectiveness of the incentive.

The choice of the rate of incentive is directly linked to the amount of incentive that it is desired to provide and the revenue cost to the government. One problem which arises as the rate of the incentive increases is that the motivation for firms to control costs is decreased, leading to so-called "gold-plating" of investments where the most cost-effective techniques are not employed. A number of tax avoidance possibilities are encountered when the rate of credit and tax allowance is too high. For example, if an investment allowance is provided, firms can flow services through a subsidiary and make money simply by increasing the amounts that the subsidiary charges its parent company for the services rendered. The basic problem is that, because the total amount of tax allowance and depreciation which can be deducted against taxable income exceeds the actual amount spent, the tax benefit to the parent company of spending one dollar exceeds the tax cost to the subsidiary of receiving a dollar of revenue.

The use of the incentives can be constrained to ensure that they cannot fully eliminate the tax payable by the firm in the year. For example, the allowance could be restricted to some percentage of taxable income or a credit could be limited to some percentage of tax otherwise payable. The calculation of these limits can interact with other provisions in a complicated manner and can cause firms to enter into arrangements of the type discussed below. They do however limit the revenue cost to the government and ensure that firms cannot entirely eliminate their tax payable through the use of incentives.

An important design issue is what to do if the firm has insufficient taxable income to fully use that incentive in the year that it is earned. In some cases in the region the incentive is simply lost. This restrictive access to the incentive operates against start-up firms without other income. This is the typical situation for new foreign investors and can effectively eliminate the benefits of the incentive for such firms. It may also lead to unproductive arrangements being devised simply to make use of the incentive. For example, an investment allowance can be transferred from a firm benefiting from a tax holiday to a taxable firm through the use of a lease. In effect the firm obtains both incentives and government revenues fall by more than the tax which would have been paid by the firm in the absence of the holiday.

The chance that the incentive may be effectively lost also increases the uncertainty to the firm in estimating the value of the incentive and so reduces its effectiveness. To avoid this problem, rules need to be provided to allow a carry forward of the incentive and to determine its treatment if there is a reorganization of the business.

A special form of investment allowance is provided by a number of countries in the region. It is a reduced tax rate for reinvested profits. It is not entirely clear why this particular form of incentive is provided and how it operates in practice. Even without special incentives, retained earnings are the major source of capital for investment in OECD countries as they are seen to be cheaper than either debt or new equity. Moreover there are a number of sources of capital and a number of uses for retained earnings, other than dividends and capital investments, such as debt retirement or offshore investments. Tracing the funds from retained earnings to investment would not be simple. Finally, it is not clear why one source of capital should be favoured over others. This distorts capital markets and favours established firms. The use of an allowance linked to the amount of investment, perhaps capped by a percentage of profits otherwise calculated, would be a more direct way to achieve the goal. It could also be better targeted to the desired activity.

C. Timing differences

Timing differences can arise either through the acceleration of deductions or the deferral of the recognition of income. The most common form of accelerated deduction is accelerated depreciation where the cost of an asset acquired may be written off at a rate that is greater than the economic rate of depreciation. This can either be in the form of a shorter period of depreciation or a special deduction in the first year. This has a similar impact to an investment allowance in the first year, but differs since the amount written off reduces the depreciation base for future years and so the total amount written off does not exceed the actual cost of the investment. Rather it allows the deductions to occur sooner than otherwise. This provides a deferral of tax which is effectively an interest free loan to the company from the government.

Important timing differences can occur in other more technical areas. For example, incomes may not be realized until there is a sale of the asset while certain costs are recognized immediately. A typical example is the current deduction of interest on an asset which is held for a period of time. A significant net profit can be realized on an asset whose pre-tax return equals the rate of interest on the funds borrowed for its purchase, simply because of the mismatching of the deductions and the taxation of the income. These technical timing differences can often be more important than any explicit investment incentives.

The technical issues associated with accelerated depreciation are similar to the issues of targeting and carryovers that face investment allowances. However the problem of deductions exceeding the cost of the investment which occurs with an investment allowance is avoided.

D. General tax rate reductions

General tax rate reductions can be provided to income from certain sources or to firms satisfying certain criteria. These reductions differ from tax holidays since the tax liability of firms is not entirely eliminated, the benefit is extended beyond new enterprises to include income from existing operations and the benefit is not time-limited. Identification of the qualifying income is the major design issue. It may require rules to define eligible tax payers, if the benefit is to be targeted to specific types of firms, such as small businesses. If only certain types of income are to qualify, then rules must be defined to measure this income. These can rely on separate accounting for different sources of income. Unfortunately this accounting approach may be manipulated by streaming costs and income so as to maximize the benefit. The alternative is to use a formula approach which will be less accurate in targeting the benefit. With either approach the rules tend to be complex and subject to manipulation.

E. Non-income tax-based incentives

In many instances taxes other than income taxes are of primary concern to potential investors. In particular, taxes on business inputs constitute a barrier to the importation of the very factors that tax incentives are designed to attract. Examples include border charges, like customs duties or turn-over taxes, on imported capital equipment and social security taxes on expatriate wages and salaries. Removal of these tax impediments to FDI would provide an incentive which eliminates distortions rather than creates them.[3]

F. Comparison of the different general incentives

The various tax incentives can differ markedly from one another in a number of important ways. In particular they can differ in terms of:

- the types of companies and activities which are likely to benefit from them;
- the time profile of the revenue impact on the government for any given level of incentive; and,
- the difficulty of administration and the possibility of tax avoidance.

G. Beneficiaries

By their construction, tax holidays are of greatest value to firms and projects which make substantial profits in the early years of operation. Such enterprises are likely to be engaged in sectors such as the retail trade, short-term construction or the service sector. They are less likely to be of benefit to major capital intensive projects which do not normally have profits in the early years. This has in fact been the experience of the countries in the region which have introduced tax holidays. Most of the beneficiaries of the tax holidays have been small firms operating in sectors such as real estate, restaurants and short term market exploitation, such as the retail trade or wood-cutting. The tax holidays are open-ended in the sense that their value depends upon the amount of profit earned. Arguably, the types of high profit activities that benefit the most are the least in need of the incentive and would have occurred in the absence of the incentive. Thus the bulk of the revenue foregone is likely to have had no beneficial impact on investment and so the ratio of benefits to costs is likely to be very low.

The experience in Asia with tax holidays targeted at export-oriented industries is relevant. Low cost assembly plants that are highly mobile can be easily attracted by this type of tax break. In a number of instances, plant was established in a country to take advantage of a tax holiday. However when the holiday expired, the plant was disassembled and moved to an adjacent jurisdiction to take advantage of the holiday offered there. The mobility that made the project responsive to the incentive also acted to limit the benefit to the country from the investment.

Investment allowances, tax credits and accelerated depreciation, on the other hand, are specifically targeted at capital investment. Their revenue cost is restricted by reference to the amount of capital that the firm is willing to put at risk. As such they are of little benefit for the quick profit types of firms.[4] Tax allowances are of greatest benefit for firms with income from existing operations. These firms can shelter a portion of such income from tax with the allowances earned on the new investment. Firms with low income or start-up firms cannot begin to take advantage of the incentive until the investment begins to earn income. Provided that a carry-forward of the incentive is allowed, an investment allowance can operate in a manner similar to a tax holiday since it can eliminate the tax liability of the firm in the early years of operation. However the incentive no longer has an unlimited amount of tax benefit; the potential tax benefit to the firm is now capped by the amount of its investment.

General tax rate reductions differ from the other incentives in that they are not specifically targeted to new activity. Income from both existing and new operations are eligible for the incentive. Thus, when viewed as a short term investment incentive they are less likely to be cost-effective than, in par-

3. The treatment of domestic firms in this regard is also important. If revenue considerations allow, importation of business capital inputs should be free from effective border charges for domestic firms as well.
4. These types of firms are far more attracted to tax holidays.

ticular, incentives which are related to the amount of the investment.

H. Profile of revenue impact

The revenue impact of tax holidays and investment allowances is, in theory, tied to the degree of new activity. Thus the revenue impact is relatively low in the early years of the programme and grows over time as more firms become eligible. A general tax rate reduction, on the other hand, has reasonably significant up-front revenue costs as it applies to income from existing operations as well. Accelerated deductions confer a timing benefit only. Thus to achieve the same incentive effect there will be a higher level of up-front cost to the government. The revenue cost actually falls over time, as in future years the tax benefits from further new investments are in part offset by the reduced deductions resulting from the acceleration of deductions on the old investments.

For investment allowances and accelerated deductions, the carry-forward of deductions by firms which cannot fully utilize them can lead to a considerable growth in the revenue cost over time. The experience of a number of OECD countries that provided broad-based investment incentives is that over one-half of incentives were earned by firms with no current taxable income. This reduced their cost in the early years of the programme. However there was a significant build up over time of unused deductions from previous years. As the firms which had these accumulations began to earn income, the accumulations were used to offset income even though they were no longer making expenditures eligible for the incentives. The claiming of the deductions was merely delayed and there was an increasing impact on tax revenues as the deductions from previous years were added to those being earned and used in the current year.

The build up of unused deductions and losses also reduced the predictability of the government's revenue stream. Firms that did not expect to be able to use their deductions for a period of time sought out ways of transferring them to firms with current taxable income. This was often done in the form of transactions which traded a lower cost of financing for the tax deductions. Thus the deductions earned in one sector reduced the taxable income of another. Loss trading mechanisms such as leasing are frequently used in this regard.

A number of countries in the region have experienced serious unexpected shortfalls in revenues during the transition period. This has been in part due to reduced economic performance and problems of tax administration in the face of a changing economic structure. Tax incentives, particularly holidays, have contributed to this shortfall as they have provided opportunities for firms to arrange their affairs to avoid paying taxes on income ordinarily subject to taxation.

I. Administration and tax avoidance

The administration of incentive schemes provides an extra challenge to tax administrators. First, they have to verify that the incentive has been correctly applied. Verification can be difficult if complicated calculations are involved. Second, administrators need to ensure that the activity or firm actually qualifies for the incentive. This can be complicated if concepts and definitions are vague or ambiguous or, as in the case of incentives for foreign-owned firms, the records establishing the eligibility of the firms are in another country.[5] Third, they must ensure that the amounts eligible for the incentive are correctly reported; for example, that the value at which a machine or service has been transferred represents its fair market value. This again can be difficult if the transaction occurs across border, particularly if it took place between related parties. The need to carry-out these audits and assessments diverts resources from other administrative tasks, which may have a substantial revenue cost of its own, given the shortages of trained staff that exist in most of the countries of the region. All of these problems have been evident in the countries in the region that have introduced tax incentives.

Avoidance experience with tax holidays. Of all the tax incentives, tax holidays have been the most susceptible to tax planning. This planning can lead to considerable revenue leakage, which can exceed the revenue foregone from incentives earned by legitimate activities. This further reduces the cost-effectiveness of tax incentives. The main tax avoidance strategies employed by firms, which are often used in combination, include:

- Fictive foreign investment. Tax holidays in a number of countries have been directed at firms with a sufficient percentage of foreign ownership. There would appear to have been considerable leakage of tax revenues arising from the creation of fictive foreign-owned companies which carried on what was in fact a domestically-owned business. One method by which this is accomplished is the transfer of funds from a domestic enterprise to a company incorporated offshore which in turn reinvested in the home country, as if it were a foreign-owned company. Thus the investment qualified for the incentive. Whether this type of transaction is classified as tax avoidance or evasion, depends on the relevant legislation. In either event it is very difficult for tax authorities in the region to detect such activity on audit.

- Transfer pricing. The existence of a tax holiday introduces the possibility of transferring profits from operations that do not qualify for the holiday to the firm that enjoys it. For example, a domestic firm transfers a small part of its operation to a joint venture with a foreign-owned company. The joint venture qualifies for the incentive. Income is then transferred to the joint venture from the original domestic company by manipulating the allocation of costs and the charges made on transactions between the firms. These types of transactions are very difficult for tax authorities to detect, and even harder to successfully challenge.

5. This problem is compounded by the limited range of tax treaties for most countries in the region which denies them access to the exchange of information facilities usually contained in the treaties.

- Roll-over of businesses. It can be very difficult to establish what is a new operation for the purposes of the tax holiday. A new corporation can be established which then purchases the assets of an existing operation in order to qualify for the incentive, even though no new activity takes place. This practice has occurred in combination with the above types of tax avoidance. In other cases, such as the construction industry, new firms were established for each new project, thus maintaining perpetual access to the holiday. This occurred in one country in the case of a logging operation that used a new company every time it moved to a new wood lot.

- Regional tax avoidance. Tax holidays also put the revenues of adjacent jurisdictions at risk. Firms exporting to third countries from the country would ordinarily pay tax on their profit from the sale. In some cases, these firms establish trans-shipment companies in an adjoining state. The sole purpose of the company being to purchase the goods from the exporting company and then sell them to the actual purchaser in the third country. The trans-shipment company qualifies for a tax holiday in the second jurisdiction. Goods are sold at cost to that company and all the profits on the sale are transferred to it through transfer pricing to be sheltered from tax by the tax holiday.

A number of countries in the region have attempted to curtail these abuses by requiring that the foreign investment exceed some threshold, say USD 50 000, in order to qualify for the incentive. While such restrictions may deter some small problems, they are unlikely to be effective in preventing tax avoidance. Firms may contribute overvalued capital goods as part of their initial capital contribution to achieve the threshold. There are no restrictions on the use of the capital. Accordingly, firms can effectively repatriate the funds in a number of ways, such as non-recourse loans, offshore deposits and returns of capital. Thus the thresholds impose no effective constraint on tax avoidance.

Other incentives. The other forms of incentives are also open to abuse. However, the scope is somewhat more limited, particularly in the case of investment-related incentives granted at moderate rates. The incentive has an upper limit related to the amount of the expenditure and so is not as exposed to the shifting of large amounts of profits as a tax holiday. Nevertheless problems can still occur, especially with assets transferred from related offshore companies. There is a motivation to overvalue the purchase price of the asset to maximize the incentive. Clearly this motivation is increased as the rate of the incentive rises. However, this problem already exists to a certain extent, as firms try to increase their depreciation bases for tax purposes. As noted above, at high rates of incentive this problem can occur (even within a country) if the rate of incentive leads to a value of tax deductions that exceeds the value of the expenditure. It is possible to increase the benefits to the enterprise on a transfer of assets or services between related companies simply by increasing the price of the item transferred. The other issue which can arise in these circumstances is the multiple access to the incentive through flipping the asset among a group of companies. Recapture rules and capital gains taxes can deal with this problem in the case of accelerated depreciation as the increased deductions of the purchaser are offset by the reduced write-offs of the seller. For investment allowances and tax credits, the problem can be dealt with through fairly simple anti-avoidance rules, such as providing the incentive only for first use of the asset in the country.

VII. SPECIAL PURPOSE INCENTIVES[6]

A. General

A serious disadvantage of offering tax incentives to attract investment is that, to the extent that the incentives are claimed by enterprises that would have invested in any event, there is a loss of tax revenue without any corresponding benefit to the host country. These costs can, in theory, be reduced if means can be found to target the incentives to particular desirable activities or to projects that would not have occurred without the incentive. Countries have employed a number of techniques to achieve this better targeting. These include:
- linking the incentive to specific low-growth regions;
- tying the incentive to particular objectives, such as employment creation, technology transfer or export promotion;
- the use of Free-Trade or Export Promotion Zones; and
- the use of administrative discretion.

Each of these approaches has potential advantages, but is likely to give rise to substantial problems in implementation.

One general problem with special incentives is that their provision inevitably leads to pressure from other deserving sectors for special treatment. This pressure is much more difficult to withstand once some targeted incentives have been given. The experience in a number of countries in the region and in the OECD has been the spread over time to other activities and the difficulty of removing the incentives in the future once the reason for them has gone. While any one targeted incentive may not involve a significant revenue cost, the total for all the resulting incentives can sharply erode government revenues from the business sector.

Regional development. Regional development has often been an objective of tax incentives in OECD countries and elsewhere. Typically, investors in designated regions – usually the more remote, economically less-developed regions of a country, or regions with high levels of unemployment – receive tax holidays, investment allowances or accelerated depreciation. Experience demonstrates that little new activity is generated in the targeted region relative to the revenue cost incurred. In so far as the incentives have any effect at all, the chief effect is to divert investment away from its optimum location.

6. This section is substantially based upon contributions by Alex Easson to the original paper.

Employment creation. Tax incentives for job creation are frequently linked with regional policies, seeking to attract investment to areas of high unemployment. In other cases, incentives are given to promote the establishment of labour-intensive industries or the employment of particular categories of workers, such as young persons, the disabled, or the long-term unemployed. Many of the issues that arise with investment incentives, such as incentives going to activities that would have occurred in any event, are also associated with employment incentives. Moreover, incentives targeted to particular types of employment or increases in the level of employment are subject to manipulation and administrative complexity.

Technology transfer. Many countries have sought to attract technology-advanced investment, or R&D activities, through the grant of tax incentives, usually with very little success. It is frequently difficult for tax authorities to determine when particular technology should qualify as "advanced" or "appropriate", and difficult to define precisely what constitutes "research". In most cases it is likely that the investor will be receiving a tax break for doing what it would have done in any event, and it is the experience of many developing countries that technology which is introduced is rarely "transferred" to the host country. It is due to the generally unsatisfactory experience with tax incentives that a number of Asian countries are turning to non-fiscal inducements, such as the establishment of "Science Parks".

Export promotion. There is evidence, especially from developing countries in Asia, to suggest that incentives to attract export-oriented investment tend to be more effective than most other forms of investment incentives. Certain types of export-oriented enterprises, notably those in the textiles and electronics sectors and other labour-intensive assembly industries, are especially sensitive to taxation. Such industries do not rely much on local sources of material supply and do not target sales at the domestic market. Rather, they are attracted to low cost environments. While the most important local cost for such industries is labour, taxes may form a significant part of costs and so tax reliefs may be especially attractive to such firms. Investment incentives are commonly provided in the form of tax holidays or special investment allowances for firms designated as "export oriented", by exemption from tax of a proportion of profits corresponding to the proportion that export sales bear to total sales, or by generous deduction provisions for expenditures aimed at export promotion. Undoubtedly, some of these policies have been successful in attracting foreign investment and have, at least in the short term, had relatively little cost in terms of tax foregone, since much of such investment would not have been attracted without tax exemptions. The benefits of such investment, however, are questionable. As noted above, many of the enterprises attracted are "footloose", and tend to move on as soon as tax holidays expire. There tends to be little in the way of creation of linkages to domestic firms, little transfer of technology, and little sourcing of local raw materials. Moreover, the success of such operations depends to a large extent upon the reaction of the countries which provide the sources of capital and the markets for the exports. Many of the incentives that could be offered to attract export-oriented investment are contrary to the provisions of the GATT; the success of others depends in part upon home countries being prepared to grant "tax sparing" treatment in their double taxation treaties (see below). With the heightened competition in world markets there is a likelihood that these issues will become more important in the future.

Free trade or export processing zones. Closely related to the issue of promotion of export-oriented investment is the phenomenon of the establishment of export processing zones. These zones, also called Customs-Free Zones, Duty-Free Zones, Free Trade Zones, or Special Economic Zones, have over the past 30 years or so been established in more than 50 countries in all parts of the globe and are now being established in many countries of Central and Eastern Europe.

The principal feature that distinguishes these zones is that they provide a discrete environment in which enterprises (usually both foreign and domestically-owned) can import machinery, components and raw materials free of customs duties and other taxes, for assembly, processing or manufacture, with a view to exporting the finished product. Normally, sales of zone products to the domestic market are treated as exports/imports, and are liable at that stage to import duties and taxes.

From the point of view of the country establishing an export processing zone (EPZ) the principal objective is to earn foreign exchange from export sales. Frequently, there are additional objectives, such as the creation of employment, technology transfer, promotion of regional policy.

Incentives to attract foreign investors to the EPZs commonly take a variety of forms:

- *Exemption from customs duties and other taxes on importation.* This is the essential feature of EPZs. Such exemptions apply to materials and components that are imported and re-exported. They are also often extended to capital goods that are used in the production process by the firm. As mentioned above, exemption from such taxes is often one of the more important tax incentives offered to foreign investors since they have an immediate impact upon costs. To the extent that zone products are re-exported, such exemptions appear to be entirely consistent with the provisions of the GATT and, so far as product taxes are concerned produce essentially the same result as the zero-rating of exports under a value added tax. The chief advantage of the zonal exemptions is in terms of administration and cash flow, as opposed to having to apply for duty and tax refunds where goods are re-exported. Such incentives can be seen as removing impediments rather than providing a special break to encourage exports.
- *Other tax incentives.* Much of the investment attracted to EPZs is highly mobile, cost-conscious and tax sensitive, and frequently additional tax incentives for investment are offered in the zones. In some cases, special incentives (e.g. tax holidays) apply for investment in the zone; in others, zone enterprises qualify for the same incentives as are provided – notably for export-oriented investment – elsewhere in the country. The concerns raised above in

relation to incentives for export-oriented investment apply equally to zonal incentives of this nature.

- *Regulatory concessions.* It is normal for a variety of non-fiscal incentives to be provided for investment in EPZs. Such incentives commonly take the form of simplified approval procedures, relaxation of exchange-control restrictions, suspension of employee rights under labour legislation, etc.
- *Subsidized infrastructure.* In many cases, the host country subsidizes EPZ activities by providing a transport and communications infrastructure, low cost utilities, low rentals for factory sites, etc. All of these, of course, come at a cost to the host country.

It is difficult to evaluate the success, or otherwise, of EPZs. In a few countries they have been successful in generating substantial foreign currency earnings. However, in other countries EPZs have proved a dismal failure, while in between are instances where it is difficult to say whether the enhanced foreign exchange earnings have been worth the costs of establishment.

Real (net) foreign exchange earnings are often but a small proportion of total export sales, since most components and raw materials are imported; textile manufacturers in some zones have even imported such items as thread and buttons. Employment creation has been impressive, but has often had little impact upon local unemployment since the great majority of jobs have been filled by young women who had not previously been part of the workforce. Technology transfer has usually been negligible and in only a very few countries have substantial backward linkages with domestic producers been established. Attempts to use EPZs as an instrument of regional development policy have mostly been total failures. Since tax incentives have been the rule in most EPZs, very little tax revenue has been generated directly, though EPZ investors have undoubtedly contributed to revenues through employment creation, in the form of payroll taxes, income tax on salaries and sales taxes on spending by employees.

It is instructive to note that the countries in which EPZs have tended to be most successful have been those which have concentrated upon generating foreign exchange earnings, without attempting to pursue ancillary objectives such as regional development, and which have emphasized the removal of obstacles to export processing rather than the provision of investment incentives *per se*. They have also tended to be countries in which the general domestic tax climate has been relatively hospitable to investment.

To the extent that tax incentives (other than exemption from taxes and duties on imports) are employed, a potential advantage of EPZs is that they localize access to the incentives and so, in theory, allow a closer monitoring of the operation of firms. However, they certainly do not eliminate the problems already referred to. There are various ways to shift profits from operations outside the zone to firms which are based in the zone through intra-group transactions, and so lead to the effective leakage of zone benefits to ordinary domestic activity.

Finally, the caution recorded in relation to tax incentives for export promotion bears repeating in the context of EPZs. Whilst there would seem to be nothing objectionable in providing exemption from customs duties and taxes on importation, other tax incentives directed specifically at export promotion may run contrary to the GATT and might invite countervailing measures that could negate any advantages obtained from the establishment of the zones.

B. Administrative discretion

Should the incentives be discretionary and only granted with the pre-approval of the authorities? There are a number of potential advantages to this approach.

- As the policy priorities of the government change, it is possible to tailor the incentives to support them, since fewer firms are affected by the changes and problems of transition can be more easily handled.
- If there appears to be a risk of tax avoidance under the scheme then the authorities can deny access to the incentive.
- Where the extent as well as the availability of the incentive are administratively determined, it may be possible to provide only that degree of incentive which is required to make the investment economic. This would improve the cost-effectiveness of the programme by improving its targeting toward incremental investment.

In practice, however, there is little evidence that these gains are realized. Approval processes can be time-consuming and cumbersome. The authorities can only obtain the detailed information necessary for evaluation from the company which has an incentive to portray it in an advantageous manner. In the real world of politics, it is difficult to deny the incentives to companies which are promising the creation of employment. Finally, the greatest problem is that an approval process undermines the transparency of the tax system which is probably the number one criterion of foreign companies making the investments. For these reasons, the track record of discretionary incentives is not encouraging.

C. Domestic versus foreign investors

Incentives offered in the region are often tied to foreign investment.[7] The incentives are sometimes directed at firms that are 100 percent owned by foreigners and at other times offered to joint ventures, often with as little as 30 percent foreign ownership. Under the tax systems that formerly existed in the region such special treatment was often appropriate. The tax regimes that applied to state-owned firms served a different purpose to tax systems in the OECD countries. Accordingly, compared to OECD practice, they had features, such as restricted deductions for interest or wages or relative-

7. These can be in the form of special tax holidays under the income tax or special reliefs from customs duties or turnover taxes.

ly slow rates of depreciation, that were not appropriate for the taxation of the income of foreign enterprises. It was necessary to apply special tax provisions to foreign-owned firms to enable them to do business in the country. It may still be necessary for those countries which have not yet changed their tax systems to provide transitional relief for foreign firms until their tax systems have been brought into line with OECD practice.

Providing tax incentives targeted only to foreign companies raises different issues when the tax system of the country is similar to those of market-oriented countries. The clear attraction for policy-makers is that the targeting dramatically reduces the revenue costs of offering the incentives as the bulk of current revenues come from domestic firms. In addition, many of the domestic firms are still state-owned and not operating fully as private sector firms. However, as more firms become privatized and must compete in the market with foreign-owned firms, the question must be asked why it would be government policy to disadvantage domestic firms relative to foreign firms. The discrimination leads to resentment which is likely to reduce voluntary compliance with the tax system, just at the time when the tax administration is most vulnerable. Domestic firms would lobby, with justification, for an extension of the incentives to them. This pressure could be difficult to resist and so the incentives would spread, leading to a deterioration of the domestic tax system. Moreover, as seen above, the restrictions often do not work. Domestic firms are induced to enter into tax avoidance strategies that have proven difficult for tax authorities to counter.

VIII. INTERNATIONAL ASPECTS OF TAX INCENTIVES

In looking at the tax treatment of foreign direct investment, it is necessary to look both at the tax treatment in the country where the activity takes place, the source country and also the tax treatment in the country of the foreign parent, the residence country. There are often tax consequences in both the source country and the residence country. This can lead to an interaction between the tax systems of the two jurisdictions that modifies the impact of a tax incentive compared to when looked at only from the point of view of the source country.

There are a number of forms in which an investment can take place. The two basic methods are through a branch and through a subsidiary. A branch is simply a division of the foreign company making the investment. It is not a separate legal entity. Accordingly, the branch's profits are ordinarily taxed as they are earned in the residence country under the principle of worldwide taxation. Any residence country tax consequences occur immediately.

The other form of investment is through a subsidiary. In this case the subsidiary of the foreign company is a separate legal entity and its income is usually not included in the income of the foreign parent until it is repatriated as a dividend. Any residence country tax consequences occur at the time of repatriation. This delay in taxation by the residence country is known as deferral.

As a subsidiary is the normal form of investment for non-financial institutions, the balance of the discussion will focus on the treatment of repatriated dividends. Much of the discussion also applies to income earned in branches, although it should be remembered that taxation in the residence-country occurs at the time the income is earned, rather than being deferred until it is repatriated as a dividend.

A. Taxation of foreign-source income

There are basically two types of tax treatments that are applied to dividends paid to the residence country. These have very different implications for the potential effectiveness of tax incentives provided by the source country.

The first type of tax treatment is the foreign tax credit method. Under this method, the residence country applies its tax regime to the income when it is repatriated, but allows a credit for any foreign taxes paid to the extent that they do not exceed the amount of residence country tax that would be levied on the income. This effectively says that the source country is allowed the first opportunity to tax the income, but that the residence country will move in to tax the income to the extent that it is not fully taxed in the source country. In the simple case of only one source of foreign income, this has clear negative implications for tax incentives. To the extent that the incentive results in a tax liability that is less than the tax burden that would be applied in the residence country, then the benefit given is effectively clawed back when the income is repatriated to the residence country. There is simply a transfer of tax revenue from the Treasury of the source country to the Treasury of the residence country. A number of OECD countries use the foreign tax credit method, unless modified by treaty, for example, the United Kingdom, and the United States.

The alternative basic system of taxing foreign-source income is the exemption method, employed by OECD countries such as France and Germany. Under this method there is no further tax on the repatriated profits and so the effective taxing back of the incentive which occurs under the tax crediting method does not occur. In fact, simple categorization of countries is difficult as many countries incorporate aspects of both systems depending upon the type of income and its country of source. A foreign tax credit is applied in some of these countries in certain circumstances, for example if there is no tax treaty or if the source country does not have a "comparable tax system". The fact that some exemption systems are structured on the basis of a "subject to tax" test or a "comparable tax" test means that the existence of a tax holiday causes the exemption not to be available in the residence country and a credit system applies in its stead. In this event the comments made in relation to credit systems become relevant.

In examining the extent of the reversal of source-country incentives through foreign tax credits there are a number of qualifications that need to be made to the simple case outlined. With deferral, to the extent that the earnings are retained in the source country and reinvested they are not subject to residence country taxation. Thus any adverse tax consequences can be deferred until the time of repatriation. There is some theoretical discussion about the true impact of deferral in that the tax on the distribution will occur at some point in the future when the income is repatriated and so should be taken into account in the planning of the firm in making its investment decision. There is little doubt that firms act as if deferral matters to them. Thus to the extent that the adverse tax consequences can be delayed they are less problematic to the companies. This does have an implication for the design of tax incentives. It suggests that incentives in the income tax of the source country are more likely to be effective than incentives that are provided at the time of repatriation such as withholding tax relief. These latter incentives are more likely to be simply a transfer to the other national Treasury.

The next qualification is that the tax crediting systems of most countries are generally limited to the amount of tax that would have been paid on the foreign income in the residence country. The recent tax reforms in OECD countries have the effect in some countries of lowering the overall domestic tax burden on foreign-source income below that of the source country taxation. This places many firms, particularly in the United States, in what is known as an excess foreign tax credit position. The residence country taxation has been completely eliminated and a residual source country burden remains. In such circumstances, relief from source country taxation does not result in a transfer of tax liability to the residence country and so is of benefit to the firm.

The final qualification is that foreign tax credit regimes are difficult to operate effectively. In particular the use of offshore financing companies can defer the taxation in the residence country indefinitely. Dividends paid from the source country can be routed to a third country that does not tax them. In addition, in some foreign tax systems which pool the income from different countries in making the calculation, it is possible to mix the income from high and low tax countries to ensure the efficient use of tax credits. In such circumstances, the transfer of the tax benefit arising from the incentive to the residence country's Treasury can be avoided.

Nevertheless, despite all of these qualifications, many companies take into account when making their investment plans the eventual tax consequences in the residence country. Whether they measure the actual impact residence country taxation will have after all tax-planning routes have been exploited or whether it is a simplification used in the evaluation of projects is not clear and certainly varies depending upon the situation of the foreign investor. Regardless of which methodology is adopted the effectiveness of tax incentives is reduced below what they would be when viewed from a purely domestic context.

B. Tax treaties and tax sparing

One method that is used to avoid this problem is "tax sparing". Under tax sparing, the residence country treats the income remitted as if it had been fully taxed and had not benefited from the tax incentive. This ensures that the full benefit of the tax incentive goes to the investor and is not simply transferred to the residence country's Treasury. Tax sparing provisions are usually granted as part of tax treaties. Traditionally, they are given by developed countries, which are most likely to be the residence country in the flow of international investments, to developing countries, which are more likely to be source countries.

The purpose of tax sparing provisions is to allow the source country to be able to provide tax reliefs without the concern that they are simply transferring money to the Treasury of the more developed country and so can be seen as preserving the sovereignty of the source country. This provides more freedom for the source country in designing its incentive regime.[8]

The true tax benefits of other incentives such as tax credits, investment allowances and, in particular, accelerated depreciation, are more difficult to calculate. Hence tax sparing provisions in treaties do not usually apply to such incentives. The result can be that the operation of the international tax system ends up increasing the total taxation over what would apply without the incentive through a combination of source and residence taxation. In particular if the residence country has a credit system without a system of carry back for excess foreign tax credits, the reduced taxation in the source country in the early years of the investment results in increased taxation over a number of years. The residence country collects tax on the investment in the early years because of the low source-country tax and does not fully credit the higher source-country tax in later years because of the foreign tax credit limit. If the investment is made through a subsidiary, the problem can be overcome by postponing dividend payments until the later years of the investment and so averaging the source country tax over the low and high years – this would be the natural pattern for the payment of dividends in any event. Other tax planning strategies may be available in the case of a branch to overcome the problem.

Not all countries, however, are willing to provide tax sparing provisions and a number of countries that have offered them in the past are reconsidering their position. The reasons are related to why foreign tax credit regimes are used instead of exemption methods. The use of a foreign tax credit ensures that when profits are repatriated they are taxed at the rate of other income in the country. This may be considered to increase the fairness of the domestic tax regime since it ensures that the recipients of foreign-source income face the same tax rates as do recipients of domestic income. A second reason for a foreign tax credit regime is to improve the integrity of the domestic tax regime. It is very difficult to accurately divide domestic income from foreign income, particularly when companies try to arrange their affairs to maximize the benefits of low tax rates in offshore jurisdictions. The use of a foreign tax credit seeks to ensure that if income is transferred to low-tax jurisdictions it is taxed fully when it is returned to the residence country. So far as there is any discernible trend with respect to tax sparing it is for OECD

8. In order to qualify for tax sparing it is necessary to be able to calculate the extent of the benefit that has been provided. This can be done most readily for simple reliefs in the form of tax holidays, low tax rates and withholding tax reliefs.

countries to be more reluctant to include such provisions in tax treaties.

The provision of incentives in one country can have implications for the tax revenues of other countries if income is diverted to the incentive country to be sheltered from taxation. Certain types of incentives, such as tax holidays and low tax rates are particularly susceptible to this type of tax planning. Certain types of activities, such as offshore finance and insurance companies and foreign sales companies can also be vehicles for international tax avoidance. Therefore, tax sparing provisions are rarely blanket exemptions and may be provided in a restricted manner. They can be time-limited or may be restricted to certain key sectors such as manufacturing. The latter limit is usually achieved by specifying the domestic incentive provisions to which the tax sparing applies. Where there is a time limit for tax sparing relief under a treaty, power to extend the time by the mutual agreement or another procedure is often included. Such restrictions may in the end not be effective in practice as income can be changed in form and source through tax-planning. It is such concerns that have led a number of countries to conclude that tax sparing provisions pose an unacceptable risk to home country tax revenues.

Just as the domestic law of one country can impact on taxation in another country, so the tax treaties of one country can affect other countries besides the treaty partner under each treaty. This arises under the practice commonly known as "treaty shopping". The basic idea is that intermediary companies are set up in third countries[9] to take advantage of provisions in the tax treaty between that country and the source country that have the effect of lowering source country taxation [10]. Part of the planning often consists of re-characterizing business income as royalties or interest. As a result an increasing number of treaties include provisions intended to deny the benefits of tax treaties in treaty shopping situations. Such provisions become particularly important when tax treaties are used within a free trade group of countries to lower taxation on cross border flows, as each country in the group becomes vulnerable to the tax treaties of the other countries in the group with third countries.

IX. CONCLUSIONS ON THE DESIGN OF THE TAX SYSTEM TO ATTRACT FDI

The foregoing discussion has highlighted the importance of non-tax factors to investors in their determination of whether or not to invest in a country. Every effort should be made to deal with those factors under the government's control which may be inhibiting FDI. It is also important to ensure that the basic tax system does not contain features that themselves deter investment. These areas should be addressed on a priority basis. The clear experience of all the countries in the region that have offered incentives is that they, in themselves, are not sufficient to overcome the other impediments to investment. That having been said it must be recognized that incentives may be justified in some circumstances and, in any event, will certainly be offered. If they are, the experience of the countries in the region offers some clear lessons on the design of such incentives.

A. Basic income tax law

The most basic concern of businesses is the lack of clarity and stability of the tax laws and their application. A number of actions by governments in the region could help to reduce the resulting uncertainty.

> Governments should move on a priority basis to provide a clear and stable legislative income tax framework. New laws that contain the main features of a tax law in clear legislative language would provide a framework for business planning. It is recognized that all tax laws evolve over time to meet changing circumstances and that this is particularly important in the economies in transition. Thus, not all aspects that characterize tax systems in OECD countries need be present. However the structure of the law should be such that it can be added to as the economy and the capacity of tax administrators evolve.
>
> Provisions, such as penalties and interest and general rules to curb tax avoidance should be added, if they are missing from the existing law. These rules provide tax authorities with the tools that they need to attack tax avoidance, thus protecting those incentives that are provided from abuse, and at the same time beginning to establish a habit of tax compliance.
>
> Clear interpretation guidelines should be developed and made public. The most persistent complaint from tax advisors is their inability to obtain clear indications of the official treatment of certain transactions and for the apparent interpretations to change over time.
>
> Basic features of the profits tax law should be consistent with international norms. This means:
> - statutory tax rates between 30 and 40 per cent;
> - depreciation rates consistent with OECD practice;
> - loss carry-forwards of 5 to 10 years;
> - deductions for costs defrayed to earn income, like interest and wages; and
> - certain technical rules necessary for business operations, e.g. tax treatment of reorganizations.

B. Income tax incentives

The overwhelming experience in the region with tax holidays has been that they are particularly susceptible to tax avoidance and have been ineffective in attracting FDI. Part of the problem in the context of attracting FDI is that a holiday is only indirectly linked to the investment. It is tied to the establishment of a new enterprise and the amount of the incentive depends not upon the size of the investment but on the prof-

9. Not being the ultimate residence and source countries.

10. Typically a treaty with a narrow definition of permanent establishment or low or zero tax rates on dividends, interest and/or royalties.

its that are made during the initial years of the investment. This is at the heart of both the tendency for holidays to be used by firms making short term investments and the various tax avoidance schemes that have been observed. These problems are significantly reduced with investment allowances and credits and so these types of incentives are recommended if the goal is the promotion of productive investment.

Investment-based incentives – While investment-linked incentives are to be preferred to tax holidays, experience has shown that they have problems themselves. There are a number of guidelines that should be followed if the incentives are to be as free from abuse as possible.

As the examples of tax avoidance activities demonstrate, the tax avoidance problems associated with investment allowances and credits are most evident at higher rates of allowance or credit. Therefore, the rates of benefit offered should be moderate.

Attempts to target the incentives too finely or at vague objectives are counterproductive in that they introduce complexity and uncertainty for both the taxpayer and the tax administrator. If the taxpayer cannot be certain of the eligibility of an expenditure for the incentive, its effect on behaviour is reduced significantly or even eliminated. Therefore, the investments eligible for the incentive should be clearly defined and the rules kept as simple as possible.

In many cases the principal justification for an incentive will be to help to create a basic amount of market oriented activity in the country. As the market develops and foreign firms become familiar with a country, the rationale for an incentive will be reduced. This suggests that incentives should be introduced for a set period of time to expire at the end of the period established. This is known as sunsetting and ensures that some review and action on the part of the government is required for the continuation of the incentive.

Upfront incentives are susceptible to sales and resales of the same asset to produce multiple access to the incentive. Appropriate recapture and capital gains rules reduce the problem and should be in place. However for an incentive such as an investment tax credit other rules are needed to ensure that an asset only receives the incentive once. One approach is to claw back the incentive if the asset is resold, perhaps within a time limit. This approach requires complex tracking of assets. A simpler approach is to allow the incentive only for the purchase of assets that have not been previously used. To allow the use of second-hand assets from abroad that might embody technology that is unavailable in the country, the rule could be extended to allow the incentive only for the first use of the asset in the country.

An asset purchased from abroad from a related person is particularly susceptible to the risk that the transaction price will be inflated so as to maximize the write-offs for depreciation purposes. Adding an investment incentive on top of depreciation only heightens this risk. Avoiding this problem is not simple, but there are some guidelines that will help. The law should contain a provision that transactions between related parties be done at fair market value. This at least establishes a legal basis for attacking the transaction and will curb somewhat the aggressiveness of major companies.

Target the incentive to assets, such as machinery and equipment, that have an external secondhand market which can be used to determine arms length prices. Intangible expenditures like know-how and business services are typically hard to value.

The key to auditing any transaction is information. Typically the taxpayer has it and the tax administrator does not. This problem is compounded in the case of foreign tax-payers. This problem is addressed internationally through the exchange of information provisions in tax treaties. Consequently, the conclusion of tax treaties with the major source countries of FDI that contain exchange of information articles is helpful.

Tax holidays – If tax holidays are to be introduced there are a number of ways that the potential for abuse can be curtailed. These also have the effect of reorienting the holidays to an objective that is related to their design. As noted above, holidays are more linked to the establishment of enterprises than to the level of investment. The experience in the countries of the region has documented the extent to which holidays can be used to shelter income from existing domestic operations from taxation through transfer pricing and the transfer of operations from existing firms to new firms that qualify for the holiday. These problems suggest a number of restrictions that eliminate some of the most obvious abuses and direct the holiday incentives toward the creation of new businesses rather than indirectly attempting to attract new investment. The objective may be pursued by a government both in relation to attracting foreign firms and in helping the establishment of new private sector activity domestically.

A frequently encountered problem was the transference of existing business assets to a new firm to qualify for the holiday. This also occurred with firms whose holidays were expiring so as to renew the holiday. This suggests that the holiday should be restricted to firms, the bulk of whose assets have not previously been employed in the country. This ratio of new-to-the-country assets should be quite high, say, 90 percent. The assets so restricted would not include buildings given that existing buildings may be renovated for a new use. This would also deny the holiday to firms that simply change their form, for example through privatization.

The second restriction would address the problem of transfer pricing and focus the incentive on the objective of the creation of new enterprises. It would deny the incentive to any company that was related to a company operating in the country that did not itself qualify for the holiday.

Holidays are frequently targeted to industries that are internationally mobile such as manufacturing, and denied to firms that are engaged in other activities that are more tied to the country, such as the distribution and wholesale trade. The question arises as to what happens if a firm is established to manufacture but carries on ancillary activities that do not qualify. A strict targeting to manufacturing could operate in conjunction with the previous restriction to deny the holiday in this situation. Another approach is to allow the holiday provided that over one-half of the assets or revenues of the company are employed in the desired activity.

If this is done, the holiday benefits should be restricted to income from the targeted activity. Profits for each activity could be separately accounted for. This is complex and subject to manipulation. A simple formula approach should be used to determine the proportion of profits to qualify for the holiday. This proportion could be on the basis of some overall figure such as wages and salaries employed, total revenues or assets.

C. Non-income taxes

Certain non-income taxes may act as impediments to FDI. These had the common characteristics of being unrelated to profit and an addition to the cost of basic inputs. The taxes most often causing problems are the application of social security taxes to wages and salaries paid to expatriates and the imposition of customs duties or turnover taxes on imports of equipment to be used in a business. In both of these cases the imposition of the tax runs directly counter to any investment incentives that may be provided and its removal should be the first "incentive" considered.

In the case of social security taxes wages and salaries paid to expatriates are at levels much higher than local wages and salaries. At the same time, there is little likelihood that the expatriate would ever benefit from the services which these taxes fund. Therefore, for expatriates with a temporary attachment to work in the country, an option to not participate in the social security plan of the country could be provided. This would provide relief from the social security taxes, but would mean that the expatriate is denied any related benefits. Education, medical coverage etc. would need to be covered privately.

A related issue is the imposition of personal income taxes. As the expatriates benefits from the general services of the country, they should pay income taxes if they are resident for tax purposes in the country. Moreover, in many cases such taxes may be creditable in the home country. However, the progressivity of the rate schedule that is linked to the domestic distribution of incomes may result in an excessive burden of tax when applied to the higher level of expatriate salary. Moreover, the expenses faced by the expatriate are likely to be higher than the local population. Thus, an enhanced tax allowance might be applied to the income of such individuals.

Customs duties on business inputs raise the cost of capital items and discourage investment. In a number of countries, this is recognized in the foreign investment laws which exempt foreign owned firms from the payment of customs duties on own-use business imports. However, these benefits are sometimes restricted to contributions of original capital or require 100 percent ownership of the firm. In other cases, other taxes like the turnover tax impose a charge on such importations. (While a VAT in theory avoids these problems as a refund is given for any taxes paid on business inputs, certain features of the VAT systems of a number of countries in the region have led to an effective tax being imposed on imports.) As these are a direct impediment to investment, duties and taxes on the import of capital goods for own use should be eliminated.

D. International design issues

A number of conclusions can also be drawn about the features of the tax system that are related to taxation in an international context. These relate both to the attraction of FDI and ensuring that countries receive their fair share of revenues from profits earned from sources within them. The vulnerability of countries in the region to tax avoidance is especially pronounced in the area of international flows of interest and business services among related parties. Tax treaties and withholding tax policies should be designed to reduce the exposure of the tax base to erosion.

Withholding taxes. Countries in the region are likely to be net capital importers over the foreseeable future. As such they will wish to have a tax treaty policy that ensures that source countries maintain a fair share of profits derived from operations within their borders. Income tax systems in the countries are, and will remain, vulnerable to tax avoidance. Withholding taxes, which tax distributions on a gross basis without deductions, are less vulnerable than income taxes to tax avoidance and in many circumstances would ensure that a country gets some revenues from operations within its border.

In order to protect revenues, countries in the region should maintain withholding taxes on payments made to non-residents outside the region. Given the reasonable level of income taxes in the region, for the most part these taxes will be creditable against home country taxes and so will not deter FDI. Moreover in combination with relatively low statutory tax rates and moderate investment incentives, they provide an incentive for reinvestment of profits which is the primary source of investment capital.

Tax bases are particularly threatened by payments between related parties, such as interest, lease payments, rents, royalties, and management fees that generate deductions against the profit tax of the countries. If there is no withholding tax on these payments then the host country gets no tax on the underlying profits. Therefore, withholding taxes should be maintained on tax base reducing payments to related non-residents.

However, withholding taxes on such payments to unrelated parties are typically passed forward, in the sense that they are added into the price charged. In such cases the withholding tax increases the cost of capital or the service to the domestic company and so reduces its ability to compete. Therefore, consideration should be given to removing withholding taxes on such payments to unrelated parties. It is recognized that this provides an opportunity for flowing what are in fact payments between related parties through unrelated firms to disguise the identity of the true recipient. Rules can be developed to confront such back-to-back transactions, but auditing is very difficult in this area.

Tax treaty network. A tax treaty network is an important ingredient in the mix of tax policies to attract FDI. There are two broad groups of tax treaties, each requiring a different policy perspective. The first group consists of the treaties between countries in the region and those countries outside of the region and which are prospective sources of FDI. From the perspective of the foreign firm a tax treaty establishes the "rules of the game" for the interaction of the source and residence country tax systems. From the perspective of the taxing authority, it provides access to the exchange of information facilities that would allow a better chance to police some of the trans-border tax avoidance schemes that firms might employ. The second group are the treaties among countries in the region. Tax treaties among countries in the region should be designed to facilitate flows of investment and trade within the region, or sub-regions, reflecting the historically close economic ties. This may often result in provisions on withholding taxes that are less stringent than in treaties with countries from outside the region. They should also be used to allow close administrative cooperation to help to counteract regional tax evasion.

The two groups of treaties have the potential to interact in ways that can frustrate the objective of protecting the receipt by the country of its fair share of tax revenues. This can occur if withholding tax rates on certain types of distributions between countries in the region and countries outside the region vary between countries. This is most likely to occur if countries in the region operate separate tax treaty negotiation programmes. This suggests that for those countries which have continuing close economic links an attempt should be made to develop a coordinated tax treaty strategy and perhaps negotiate in concert. Consideration should also be given to the problem of treaty shopping in this context and the possible inclusion of provisions to protect the domestic tax base against this practice.

Countries should endeavour to expand their tax treaty networks. This would facilitate both tax compliance and tax administration. Access to tax sparing is through treaties and many countries with exemption systems for treaty countries apply a foreign tax credit system to non-treaty countries. Thus the existence of treaties makes any incentives which are provided more effective.

E. Tax competition

Experience with tax incentives, particularly in Asia, suggests that so-called footloose manufacturing plants for export may be influenced by tax incentives when choosing the location for a new plant when they are comparing sites in different countries that are otherwise similar. This situation may also occur where a firm targets a region for a strategic investment, but is indifferent as to which country it operates from. For example, it may view any one national market in the region to be insufficient for efficient production and plans to supply the entire region from one plant. Countries may therefore be tempted to try to attract these footloose export industries.

Another reason that policy makers give for offering tax incentives is that they are necessary in order to maintain their country's competitive position vis a vis neighbouring countries. They may consider that another country has a natural advantage, such as location or raw materials that makes it more attractive as a destination for foreign investment.

This rationale can be criticized on basic principles. All countries face natural advantages and disadvantages in relation to other countries. The provision of a tax incentive merely shifts the private disadvantage from the investor in the particular activity to other economic agents in the country. It does nothing to change the total disadvantage to society as it does not affect the social rate of return which is the sum of the private after-tax return and the taxes collected from the activity. In fact the competitive position of the country might be diminished overall as the production in the economy is less efficiently organized than it would have been without the incentive.

It is not necessary to rely on such economic efficiency arguments, however to see the potential futility of tax competition. The normal response of a country that views itself as being in competition for foreign investment to the tax incentives of another country is to introduce some form of off-setting incentive. Thus in the end the tax incentives offered by the two countries do nothing to alter the relative incentive to invest between the two countries. The only result of the competition is that both countries receive lower tax revenues. They would both be better off if they could agree not to compete.

The foregoing suggests that countries in the region should attempt to develop coordinated policies and processes to reduce the possibility of counter-productive tax competition. The OECD may provide an appropriate forum for such discussions to take place.

Given the inability of OECD countries to develop mechanisms in this area, one cannot be too sanguine about the prospects for reaching binding accords. Nevertheless, there are some reasons for optimism. A number of countries in the region have eliminated incentives in concert in an attempt to avoid tax competition, although there is some pressure on this. Secondly, among OECD countries, the wave of tax reform that swept the tax world in the latter half of the 1980s, had the effect of sweeping away many tax incentives in different countries at the same time. While there was no prearrangement for this to happen, the move by a number of influential countries certainly provided an opportunity for other countries to do the same.

AUSTRALIA

The Income Tax Simplification Experience to Date

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I. INTRODUCTION

Since Australia's main income tax legislation, the *Income Tax Assessment Act 1936* (the Act), was introduced in 1936 it has grown from 126 pages to over 5,000 pages,[1] doubling in size every seven years.[2] When this ongoing dramatic increase in legislation[3] is viewed in conjunction with the associated increase in the body of income tax case law and Commissioner's rulings, the massive scale of Australia's income tax laws is evident.

The judiciary, tax administrators, tax practitioners and taxpayers are faced with this mass of material when searching for the rule(s) that deal with their particular problem. The difficulty of this process has given rise to protests that the tax legislation is complex. These protests are not new.[4] Perceptions of the complexity of income tax laws had reached the point that even members of the Australian High Court expressed concern at the difficulty of applying the legislation to relatively simple transactions.[5] In the Federal Court, Hill J noted that one section had been drafted:

> . . . with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms.[6]

In recognition of this complexity and the complexity of other revenue laws both the Commonwealth and state governments have embarked upon substantial revenue law simplification projects. At the state level a Stamp Duty Harmonization Rewrite Project is under way.[7] At the Commonwealth level, law simplification projects have already been completed in respect of the sales tax laws[8] and a rewrite of the income tax laws under the banner of the Tax Law Improvement Project ("the Project") has begun. This article will focus on the process of simplification adopted by the Project and review its progress.

II. ORIGINS OF THE PROJECT

The origins of the Project can be traced to statements made on 15 February 1990 by the then Treasurer Keating, who advocated a simplification of the Act.[9] A perceived lack of action since that announcement[10] resulted in harsh criticism from the professional accounting and law associations and there were renewed calls for simplification of the Act.[11] These calls coupled with the recommendation from the Commonwealth Parliament's Joint Committee of Public Accounts

1. For a list of the major changes since 1986 see Dirkis, M., "Australia: The times they are a changing: Tax Reform in 1993/94", 48 *Bulletin for International Fiscal Documentation* 10 (1994) at 492.
2. Nolan, B., and Reid, T., "Re-writing the Tax Act" (1994) 22 *Federal Law Review* at 448.
3. An example of this growth rate is that in 1994 alone over 6,000 pages of bills, explanatory memoranda, court case reports and tax rulings and determinations were issued: see "Tax laws a feast of Xmas reading", *Australian Financial Review* 16 December 1994, at 3. This consisted of 14 tax related bills, 32 tax rulings, 42 draft tax rulings, 98 tax determinations, 116 draft tax determinations, 13 superannuation guarantee rulings and determinations, 5 draft superannuation guarantee rulings and determinations, 86 Administrative Appeals Tribunal decisions and 116 court decisions, plus press releases from the Government, Australian Taxation Office (ATO), Insurance and Superannuation Commission and minutes of ATO tax liaison groups: see "1994 – a busy tax year" (1994) *CCH Tax Week* at 905.
4. In 1934, Dixon J, in describing the structure of the then new *Sales Tax Assessment Acts* (1 to 9) 1930, commented in *DFCT(SA) v. Ellis and Clark* (1934) 52 CLR 85, at 89 that "... the legislation depends in a remarkable degree upon the regulations made under the power which it confers on the Executive. Without the regulations, not only is it unworkable, but the expression of legislative policy is so inadequate as almost to be unintelligible.
5. *Hepples v. FCT* 91 ATC 4808, per Mason CJ and Deane J at 4818-19.
6. *FCT v. Cooling* 90 ATC 4472, at 4488.
7. This project involves the states of New South Wales, South Australia, Tasmania and Victoria and the Australian Capital Territory. The stamp duty acts and the administrative acts are the primary focus of the project team, with draft legislation being released on 31 July 1995. Similar projects are planned for payroll taxes and financial institutions duty – "Stamp duty slug feared in rewrite", *The Australian*, 2 August 1994, at 35.
8. *Sales Tax Assessment Act 1992* and *Sales Tax (Exemptions and Classifications) Act 1992*.
9. "Treasurer talked about tax simplification" (1990) 24 *Taxation in Australia* at 602.
10. In a press release on 13 December 1990, the Treasurer made his first response, see "Income Tax simplification the first instalment" (1990-91) 25 *Taxation in Australia* at 557. This response was criticized as lacklustre and the pressure for reform continued, see Ed, "Simplification Marathon: Hares and Tortoises" (1991) 26 *Taxation in Australia* at 248.
11. For example: Ed, "Enough to give you a complex" (1991) 26 *Taxation in Australia* at 244; Ed, "A recalcitrant child" (1991) 26 *Taxation in Australia* at 247; "Experts step up pressure to simplify the tax laws" *Australian Financial Review*, 12 November 1993, at 7.

that a redraft of the Act be undertaken as a matter of priority,[12] prompted the Government to establish the Project team.[13] The Government's decision to establish the Project appears also to have been motivated by a belief that the rewrite will result in a reduction in compliance costs, resulting in significant microeconomic reform.[14]

III. SCOPE OF THE PROJECT

The scope of the Project encompasses the rewrite of the income tax law including the fringe benefits tax law.[15] The Project only embraces the rewording, renumbering and restructuring of the existing legislation, and will therefore not entail a consideration of taxation policy.[16] One major reason for this exclusion is to prevent the Project becoming "bogged down in policy debate".[17] The time limit for the redraft is three years, starting from 1 July 1994.[18]

IV. APPROACH TO THE REWRITE

The Project team has examined a number of ways of delivering the rewritten legislation. The first approach was to deliver it as a single package, the so called "big bang approach".[19] The big bang approach has the advantage of providing the maximum time for preparation and implementation, thus enabling the experience gained over the project to be fully incorporated into the end product.[20] As a corollary the overlap between the old and new laws is kept to a minimum. This facilitates the evaluation of the revised law. However, the big bang approach was rejected as it was felt that the package would be so large that it could not be digested by either the public or the parliament.

The rejection of the big bang approach has been criticized. Lehmann argues that as legislation cannot be judged until the entire package is available for scrutiny, the abandonment of the big bang approach affects the ability of persons to adequately comment on the draft legislation.[21]

A second alternative was to use an approach similar to the two-stage process adopted in New Zealand. Under the first stage of this process the new legislative framework is introduced into the Act by restructuring and renumbering existing parts and sections. In the second stage a substantive rewrite of the provisions is undertaken.

It is claimed that this approach is easier to deliver in a staged way, but it still involves the rewriting of large blocks of legislation. Duplication is a further problem as all provisions will require renumbering.[22] Also, it is harder to graft a new structure on to the existing law than to create an entirely new system.

The approach ultimately adopted for the Australian rewrite is a system of *progressive replacement*. Under this approach the rewritten legislation is delivered progressively to the community. The Government states that this method maximizes the benefits to its users, minimizes disruption, encourages community participation and allows for education and training in respect of the new law.[23]

In line with this approach the Project team is to initially concentrate on the core provisions of the income tax law (concepts of income, deductions and rebates). Discussion papers and exposure drafts of legislation will be released progressively.[24]

V. THE PROGRESS OF THE PROJECT

Despite concerns about the progress of the Project,[25] in August 1994 the Committee released an information paper[26] and draft legislation[27] on the substantiation provisions. In May 1995 it released *Information Paper No. 2*[28] and three legislative drafts covering the key provisions of the income tax law,[29] the mining, quarrying and petroleum mining industries provisions[30] and the loss deduction provisions.[31] On 27 July 1995 the Assistant Treasurer released further exposure drafts in respect of trading stock[32] and building write-offs.[33]

To commence the second stage of the Project, on 7 November 1995, *Information Paper No. 3* was released which outlines the proposed approach to be adopted in rewriting the capital gains tax provisions.[34] Finally on 30 November the Government introduced into parliament the first three final

12. 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), recommendations 22 and 23; also see paras. 5.22-5.38. See Dirkis, M., *supra* note 1 for a detailed discussion of this report.
13. Treasurer's Press Release No 172/1993 of 15 December 1993.
14. "Gear attacks gripes about tax rewrite", *The Australian*, 28 July 1995, at 27.
15. *Supra* note 2 at 451.
16. Tax Law Improvement Project, *Information paper No. 1* – The Broad Framework (Canberra: AGPS, 1994).
17. *Ibid.*, Appendix 1. The Government's resistance to opening the policy debate has persisted see "Tax project to fix the language, not the law," *The Australian*, 14 September 1995, at 25.
18. Treasurer's Press Release No. 17/1994 of 20 February 1994.
19. Tax Law Improvement Project, *Information paper No. 2* – Building the New Law (Canberra: AGPS, 1995), at 29.
20. *Supra* note 2 at 453.
21. Lehmann, G., "The reform that does not reform and the simplification that does not simplify – The Tax Law Improvement Project fiasco" (1995) *Butterworths Weekly Tax Bulletin* at para. 675.
22. *Supra* note 19 at 27.
23. *Ibid.* at 28.
24. Assistant Treasurer's Press Release No. 87/1994 of 12 July 1994.
25. Roach, P.M., "Hasten Slowly" (1994) 65(11) *Charter* at 24.
26. *Supra* note 15.
27. Tax Law Improvement Project, *Exposure Draft No. 1* – Substantiation (Canberra: AGPS, 1994); Granted Royal assent on 7 April 1995 as *Tax Law Improvement (Substantiation) Act 1995* (No. 30 of 1995).
28. *Supra* note 19.
29. Tax Law Improvement Project, *Exposure Draft No. 2* – Income Tax Assessment Bill 1995 (Canberra: AGPS, 1995).
30. Tax Law Improvement Project, *Exposure Draft No. 3* – The Mining, Quarrying and Petroleum Mining Industries (Canberra: AGPS, 1995).
31. Tax Law Improvement Project, *Exposure Draft No. 4* – Deductions for Losses (Canberra: AGPS, 1995).
32. Tax Law Improvement Project, *Exposure Draft No. 5* – Assessable Income – Trading Stock (Canberra: AGPS, 1995).
33. Tax Law Improvement Project, *Exposure Draft No. 6* – Deductions: particular items – Building write-offs (Canberra: AGPS, 1995).
34. Tax Law Improvement Project, *Information Paper No. 3 – Capital Gains Tax Finding a Better Structure* (Canberra: AGPS, 1995), at 7.

bills to emerge from the project.[35] The most important of these bills was the *Income Tax Assessment Bill 1995* (the "Assessment Bill") which includes the revised versions of the draft legislation in respect of the key provisions of the income tax law, the mining, quarrying and petroleum mining industries provisions, the loss deduction provisions, the capital allowance provisions for building and the previously enacted substantiation provisions.[36] The measures announced on 27 July 1995 (in respect of trading stock and the deduction provisions in relation to building) were not included.

However, whether the bills retain their current form is far from certain. First the bills have been referred to a Parliamentary committee, which is due to report by 22 February 1996 following public hearings. A second problem is the uncertainty caused by a pending election which if called will cause the bills to lapse.

VI. KEY ELEMENTS OF THE NEW LEGISLATION

The three bills are the first of a number of bills to be introduced as part of the progressive replacement process. The balance of the legislation will be introduced towards the end of 1996 and the beginning of 1997.[37] As the Assessment Bill only contains some of the key design features of the new legislative scheme, the following discussion is couched in terms of the overall legislative structure rather than the specifics of the Assessment Bill.

(i) Structure of the new Law

The objective of the Project is to ensure that a tax agent will be able to pick up the legislation, start at page 1 and be led to the appropriate provisions relating to the particular point at issue.

The new legislation is divided into three tiers. The first tier of the legislation (set out in part in the Assessment Bill) will contain core provisions that operate with respect to all taxpayers. The second tier includes the provisions which apply to a wide range of taxpayers and includes the depreciation rules. The third tier includes the provisions which consist of provisions grouped according to particular subject areas, such as superannuation and provisions which apply to specialist taxpayers such as the mining industry.

(ii) Renumbering

Associated with the restructuring of the Act, the new legislation will abandon the much criticized alphanumeric numbering system and will adopt a two-number system. The first number will indicate the part of the Act while the second number will denote the section (e.g. Section 6-30, Section 6-35). It is claimed that this method will be easier to follow and will also facilitate future legislative amendments.

(iii) Simple English

The legislation is expressed in what is misguidedly called "simple English". It is claimed that the convoluted sentences of the past will disappear but the complex concepts such as income and capital will remain. The following legislative extracts of the existing and proposed deduction provisions illustrate the contrast between the old and new drafting styles:

Section 51(1) – Existing *Income Tax Assessment Act 1936*

All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

Section 8-1 – *Income Tax Assessment Bill 1995*

(1) You can *deduct* from your assessable income any loss or outgoing to the extent that:
(a) it is incurred in gaining or producing your assessable income; or
(b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:
(a) it is a loss or outgoing of capital, or of a capital nature; or
(b) it is a loss or outgoing of a private or domestic nature; or
(c) it is incurred in relation to gaining or producing your *exempt income; or
(d) a provision of this Act prevents you from deducting it.

(3) A loss or outgoing that you can deduct under this section is called a *general deduction.*

* defined term included in the dictionary (see below).

(iv) The dictionary

The legislation contains a dictionary. The purpose of the dictionary is to create a central reference point for locating the meaning of defined terms used in the new law.[38] The terms will either be defined in the dictionary or the dictionary will direct the reader to the place where the term is defined. Except for the terms which relate either to core concepts ("income tax", "this Act", "assessment", etc.) or key participants in the income tax system ("you", "company", "Australian resident", etc.), all defined terms will be identified by the asterisk symbol which will be placed in front of the term.

35. *Income Tax Assessment Bill 1995, Income Tax (Transitional Provisions) Bill 1995* and the *Income Tax (Consequential Amendments) Bill 1995.*
36. *Supra* note 27.
37. *Supra* note 19 at 31 and note 34 at 3.
38. Explanatory Memorandum to the Income Tax Assessment Bill 1995, Income Tax (Transitional Provisions) Bill 1995 and the Income Tax (Consequential Amendments) Bill 1995 at 131.

Words which have an ordinary meaning (agreement, expenditure, expense, paid, etc.) will not be defined.

(v) Signposting

Another useful feature of the legislation is the use of what is called "signposting" – i.e. cross-referencing. The purpose of the cross-referencing is to direct the reader to further parts of the legislation which deal with the entity or facts considered by the provision being read. The Assessment Bill is cross Referenced not only to the *Income Tax Assessment Act 1936*, but also to the *Tax Administration Act 1953*.

(vi) Flow charts, diagrams, formulae

The legislation also uses flow charts, diagrams and formulae where the legislation is more easily understood in that format. It is claimed that this will facilitate the rewriting of the legislation in simple English by obviating, in many cases, the need to convey formulae in statutory longhand.

VII. CRITICISMS AND CONCERNS

Despite the above mentioned innovations, the Project has become subject to a number of criticisms. The major criticisms and concerns are considered below.

A. Defining complexity

Whilst the objective of the Project is apparently to reduce the complexity of the Act, nowhere is there a statement of criteria for the determination of what is an acceptable level of complexity. Whilst academic writers have generally accepted that some degree of complexity goes hand in hand with the income tax, the Project team has not undertaken substantial research with the objective of determining the optimum level of complexity.[39]

B. Exclusion of tax policy review

The exclusion of a reconsideration of income tax policy[40] has been widely criticized. The exclusion is based upon a misconception of the relationship between tax policy and tax administration. As much of the perceived complexity in the current legislation emanates from the ad hoc departure from a relatively small number of core concepts, the exclusion of tax policy considerations emasculates the simplification project.[41]

C. Target audience

The information papers and other publications associated with the Project have adopted an erratic approach when attempting to identify the targeted readership of the simplified legislation. This readership was initially identified in *Information Paper No. 1* as the individual taxpayer. The Information Paper endorsed the proposition that the Act ought to constitute a comprehensible and comprehensive statement of taxpayer obligations. It concluded that the Act: "... has long since ceased to be a document that can be used by people to understand their rights and obligations under the tax law".

Information Paper No. 2 reiterated the objective of targeting the ordinary taxpayer by stating:[42]

We want to restructure and rewrite the tax law so that a reader can:

- open up the new law;
- follow a path that takes him or her to exactly those provisions that apply to him or her (or his or her client);
- be certain that he or she has found all the relevant provisions; and
- understand and apply those provisions.

If we can achieve that, then we will also have more people understanding their tax rights and obligations. They will be able to work out more easily what tax they have to pay and they will save time and money.

Further, when speaking of the signposting to be adopted in the Draft, the Project team stated in *Information Paper No. 2*[43] that:

> Eventually, by following these signposts readers will find all the information they need to tell them exactly what the tax obligations are for persons in their position and circumstances.

These statements imply that the legislation is to be redrafted to enable ordinary taxpayers to understand their obligations under the legislation. The use of the word "you" throughout the Draft and the educative nature of various sections of the Draft reflect this approach. This objective would therefore suggest that the purpose of the project was to open the tax legislation to wider scrutiny and understanding, primarily so that taxpayers with a do-it-yourself bent could more easily complete and lodge their own tax returns. Of course, a further consequence of this approach might have been to facilitate a more informed tax policy debate.

However, by late 1994 the Project team determined that it was impractical to focus on this audience as the rewritten law would have been unsuitable for those who use the tax legisla-

39. In fact, by November 1994 the Project team had only tested 18 individuals on the readability of the redrafted substantiation provisions using the "reading aloud method" (*supra* note 2 at 459). All subsequent testing has been done using the redrafted substantiation provisions. Between February and April 1995 a large attitudinal survey was undertaken with 2780 survey forms being despatched. However, the purpose of the survey was to evaluate the perceptions of the tax legislation held by tax agents, small business, large business, and individuals, rather than determine the ultimate level of complexity. Finally, during May and July 1995, 44 participants were subjected to "Cloze" testing, whereby they were presented with passages of old and new legislation to gauge the participants' understanding of the text. Unfortunately the new text only increased understandability slightly – see Wallschutzky, I., and Muston, M., "Evaluation of the Tax Law Improvement Project: Stages 1 & 2 Research" (December, 1995) Australian Taxation Office 1995 Compliance Research Conference paper, at 28.

40. Other issues of tax policy which might have been addressed with a view to their impact on tax law simplification include the identification of tax entities (should the family unit be taxed? and should the company be treated as a separate entity in all circumstances?) and the role of "tax expenditures" in the income tax legislation.

41. *Supra* note 21 at para 675.

42. *Supra* note 19 at 5.

43. *Ibid.* at 9.

tion most, i.e. tax professionals.[44] Thus, the revised target group was to be tax professionals. By June 1995 there appears to have been another change in focus. In a Seminar paper released by the Project team it was stated[45] that the Project should target "the suburban tax agent as a typical audience".

The change in target audience from taxpayers to tax professionals should logically lead to a change in the nature and quantum of the rewrite that is required. Following from this, if the Project's objective is to rewrite the legislation so that a suburban tax agent regards the legislation as, if not simple, at least not excessively complex, many of the existing provisions need not be rewritten. The new focus of the project would seem to merely require the identification of those provisions commonly used by suburban tax agents which are perceived as excessively complex. Since many of the provisions which might be regarded as complex (e.g. the CFC rules), would only be considered by a suburban tax agent in a small number of cases, many complex provisions would not fall within the scope of the project. Similarly as the provisions dealing with mining expenditure are more likely to be encountered by "city" rather than suburban tax agents, there would appear to be little point in rewriting those provisions.

However, despite this change the language of the Draft does not reflect the new sophisticated target audience. The registration requirements in Section 251J and Section 251BC of the Act require that an applicant for registration as a tax agent should hold the qualifications prescribed in Reg 156 of the *Income Tax Regulations*.[46] Further, the case law in the late 1980s and early 1990s reveals that given these strict requirements it is very difficult to be registered, unless the applicant possesses considerable knowledge of the application of the Act across a wide range of taxpayers and has some years experience practising as an employee to a tax agent.[47]

D. Structure

(i) Structure of the new Law

As mentioned above the draft legislation will be divided into three components. It is proposed that the entire capital gains provisions be placed in the third (specialist) tier. The Project argues that the capital gains area is a specialist area because it contains unique terms such as "asset" and "disposal".[48] However, this approach is flawed as the capital gains tax general provisions apply to many taxpayers and are by no means restricted to only special types of taxpayers. For example, the exemption of principal domestic residences from the operation of the capital gains provisions is just one capital gains provision with widespread application. It may therefore have been better to split up the capital gains provisions by placing the general operative provisions in layer two and the specialist provisions in layer three. For example, the company rollover provisions could be placed with provisions dealing with corporate taxpayers, while bonus share provisions could be placed in the financial transactions area.

(ii) Signposting

It is unclear to what extent the signposting will direct the reader to all relevant provisions. This is because it is not clear whether it is intended to direct the reader to the *International Agreements Act 1953*, to warn of the potential application of the terms of a double tax agreement or to direct the reader to other related tax legislation such as the *Fringe Benefits Tax Assessment Act 1986*. Furthermore, direction could conceivably be given to relevant court and tribunal decisions or even to rulings and determinations issued by the Australian Taxation Office. Given the decision to introduce signposting, logic suggests that partial signposting would not achieve the implied objective of providing a comprehensive guide to the relevant tax materials.

VIII. CONCLUSION

The Project is only one year into its three-year life and already its Achilles' heel is apparent. Real simplification cannot be achieved in the absence of a policy review. Even in the context of the limited ambitions of the Project, serious shortcomings remain. The major shortcoming of the Project is the absence of any clear attempt to write the legislation for the target audience, "the suburban tax agent". This problem is compounded by the failure to undertake widespread testing to determine what constitutes legislative "complexity" for this target group. Indeed, given the target audience, it might be suggested that there was little need to embark upon such a costly rewrite at all. To simplify the legislation for those already endowed with a considerable knowledge of the law would perhaps merely have required the renumbering of the Act and the judicious editing of some of the more turgid provisions!

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44. *Supra* note 2 at 457.
45. Nolan, B, Allerdice, R, and Gaylard, S, "The Tax Pyramid" (1995) a Tax Law Improvement Project seminar paper presented in Perth, Sydney, Melbourne and Brisbane in June/July at 3.
46. For example the prescribed qualifications for an applicant accountant under Reg. 156 are that the applicant must have a degree, diploma or other qualification from a tertiary institution (university, etc.) in accountancy or law; have been employed in *relevant employment* at least 12 months out of the last 5 years; and have completed a course of study in Australian tax law by passing a written examination. Reg. 156(2) defines "relevant employment" to mean employment involving substantive tax matters including the preparation of a wide range of returns, the preparation or examination of objections to assessments, and the provision of advice in relation to income tax returns, assessments or objections.
47. See *Re Culmer v. Tax Agents' Board 90 ATC 2018*, *Re Civitti v. Tax Agents' Board of Victoria* 90 ATC 2039, and *Re Chenouda v. Tax Agents' Board of NSW* 91 ATC 2027.
48. *Supra* note 34.

NEW ZEALAND

Taxpayer Compliance, Penalties and Disputes Resolution Bill: An Update

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I. INTRODUCTION

A. History of the proposed reforms and structure of the Bill

The history behind the introduction of the Tax Compliance, Penalties and Disputes Resolution Bill with respect to the tax compliance and penalties aspects has been discussed in-depth in the Bulletin on two previous occasions.[1] Two discussion documents were issued, the first in August 1994, the second in April 1995. Both discussion documents are evidence of the Generic Tax Policy Process in operation, a process which has consultation as its hallmark. The conclusion in the earlier of the two articles was that the underlying direction of the statements in the first discussion document was long overdue and that the proposed higher penalties were important in raising the level of tax compliance in New Zealand. Several deficiencies were identified, including a failure to address many of the issues in the tax compliance literature.

The second article emphasized the importance of making submissions on Government policy, and the opportunities that consultation with taxpayers can provide in creating more workable legislation. It was suggested in this article that success in this respect could be measured by the reduction in most of the proposed civil penalty rates from those set out in the first discussion document, and the decision to delay the implementation date for the new reforms by twelve months. The importance of forward planning was emphasized as fundamental to successfully complying with the proposed changes. Documentation to support actions and familiarity with the legal standard of reasonableness were highlighted as vital issues for every taxpayer to consider. The Bill however sheds no light on the question as to whether a tax amnesty will precede the imposition of the new penalties regime.

The Bill largely adopts the policy considerations and draft legislation proposals contained in the second discussion document. Nevertheless, there are some changes, especially in the manner of drafting the proposed new legislation. The style of the draft legislation contained in the Bill is intended to fit coherently into the structure of the Tax Administration Act 1994 (TAA), and provisions relating to specific tax regimes have also been included in the Bill. The style of drafting has also been altered to provide a fairer reflection of the plain English language approach which, the Government resolved several years ago, should apply to all legislative changes. The comprehensive coverage of the reforms is vividly illustrated in the variety of taxes affected, and these changes are contained in each of the eleven parts of the Bill (the first part contains the substantial reforms to tax administration, the latter parts the consequential amendments to various Revenue acts):

I. Tax Administration
II. Taxation Review Authorities
III. Income Tax
IV. Goods and Services Tax
V. Stamp and Cheque Duties
VI. Gaming Duties
VII. Estate and Gift Duties
VIII. Student Loan Scheme
IX. Accident Rehabilitation and Compensation Insurance
X. Child Support
XI. Summary Proceedings

Operative dates for the changes remain as proposed in the second discussion document; the proposals will be effective for the 1997/98 income year, (i.e. effective at the earliest from 1 April 1997). The disputes resolution procedures will be implemented from 1 April 1996, which leaves very little time to gain familiarity with the new processes before the proposals take effect.

1. See Sawyer, A. J., "Raising the Threshold for Taxpayer Compliance: A New Era of Compliance Standards and Penalties", 48 *Bulletin for International Fiscal Documentation* 12 (1994), at 655; and Sawyer, A. J., "Taxpayer Compliance Standards and Penalties: Version II Signifies Progress," 49 *Bulletin for International Fiscal Documentation*, 10 (1995), at 472. Readers are encouraged to refer to these two articles to gain a fuller appreciation of the reforms.

B. Background to the disputes resolution procedures proposals

Following the concerns and almost scathing remarks in the Organisational Review Committee's Review of the IRD,[2] with respect to the disputes resolution process, the Bill provides the Government's response to the concerns and reflects submissions made on the discussion document issued in December 1994.[3] A major shortcoming identified in the Review was the existing system's failure to adequately support early identification and prompt resolution of issues that lead to tax disputes; rather the system promotes preparation of cases for hearing in a judicial forum. The proposed procedures emphasize information disclosure and discussion between the Commissioner and the taxpayer; each should be fully informed of the facts, propositions of law and interpretations upon which the other bases his tax position. The focus and thrust of the changes are towards a greater "up-front" commitment of the Commissioner's specialist technical resources in the pre-assessment phase, and full and frank disclosure by the taxpayer. Taxpayers are also permitted to initiate litigation of disputes and will be offered a new forum for the settling of disputes, a small claims jurisdiction of the Taxation Review Authority.

The process is intended to commence with the issue of a notice of proposed adjustment, either by the Commissioner or the taxpayer, and should there be disagreement, then the Commissioner will issue a disclosure notice. When a disclosure notice is issued, both the Commissioner and the taxpayer must disclose in writing the items of evidence and propositions of law which each relies upon in their respective views of the assessment, and exchange the pertinent details. Rules on the admissibility and exclusion of evidence are included in the Bill. The Bill also contains proposals to change the existing statute bar on the amendment of assessments and a facility for a taxpayer to increase this four-year period by a further six months.

Two important aspects of the new procedures are not included in the Bill, namely the conference procedure between an official of the IRD and the taxpayer prior to an amendment to an assessment, and the new adjudication unit to be set up within the IRD. The Commissioner is charged with the responsibility of implementing the necessary administrative procedures to give effect to these policy decisions. Detailed policy statements will disseminate from the IRD following the enactment of the Bill, including a "plain English" explanation of the procedures for taxpayers, and a focus on the non-legislated components of the new procedures. The procedures have also been designed to harmonize with the new penalties provisions and to provide more efficient and expeditious handling of disputes over penalties. The article will now review in more detail the developments since the second discussion document which are contained in the Bill.

II. COMPLIANCE AND PENALTIES PROVISIONS – DEVELOPMENTS SINCE THE SECOND DISCUSSION DOCUMENT

A. Taxpayers' tax obligations and possible obligations for the Commissioner

The Bill proposes to add a new Part IIA to the TAA ("the principal Act"), which includes a statement of taxpayers' primary tax obligations.[4] Essentially taxpayers will be required to:

(i) correctly determine the amount of tax payable by them under the law,
(ii) deduct or withhold the correct amount of taxes as required under the law,
(iii) pay tax on time,
(iv) keep all necessary information and maintain the necessary accounts and balances as required to under the law,
(v) disclose to the Commissioner in a timely and useful way all the information he or she is entitled to under the law,
(vi) cooperate with the Commissioner in a way that assists in the exercise of the Commissioner's powers under the law, and
(vii) comply with all other obligations imposed on taxpayers under the law (the "catch all" provision).

The succinct statement of these tax obligations should enable taxpayers, over time, to become familiar with what is expected of them if they are to display the required minimum level of compliance. However, taxpayers must be conscious of the fact that a breach of the obligations will attract a penalty.[5]

The first of these tax obligations creates its own problems; as it will not be possible to conclusively determine the correct amount of tax payable until the dispute resolution opportunities are either exhausted or lapse with the passing of time. Whenever the Commissioner and a taxpayer disagree over the correct amount of tax, the taxpayer will be deemed to be in breach of the first obligation, and primarily liable for the repercussions, including penalties. However, the disputes resolution procedures provide a process to defer a portion of the penalties and tax shortfall pending the final resolution of the dispute. With the breadth of scope contained in obligation (vii), serious consideration should be given to extending the contents of the obligation, such as to provide further reference to other tax obligations imposed on taxpayers, alternatively authoritative guidelines should be issued to assist taxpayers in complying with this obligation. Additionally obligation (vi) should be modified to incorporate an acceptable degree of reasonable cooperation, since reasonableness is a consistent theme throughout the Bill.

2. Organisational Review Committee, Organisational Review of the IRD, (Wellington, *Government Printer*, April 1994).
3. New Zealand Government, "Resolving tax disputes: proposed procedures: A Government consultative document", (Wellington, *Government Printer*, 1994).
4. Based upon the TAA, proposed Sec(s). 15A and 15B.
5. The exact amount of which depends upon the nature and seriousness of the breach.

Encouraging compliance should not be considered a one-sided process, and to this end, the Bill offers an opportunity to develop and legislate for taxpayers rights and as a counterpart to impose obligations on the Commissioner. These rights could be included by way of a new section, rather than be referred to in obscure parts of the Inland Revenue Acts or ignored entirely.[6] This new section *could* read as follows:[7]

"15C. Commissioner's tax obligations – The Commissioner must do the following:

(a) take all reasonable steps to provide taxpayers with reasonable certainty under the tax law with respect to their liability to tax;
(b) provide taxpayers with a full explanation of the basis of any assessment or reassessment imposing on them a liability for tax;
(c) give every taxpayer equal, fair and courteous treatment under the law;
(d) adequately inform taxpayers of their rights to object and appeal decisions made against them by the Commissioner;
(e) ensure that the costs of any review are reasonable and have regard to the resources of the taxpayer concerned, with taxpayers having the right to have decisions of department officers reviewed internally by the department, and to have disputes with the department resolved quickly, with the minimum of cost to the taxpayer;
(f) ensure that taxpayers are advised of their right, (and given a reasonable opportunity,) to obtain confidential advice from any recognized tax adviser;
(g) ensure that at all times taxpayers are advised of their right, (and given a reasonable opportunity) to be represented, when dealing with the department. They should also be made aware that they are entitled to natural justice in respect of those dealings;
(h allow taxpayers to exercise their legal and other rights without adverse inferences being made against them by the Commissioner or officers of the department;
(i) maintain the taxpayers' right to privacy in respect of their taxation affairs, unless otherwise specifically provided for in the tax laws;
(j) compensate taxpayers for the loss resulting from any actions taken against them by the department where such actions were without lawful authority or cause;
(k) operate an impartial dispute resolution service, with sufficient resources to enable the investigation and resolution of all matters taxpayers may raise."

The proposed Part IIA of the TAA should be foremost in every taxpayer's mind, whether the taxpayer is a New Zealand resident or a non-resident that undertakes business or has investments in New Zealand. Breach of any obligation will be the catalyst for the imposition of a penalty coupled in many cases with the imposition of the use of money interest regime.

B. Reasonable care test

As proposed in the second discussion document, where a taxpayer has failed to take reasonable care,[8] then that taxpayer will be liable to a penalty of 20 percent of the tax shortfall. Reference must be made to the common law to ascertain the necessary standard of conduct demonstrating reasonable care. In the commentary accompanying the Bill, the Government proposes that the standard will encompass the concept of whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood the prospect that an act (or failure to act) would cause a tax shortfall, having regard to all the circumstances. The test is an objective one, but related to the particular circumstances of the taxpayer. Subjective factors such as whether the taxpayer actually foresaw an act (or failure to act) would cause a tax shortfall and the intentions of the taxpayer are irrelevant. The required standard of reasonable care will depend upon the type of obligation and the nature of the taxpayer's personal and business activities for which tax obligations arise. Taxpayers will need to take reasonable care in interpreting the tax laws, i.e. they may need to consult respectable and expert tax advisers and/or the IRD.

It is proposed that practical guidance will be offered through IRD publications, including reference to pertinent case law on the standard of reasonable care in other areas of the law, such as negligence in the law of torts. Important factors to enable an assessment as to whether a taxpayer has maintained the required standard of reasonable care include consideration of the complexity of the law and the transactions, the materiality of the shortfall, and the difficulty and expense of taking precautions. In taking into account the practical limitations faced by taxpayers, this standard attempts to balance the taxpayers obligations with the compliance costs associated with achieving the reasonable care standard.

C. Reasonably arguable position test

A taxpayer must be able to demonstrate that he has taken a reasonably arguable (tax) position.[9] This provision relates to situations where the Commissioner contends that a taxpayer has taken an incorrect position or interpretation, whereas the standard requires the taxpayer's interpretation to be "about as likely as not". The taxpayer's argument must be sufficient to support a reasonable expectation that the taxpayer could win on the argument in court. Evaluation of the position must not be conducted *ex post* but rather *ex ante* in light of the surrounding circumstances. An expectation which is lower than a 50 percent chance of success may be sufficient. It is important to note that the legislation does not set out any minimum level of expected success.

The standard is only applicable to situations where a sizeable amount of tax is involved (NZD 10,000, which must also be in excess of 1 percent of the total amount a taxpayer has returned for the period). The commentary to the Bill offers further assistance to taxpayers in ensuring that they can substantiate their tax position as one which is reasonably

6. The following proposed obligations of the Commissioner are based upon proposals in Australia to create a Charter of Taxpayers' Rights.
7. TAA, as proposed by the author to be a new Sec. 15C.
8. TAA, proposed Sec. 141A.
9. TAA, proposed Sec. 141B.

arguable. Taxpayers will need to be familiar with the relevant tax laws and court decisions; in the absence of court decisions, the commentary to the Bill, binding tax rulings, tax opinions, legal articles and related materials will be relevant. Therefore, until a body of law develops in an area, what may be a "reasonable interpretation" will in fact be influenced by the opinions of advisers and academics, together with the frequently "pro-revenue" view contained in binding tax rulings.[10]

D. Abusive tax position test

The implications of a taxpayer exhibiting gross carelessness remain as proposed in the second discussion document.[11] A taxpayer who takes an abusive tax position is a person whose actions have as a dominant purpose (when viewed objectively), the taking of a tax position that reduces or removes tax liabilities or creates tax benefits, either directly, or indirectly.[12] Taxpayers need only be concerned about the potential of incurring a penalty for taking an abusive tax position if the amount of the tax shortfall exceeds NZD 10,000.

The commentary provides indications of activities which, on examination, if they form part of a taxpayer's dominant purpose, blur the distinction between an abusive tax position and evasion (the latter attracting a higher shortfall penalty and the possibility of criminal sanctions[13]). The commentary states that a dominant purpose (to be ascertained objectively), may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws. An abusive tax position may be established by the IRD on the balance of probabilities, with the onus on the taxpayer to establish that his or her action did not amount to taking an abusive tax position.[14]

The aspects of concealment of information and non-availability of evidence are suggestive of evasion rather than avoidance (that is a deliberate, wilful or knowing breach of an obligation). An abusive tax position, as defined in the draft legislation and discussed in the commentary, has muddied the waters that separate tax avoidance and evasion, reducing further any certainty that taxpayers may have in ascertaining whether their (proposed) actions will be construed as tax avoidance or tax evasion.

E. Obstruction of the Commissioner

If a taxpayer actually obstructs or hinders the Commissioner, the original shortfall penalty is increased by 25 percent.[15] However, there is no guidance in the legislation as to what constitutes obstruction. While hindrance was the term used in the discussion documents, the commentary to the legislation suggests that hindrance and obstruction are interchangeable terms.[16] An omission in the legislation is the absence of a taxpayer's right to challenge a claim made by the Commissioner that he was obstructed by the taxpayer in carrying out an audit or in otherwise ascertaining the taxpayer's correct tax position.

F. Criminal penalties – obstruction

The Bill creates a criminal offence of obstructing the Commissioner or an officer of the IRD in carrying out their lawful duties or exercising their lawful powers[17] (as distinct from the process of hindering or obstructing the Commissioner from carrying out an investigation). This offence attracts a fine of up to NZD 25,000 for a first offence and up to NZD 50,000 for each subsequent offence.

G. Remission of penalties and tax agents

Penalties may be remitted in two situations; when there is reasonable cause or when it would be consistent with collecting the highest net revenue over time. The first category of remission, for the late payment penalty and the late filing penalty, permits the Commissioner a discretion to remit the penalty if the failure to pay or file was due to a reasonable cause beyond the taxpayer's control and the taxpayer remedies the default as soon as is practicable.[18] A taxpayer's financial position may never be successfully argued as an exceptional circumstance justifying remission of a penalty. Submissions on the second discussion document have resulted in the extension of the remission discretion to situations involving tax agents. An act or omission will be beyond the control of a tax agent if it could not have been anticipated, and the effect of which could not have been avoided by compliance with accepted standards of business organization and professional conduct. The Bill retains the discretion for granting remission if this would enable the collection of higher net revenues over time.[19]

The situation concerning tax agents' liability has been retained from the second discussion document. While the offence of aiding and abetting has been strengthened, there is minimal scope to include, within the legislation, provisions to encourage high standards amongst tax advisers, especially where these advisers are not bound by effective professional codes of ethics. In this regard I would argue that research must be initiated with respect to determining the level of compliance by tax advisers with tax laws. It should also examine the extent to which tax advisers promote avoidance, take positions which do not allow them to hold a reasonably arguable position, promote abusive tax positions and the extent to which they are involved in promoting activities that amount to evasion.

10. A failure to attain this standard will attract a 20 percent penalty, levied on the amount of the taxpayer's tax shortfall.
11. TAA, proposed Sec. 141C.
12. TAA, proposed Sec. 141D.
13. TAA, proposed Sec. 141E.
14. TAA, proposed Sec. 149A.
15. TAA, proposed Sec. 141K.
16. This is surprising since in normal usage obstruction connotes a more deliberate and serious action than hindrance, and therefore it should invoke a more serious sanction on a taxpayer.
17. TAA, proposed Sec. 143H.
18. TAA, proposed Sec. 183A.
19. TAA, proposed Sec. 183D.

H. Changes to other taxes and miscellaneous issues

Penalty provisions in other Inland Revenue Acts and the Accident Rehabilitation and Compensation Insurance Act will be repealed and the generic provisions of the TAA will be applied. With respect to the Stamp and Cheque Duties Act 1971, the payment dates will be simplified and remission provisions will be introduced allowing for a six month period for presentation of a document for stamping after execution and due recognition for delays beyond the control of the taxpayer. Similar provisions, together with an interest on late payment of tax regime, will be introduced into the Estate and Gift Duties Act 1968.

The Approved Issuer Levy (AIL) applies to securities registered by the Commissioner, in lieu of non-resident withholding tax (NRWT). If the issuer of a security does not comply, the taxpayer automatically defaults to the NRWT regime and the new penalty regime will apply to any non-compliance with its requirements. In these circumstances there is no need to explicitly apply any aspect of the new regime to the AIL, so non-residents will experience little in the way of change in this area. Changes are also proposed to the Gaming Duties Act 1971 and to the Student Loan Scheme Act 1992, along with the Goods and Services Tax Act 1985.

Taxpayers should be aware, especially non-residents with operations or investments in New Zealand, that any transactions entered into now and which continue until the 1997/98 income year, or which have been entered into and could be subject to review from 1 April 1997[20], may be subject to the new compliance, penalties and disputes regime. Documentation and supporting materials, including evidence of resolutions and decisions, will become extremely important to limit the imposition of penalties. Consequently taxpayers and businesses may need to review their documentation systems before the changes become law.

III. DISPUTES RESOLUTION PROCEDURES

The Bill incorporates the changes proposed in the discussion document on disputes resolution procedures, together with the implications of submissions received on that discussion document. The purposes behind the new disputes resolution procedures are as follows[21]:

"PART IV DISPUTES PROCEDURES

89A. Purpose of this Part:

(1) The purpose of this Part is to establish procedures that will-
   (a) Improve the accuracy of disputable decisions made by the Commissioner under certain of the Inland Revenue Acts; and
   (b) Reduce the likelihood of disputes arising between the Commissioner and taxpayers by encouraging open and full communication-
      (i) To the Commissioner, of all information necessary to making accurate disputable decisions; and
      (ii) To the taxpayers, of the basis for disputable decisions to be made by the Commissioner; and
   (c) Promote the easy identification of the basis for any dispute concerning a disputable decision; and
   (d) Promote the prompt and efficient resolution of any dispute concerning a disputable decision by requiring the issues and evidence to be considered by the Commissioner and a disputant before the disputant commences proceedings.

(2) This Part does not apply with respect to any tax returns or notices of assessments that are, or become, subject to objection proceedings[22] under Part VIII."

The proposed changes in Part IVA of the principal Act are scheduled to be effective from 1 April 1996. The more important proposals are discussed below.

A. Notice of proposed adjustment

If at the conclusion of an audit, the Commissioner proposes to amend an assessment or to reassess a taxpayer, the Commissioner will issue a "notice of proposed adjustment", setting out the proposed adjustments to the taxpayer's return.[23] If the taxpayer does not accept this adjustment, then he or she will have two months to respond. If the taxpayer does not respond within this period, then he or she will be deemed to have accepted the adjustment and will normally be prevented from taking any further dispute action over the assessment.

If the taxpayer disputes a notice of adjustment by issuing a response notice,[24] a pre-assessment conference will be held between the parties to determine exactly what issues are at stake and, where possible, to resolve these issues at this stage. This is an administrative procedure to be created and administered by the IRD. This process is directed at resolving the dispute in a mutually acceptable manner without the need for recourse to either the Adjudication Unit within the IRD or to the court system.

B. Disclosure notices

If the pre-assessment conference fails to bring about a resolution, the Commissioner may then issue a disclosure notice, which will require both the Commissioner and the taxpayer to submit, in writing, the factual and legal bases for their arguments, and an outline of their supporting evidence in

20. These would include transactions that have income tax implications, from at any stage up to and including the 1997/98 income year and which remain effective as at the end of the 1997/98 income year.
21. TAA, proposed Sec. 89A, introduced by clause 12 of the Bill.
22. Objection proceedings refers to the process of objecting to assessments and determinations, and the rights and obligations conferred on the Commissioner and the taxpayers concerned. It also encompasses the case stated and test case procedures. This part will become largely redundant when Part VIIIA entitled "Challenges" is fully operational.
23. TAA, proposed Sec(s). 89B to 89L; note that a taxpayer may also issue a notice of proposed adjustment under Sec. 89D.
24. TAA, proposed Sec. 89G.

relation to each matter in dispute.[25] It is vital for taxpayers to raise all of the issues and legal matters at this pre-assessment meeting, since legal arguments and evidence not submitted in response to the disclosure notice cannot be raised or submitted later in court, save in exceptional circumstances (see paragraph C below).

Issues which remain unresolved at the conclusion of the pre-assessment conference will be referred to the new Adjudication Unit set up within the IRD. The role of the adjudicator assigned to a particular case (an IRD official), will be to consider the factual and legal arguments of both parties and to impartially determine whether the proposed adjustment is correct by applying the law to the facts. It will be extremely difficult for an adjudicator to act impartially in a dispute, let alone satisfy a taxpayer that they have acted impartially, and were not constrained by IRD policy or directives where their decision goes against the taxpayer. Perceptions of breaches of natural justice will abound.[26] Following the adjudication procedure, an assessment will be issued by the Commissioner.

C. Evidence rules and the litigation process

It is of paramount importance that both the Commissioner and taxpayers identify and where possible, resolve issues as part of the assessment process. Facts and evidence not previously brought before the parties will not be able to be introduced unless the evidence and/or issues raised by those facts and propositions of law relate directly and exclusively to the facts, evidence or related issues,[27] and the taxpayer and Commissioner could not, with due diligence, have discovered the facts or evidence before challenging the assessment; and the weight of the new facts or evidence is such that, if admitted, they will necessarily be conclusive to the challenge of the assessment.[28]

D. Small claims jurisdiction of the Taxation Review Authority

While a taxpayer currently has the option of issuing proceedings in the Taxation Review Authority (TRA) or High Court, the Bill proposes that a taxpayer may choose to file a claim in the proposed small claims jurisdiction of the TRA.[29] The small claims jurisdiction of the TRA limits the tax (or tax effect) involved to NZD 15,000; it also requires that the facts are clear and not in dispute, and that there are no significant issues of precedent. Choosing the small claims jurisdiction curtails any right of appeal the taxpayer could have utilized in the other judicial forums.

The hearing in the small claims jurisdiction of the TRA is intended to be as informal as possible; it is designed for the individual taxpayer who wishes to present his own case without legal representation hence minimizing costs.[30] For other than small claims, it is unlikely that overseas entities or individuals would consider the small claims jurisdiction of the TRA as an appropriate forum. Documents relating to hearings before the TRA will be filed by the taxpayer and will be similar to the existing points of objection notice.

E. Statute bar for reassessments

In all situations where the Commissioner is considering a reassessment, legislative time bars operate under Sections 108 to 108B of the TAA. These Sections restrict reconsideration of an assessment to four years following the end of the year in which the return is filed, but the period is extended to ten years [31], where a return is fraudulent or wilfully misleading, or does not mention income of a particular nature or from a particular source. Previously the time period ran from the end of the year in which the return was originally assessed.

IV. CONCLUSIONS

The Taxpayer Compliance, Penalties and Disputes Resolution Bill 1995 represents a major step forward aimed at re-emphasizing the obligations of taxpayers *vis-à-vis* the imposition of a new penalties regime, whilst at the same time enhancing the process of dispute resolution. A significant number of the proposals have received the endorsement of tax professionals. This is partly attributable to the consultative process the Government has followed through the issue of discussion documents and consideration of submissions. This is not to say that valid concerns have not been expressed by tax professionals over the harshness of the operation of aspects of the proposed penalties and the imposition of interest on the late payment of tax in situations involving reassessments. The operating environment for taxpayers is long overdue for a comprehensive overhaul. The scope of the changes are unprecedented in New Zealand's tax history but the intention of the changes are certainly not unfamiliar to many taxpayers operating in other jurisdictions.

The proposals have, hardly surprisingly, a pro-revenue slant.[32] The overwhelming emphasis is a focus on expectations of taxpayers' behaviour and severe sanctions, should taxpayers be considered by the Commissioner to have been non-compliant. Unfortunately the Bill's proposals do not contain provisions subjecting the Commissioner's conduct to similar scrutiny.

25. TAA, proposed Sec. 89M.
26. Secrecy provisions would prevent disclosure of a taxpayer's tax affairs with another taxpayer, so it will be impossible for the IRD official to prove to a third party that he has acted fairly.
27. TAA, proposed Sec. 138G.
28. These rules are based on principles adopted by the New Zealand Court of Appeal in *Sulco Limited v. E.S. Redit and Company Limited and Anor* [1959] NZLR 45.
29. TAA, proposed Sec. 89E; and Taxation Review Authorities Act 1994, proposed Sec. 13B.
30. Costs of actions heard before the TRA remain with each of the parties. In the High Court, costs may be allocated in accordance with the High Court Rules and judicial discretion. While the number of disputes that make it to a judicial forum are likely to reduce following implementation of the new dispute resolution procedures, the opportunities for disputes and ensuing litigation following the new compliance standards and severity of penalties will escalate.
31. From the end of the year in which the return is filed.
32. Any other viewpoint would be surprising given that the New Zealand Government initiated the changes and that taxation is the single largest contributor to its revenue.

Initially there will need to be a transition period when the courts are required to determine the scope of the new concepts in the Bill, especially the breadth and practical content of the obligations of taxpayers.[33] The courts will also need to determine if there is an express or implied standard of conduct expected of the Commissioner. Other concepts such as reasonable care, lack of a reasonably arguable position, gross carelessness, and the distinction between avoidance, an abusive tax position and evasion, will require elaboration by the courts.

The IRD will have a vital educational role in providing guidebooks and explanatory materials concerning the new regimes; measurement of the success of the department will commence as the disputes resolution procedures changes take effect.

A significant number of the proposed changes are reflective of overseas standards and expectations; nevertheless non-resident taxpayers should consult their New Zealand tax advisers to ensure that, as far as their New Zealand tax liability is concerned, they are in a position to comply with the new regimes and are aware of the consequences should they fail to achieve the required standards.

33. TAA, proposed Sec. 15B.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

MARCH 1996

Application of tax treaties, Amsterdam, 4-6 March 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Meeting of the International Tax Planning Association, Budapest, 7-8 March 1996 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

APRIL 1996

International tax planning techniques, Amsterdam, 11-12 April 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

UNITED STATES

Thoughts on the New US–France Income Tax Treaty*

Stephanie H. Simonard
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Ms Simonard is a dual national of the United States and France. She moved to Paris in 1972 to join the local office of *KPMG* and was a tax partner there from 1986-1992. In 1993 she established her own international tax practice *Cabinet Simonard*. Ms Simonard's experience includes close involvement with the negotiations leading to the US–France income tax treaty. She has twice personally testified on legislative tax matters to the US Congress, has authored numerous articles and has spoken at very many conferences and seminars on international taxation matters.

* This article is an excerpt from Ms Simonard's presentation given at the 18th Annual ATI Congress held in Cannes 6-8 November 1995.

I. GENERAL OVERVIEW

The US–France income and capital tax Treaty of 31 August 1994 entered into force on 30 December 1995. In general, the treaty effectively applies as of 1 January 1996 or to taxable periods beginning on or after 1 January 1996. Pursuant to Article 33 however, various other effective dates may apply depending on the type of tax or income covered. For example, the withholding tax provisions for dividends and interest are generally effective as from 1 February 1996.

Under the old treaty, in most cases Americans living in France had since 1988 benefited from a special French income tax exemption for US source dividends, interest (including municipal bond interest), capital gains and royalties, as well as real estate income and certain business, pension, teaching, trainee, alimony and annuity income. US citizens in France who were partners of American professional partnerships also benefited from an exemption of up to 50% of their partnership income. While exempt from French tax, such income was nevertheless required to be reported on an annex to the French income tax return and used to increase the average French rate of tax for other income taxable in France (exemption with progression concept).[1]

Under the new treaty provisions exemptions from French tax will no longer exist for Americans residing in France; rather a *credit* method will be used to alleviate double taxation. This means that for assessment of tax on income from items which were exempt under the old treaty, a credit is provided in the amount of the French tax applicable to these items[2]. As under the old treaty, exceptions apply to the above general rules. For example, different rules apply to income derived from closely-held US companies.

For those US citizens who are not also dual nationals, the five-year exemption[3] from French wealth tax on non-French assets is maintained under the new treaty i.e. this exemption applies to those Americans who do not have French citizenship when they take up residence in France and do not acquire French citizenship during the five-year exemption period.

II. NEW PROVISIONS

Contributions to US pension plans will now be deductible in France and possibly vice versa (Article 19).

Directors' fees (Article 16) are now specifically addressed in the new treaty, giving the primary right of taxation to the payer's (source) country rather than the country of the recipient's residence. However, also see Relief from double taxation, below.

The independent personal services article (Article 14) no longer includes a 183-day rule exception. Rather taxation is reserved to the country of residence unless services are regularly performed in the other country and connected to a *fixed base*[4] "regularly available" to the taxpayer there.

Stock options: a 1978 Exchange of Letters concerning the 1967 treaty provided that US qualified stock options owned by US citizens would be taxable as compensation in France "at the time and to the extent the exercise of the option or the disposition of stock gives rise to ordinary income for US tax purposes".

The treatment of stock options is not addressed at all by the new treaty and a priori an Exchange of Letters under the old treaty will hold no authority. A member of the French tax treaty negotiating team (S.L.F.) has privately indicated that the French tax administration is undecided as to the position

1. Under the old treaty France generally computed the taxpayer's liability at the rate applicable as if no income had been excluded under the treaty. This treatment was called "exemption with progression" or *taux effectif global*.
2. The exemption pertaining under the old treaty is therefore effectively retained, as the taxpayer's French tax liability is extinguished by way of a credit equal to the French tax otherwise payable.
3. It is interesting to note that the five-year exemption may be claimed more than once. However, where an individual wishes to claim the relief for a second time, he must cease to be a French resident for a period of at least three years.
4. The term "fixed base" is not defined in the treaty. It is however thought that its meaning is analogous to the term "permanent establishment" which is defined in Art. 5.

to be adopted on this matter. A similar situation exists with the French tax treatment of American trust income, which was covered by French pronouncements interpreting the former treaty.

Teachers and researchers (Article 20) retain a two-year French tax exemption, but it only applies once per taxpayer (i.e. no renewals or multiple visits). The exemption is restricted to applying only in circumstances where the individual is *invited* by the US Government, university, or other recognized educational or research institution, to carry on teaching or research.

III. RELIEF FROM DOUBLE TAXATION

Article 24, providing Relief from double taxation, is now extremely complex. A dual credit method replaces the exemption method. The following summarizes the tax treatment of US citizen individuals residing in France:

- Generally all income is fully taxable in France if from non-US sources.
- US source income is also taxable in France with respect to directors' fees (new), artists and sportsmen. In these cases, double tax relief takes the form of a tax credit being allowed for the US income tax. This credit is restricted to the amount of the French income tax payable on the relevant income.
- This credit treatment also applies to most other US sources of income. This means that a credit equal to the French tax on various US income earned by US citizens resident in France will apply to US source income from dependent and independent services (as these services are defined in Articles 14 and 15, respectively), most US source dividends, interest, royalties, capital gains and financial option income if not from closely-held US companies, as well as US pensions attributed to services rendered while employed in the US, and earnings received by certain researchers, teachers, student trainees, and US source alimony and annuities.

IV. CONCLUSION

The changes in the new treaty appear to maintain a result similar to that under the old treaty but using different terminology and procedures. However, numerous questions arise concerning the exact application of the new provisions. In general, Americans should not be unduly anxious about the results, but they should know that the new treaty will undoubtedly enhance the enforcement ability of the French tax authorities and will eliminate what the French viewed as overly favourable tax reductions available under the old treaty by way of the *taux effectif global* tax calculation. Also, US taxes appear to be no longer deductible in the calculation of reportable US income. All Americans living in France should review how the complex new treaty provisions will affect them personally.

CUMULATIVE INDEX – 1996

I. ARTICLES

II. REPORTS AND DOCUMENTS

III. IFA NEWS

V. BIBLIOGRAPHY

IFA NEWS

AUSTRIAN BRANCH

14 March 1996. General Meeting with Presentation of the Austrian National Reports for the Geneva 1996 Congress. Speakers: Prof. Dr Gassner, Doz. Dr Göth. Seminar on "Enterprise Financing from the viewpoint of international tax law". Speakers: Prof. Dr Burmester (Trier), Prof. DDr Lechner.

13 May 1996. Seminar on "Double Tax Treaties and EC law". Speakers: Prof. Dr Gassner, Prof. Dr Lang, Prof. DDr Lechner, Prof. Dr Lehner (Berlin), Dr Staringer, MMag. Schuch, Dr Tumpel, Mag. Jann, Mag. Toifl, Urtz, Dr Lahodny-Karner.

FRENCH BRANCH

29-30 August 1996. Joint meeting with the US Branch (in Dijon, tentatively).

NEW ZEALAND BRANCH

22-24 February 1996. Annual conference, The Chateau, Mt. Ruapehu.

Topics:

- Ethical responsibilities of tax professionals
- Tax compliance and dispute resolution
- Advance rulings
- Core provisions of the Income Tax Act
- International tax
- Reorganization of the Inland Revenue Department

Keynote speaker: Prof. William Streng (USA).

SWITZERLAND

1 February 1996. Basel, Extraordinary Meeting.

6 June 1996. Zürich, Annual General Meeting.

7 November 1996. Bern, Extraordinary Meeting.

UK BRANCH

20 February 1996. Seminar on "The new UK Law on thin capitalization; A comparison with the approach in other major countries". Speakers: Mr Ian Hardie, International Manager, Inland Revenue and Mr Brian Hornsby, Tax Partner, Coopers & Lybrand.

7 March 1996. Seminar on "Recent tax cases" Speaker: Mr David Milne QC.

18 April 1996. Seminar on "Simplification of tax legislation" Speaker: Mr Graham Aaronson QC.

6 May 1996. Seminar on "The decisions of the European Court" Speaker: Mr Paul Farmer, Legal Secretary, Court of Justice of the European Communities.

10 May 1996. Branch Dinner.

12 June 1996. Annual General Meeting and an international tax topic of current interest.

US BRANCH

29 February-1 March, 1996. Annual Meeting, Mayfair House Hotel, Coconut Grove, Florida.

May/June 1996. Joint meeting with the Canadian Branch in Montreal or Toronto

30-31 August 1996. Joint Meeting with the French Branch (in Dijon, tentatively).

In Denver, the Rocky Mountain Region has a breakfast meeting every month.

ANNUAL IFA CONGRESSES

Geneva, 1-6 September 1996

The two main subjects are:

Subject I: Principles for the determination of the income and capital of permanent establishments and their applications to banks, insurance companies and other financial institutions.

Subject II: International aspects of thin capitalization.

The Seminars will treat the following topics:

- Tax issues in the context of a Federal System
- International tax aspects of the economic relations with Eastern European countries
- The influence of civil law and accounting principles in determining taxable income
- OECD Model Treaty – 1996 and beyond
- Visions of international taxation in the XXIst Century.

New Delhi, 19-24 October, 1997

The two main subjects are:

Subject I: The taxation of income derived from the import of technology.

Subject II: The taxation of investment funds.
The final directives will be distributed in the first week of April 1996.

Future Venues

London, 4-9 October, 1998
Jerusalem, 10-15 October, 1999
Munich, 2000
San Francisco, 2001
Oslo, 2002
Sydney, 2003

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 41-44 of the January 1996 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

AFRICA

Morocco

Akesbi, Najib.
L'impôt, l'état et l'ajustement.
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(B. 13.489)

South Africa

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Durban, Butterworth Publishers (Pty) Ltd., 8 Walter Place, Waterval Park, Mayville 4091, PO Box 792, Durban 4000. 1995, pp. 920. 160.- R. ISBN: 409 11470 7.
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(B. 13.507)

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New York, Deloitte Touche Tohmatsu International. 1995, pp. 232.
Guide designed to provide potential foreign investors with fundamental information about the business environment in the various countries, including details about the forms of business available, the tax regimes and rates, any investment incentives offered, and the countries' double tax treaty networks.
(B. 58.120)

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New York, UN United Nations. 1995. Development Papers No. 17, pp. 115.
ISBN: 92 1 119676 0.
Seminar papers of the ESCAP/World Bank Seminar on East/South Asian Growth Experience, held at Bangkok on 19 and 20 May 1994. Contributions by various authors include: "Policy implications of development experience of East/South-East Asia for South Asia – an overview"; "Economic growth in East/South-East Asia – relevance for South Asia"; "Subregional development zones in East/South-East Asia – lessons and policy implications".
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Australia

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Editor Peter McDonald. 76th Edition.
Melbourne, Australian Taxpayers' Association. 1995, pp. 1530. A$ 35.-.
Annual publication designed to provide, in a comprehensive but concise form, the main features of the various taxes levied by the Commonwealth and the States (corporate and individual income taxes, fringe benefits, sales tax, capital gains tax, superannuation funds, gift tax). Covers changes up to 30 June 1995 including those announced in the 1995/96 Federal Budget.
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New York, Deloitte Touche Tohmatsu International. 1995, pp. 135.
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LATIN AMERICA

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International Tax and Business Guide: Mexico.
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AUSTRALIA

THE DEDUCTIBILITY OF INTEREST: CAN AUSTRALIA LEARN FROM INTERNATIONAL EXPERIENCE ON THE SUBJECT?

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I. INTRODUCTION

The purpose of this article is to analyse and compare the laws governing the deductibility of interest in a number of developed countries, namely the United Kingdom, the United States, New Zealand and Canada in the hope that Australia may learn from international experience on the subject. Taxation policy arguments for either restricting or denying a deduction for interest expenditure are also reviewed. Finally, legislation for Australia on interest deductibility is suggested.

II. ANALYSIS OF LAWS GOVERNING THE DEDUCTIBILITY OF INTEREST

A. The United Kingdom

In the United Kingdom, the laws relating to interest deductibility are contained in the *Income and Corporation Taxes Act 1988*. This Act contains detailed legislation regarding interest relief for both individual and business taxpayers. Income tax relief for interest is available to individual taxpayers under Section 353(1) when the interest is:

- annual interest chargeable to tax under Case III of Schedule D; or
- interest payable in the United Kingdom or Republic of Ireland on an advance from a bank, member of a stock exchange or discount house carrying on a bona fide business in the United Kingdom or Republic of Ireland.

Notwithstanding the above, in general interest paid on money borrowed to fund personal expenditure is not tax deductible. However relief is available for interest falling under the following categories:

- loans to purchase machinery or plant (Section 359);
- loans to acquire an interest in a close company (Section 360);
- loans to acquire an interest in a cooperative (Section 361);
- loans to invest in an employee-controlled company (Section 361);
- loans to acquire an interest in a partnership (Section 362);
- loans to pay inheritance tax (Section 364); and
- loans to purchase a life annuity (Section 365).

In order to obtain interest relief, taxpayers must first make claims.[1] The interest expenditure is then deducted or set off against income for the year in which the interest is paid. Relief under Section 353 is not available for interest paid on overdraft or credit card arrangements. Where interest paid by a taxpayer is at a rate which exceeds a reasonable commercial rate of interest, the excess is ineligible for relief.[2]

Interest relief is also available under Section 353 for individual taxpayers who take out loans to acquire land and buildings (including certain caravans and houseboats). This relief is subject to numerous conditions and restrictions which are set out in Sections 354 to 358. Usually, relief is applicable where land and buildings are let commercially or where land and buildings are the only or main residence of the borrower. In relation to the second type of loan, viz. loans to acquire an individual's residence, relief is normally given through the MIRAS (mortgage interest relief at source) system. To qualify for relief, the borrowed money must have been applied to:

- purchase land or buildings (including certain caravans and houseboats);
- improve or develop land or buildings (on borrowings taken out before 6 April 1988); or
- pay off another loan in respect of which interest was eligible for relief.[3]

It should be noted that over recent years MIRAS relief has become severely restricted.[4]

Income tax relief for interest is less restricted for business taxpayers. Ordinarily, for expenditure to be deductible for business taxpayers, it must be wholly and exclusively laid out or expended for the purposes of the trade, profession or

1. Secs. 353(1) and 366(1).
2. Sec. 353(3)(a) and (b).
3. Sec. 354(1).
4. Only interest paid on the first GBP 30,000 of borrowings qualifies for tax relief and relief is now only given at the rate of 15% on the gross interest.

vocation.[5] Yearly interest is allowed specifically as a deduction.[6] Thus, interest paid by business taxpayers is generally deductible as a business expense whether it be incurred on a long-term[7] or short-term basis. This means that relief is available for interest on bank overdrafts and on other temporary financial facilities, as well as on long-term loans which provide capital assets for the business. It is not necessary for a loan to fall within one of the categories in respect of which an individual taxpayer is permitted to deduct interest from total income, although, interest which receives relief under these specific provisions cannot also be deducted in determining business profits. To do so would give double relief.[8]

In conclusion, the UK legislation governing the deductibility of interest is complicated for individual taxpayers. No direct reference is made in the legislation on how interest is to be allocated or traced to the specific categories of deductibility. This shortcoming means that the legislation on interest deductibility is incomplete and open to abuse. In certain circumstances individual taxpayers can arrange their financial affairs in ways to maximize interest deductions.

B. The United States

In the United States, the *Tax Reform Act of 1986* placed major restrictions on the deductibility of interest payments for both corporate and non-corporate taxpayers. As a result, the US Internal Revenue Code classifies interest into five categories for non-corporate taxpayers:

- qualified residence interest;
- trade or business interest;
- investment interest;
- interest attributable to a passive activity; and
- personal interest (all other interest).[9]

Depending upon the classification of the interest, a taxpayer may be subject to various restrictions. If interest falls within the first category, it obtains the most favourable taxation treatment, and so on down the list. No deduction is available where the interest falls within the fifth category. Therefore, the criteria used for classifying (or allocating) interest into the five different categories is critical. The Internal Revenue Service (IRS) has issued temporary regulations which impose rules for the allocation of debt. The allocation of debt, in turn, determines the tax treatment of the related interest. The general rule is that debt is allocated by tracing disbursements of the debt proceeds to specific expenditures[10] and is not affected by the nature of the property used to secure the debt.[11] Normally, the temporary regulations allocate debt and the interest related thereto between five classes of expenditure:

- trade or business expenditure;
- investment expenditure;[12]
- passive activity expenditure;
- portfolio expenditure;[12] and
- personal expenditure.

Once a debt is allocated to one of these expenditures, it will remain so until the debt is repaid or is re-allocated.[13] An exception to the tracing rules applies to "qualified residence interest". If interest comprises qualified residence interest under IRC Section 163(h), it is deductible without regard to the tracing rules.[14]

The major limitations imposed on the deductibility of interest by the *Tax Reform Act of 1986* generally do not apply to corporate taxpayers.[15] Where corporate taxpayers incur an interest expense in a trade or business, that interest is deductible from the gross income derived. However, corporations are subject to legislation which either prohibits or limits the deductibility of interest in certain situations such as earnings stripping payments, debt financed portfolio shares, commodity straddles and the purchase of certain other securities. Since the 1986 legislation was enacted, many tax commentators[16] have protested about the enormous complexity of it and in particular the tracing regulations which apply to non-corporate taxpayers. Apart from the complexity of the legislation, many taxpayers would find the interest allocation requirements difficult to satisfy in practice unless they established separate bank accounts for each debt and limited expenditure from those accounts to one category of expenditure.[17]

The distinctions which the legislation makes among categories of interest and the temporary regulations mechanical tracing approach, invites manipulation and uneconomic behaviour.[18] The fungible nature of money encourages taxpayers who carry on a business to make business and investment expenditures with borrowed funds and personal expenditures with other funds. Moreover, the rules encourage taxpayers to complicate even the most common transactions to maximize interest deductions.

Even if one agrees with applying the mechanistic tracing rules, in practice those rules are arbitrary and incomplete. They do not apply, for example, to qualified residence interest as such interest is deductible without resort to these rules. Moreover, the rules do not apply to corporate taxpayers.

5. Sec. 74(a).
6. Sec. 74(m).
7. That is yearly interest.
8. Sec. 368(4).
9. Sec. 163(h)(2). The Code also provides for a sixth category, viz. interest imposed for the late payment of particular estate taxes (Sec. 163(h)(2)(E)). This category is not considered in this article.
10. Temp. Reg. Sec. 1.173-8T(a)(3).
11. Temp. Reg. Sec. 1.163-8T(c)(1).
12. Investment expenditure and portfolio expenditure are both subject to "investment interest" limitations.
13. Temp. Reg. Sec. 1.163-8T(c)(2)(i).
14. Temp. Reg. Sec. 1.163-8T(m)(3).
15. An exception to this conclusion relates to "closely held corporations". That is a corporation in which five or fewer persons, directly or through attribution, own at least fifty per cent of the shares (Secs. 465(a)(1)(B), 469(j)(1) and 542(a)(2)). In this case, the rules relating to passive activity interest and portfolio interest are applicable, but not the investment or personal interest rules (Secs. 469(e)(2), 163(d)(1), 163(h)(1)).
16. See for example, M.J. Grace, "Proposals to Simplify Interest Deductions: An Admission Against Interest and Some Recommendations", *Taxes – The Tax Magazine* (October 1990) at 743-745; C.D. Block, "The Trouble With Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986", *University of Florida Law Review* (Fall 1988) at 692 & 739; and D.M. Weiner, "Allocation of Interest Expense", *Major Tax Planning* (1988), Chap. 8 at 8.66.
17. Grace, *supra* note 16, at 743.
18. Id.

Despite the detailed legislative approach the United States follows in order to prevent abuses caused by allowing a general deduction for interest, in practice it appears that the approach may not be entirely workable. In fact, it has been suggested that there is even a temptation to repeal the new provisions.[19] Of course, whether such a complex approach is necessary is a matter of opinion. Two congressional tax-writing staffs; the Staff of the Joint Committee on Taxation and the Majority Tax Staff of the Committee on Ways and Means, have formally recommended simplifying the interest deduction and allocation rules for non-business interest.[20]

The Joint Committee on Taxation has suggested three alternative methods for simplifying the deduction for non-business interest expenditure:

- only permit individuals to deduct a specified percentage of all non-business interest paid or incurred in a taxable year. For the purposes of this proposal, "non-business interest" includes personal interest, qualified residence interest and investment interest as defined under the present law;
- as for the first alternative, except that instead of being limited to a percentage, non-business interest would be limited to net investment income for the year plus an additional dollar amount that the proposal does not specify; or
- permit individuals to deduct non-business interest other than qualified residence interest up to the individual's net investment income for the year. Under this option, non-business interest would encompass only personal interest and investment interest. Qualified residence interest would be dealt with separately and presumably would be deductible to the extent to which the current law provides. Disallowed non-business interest would be carried forward and subjected to the same rules and limitations in the next taxable year.

The Ways and Means Majority proposal dealt with the qualified residence interest rules and the interest allocation regulations. The committee proposed to:

- codify the various interpretations of the qualified residence interest rules issued by the IRS, while the rules for repayment of certain loans would be explained; and
- revise the regulations relating to the allocation rules.[21]

To date, Congress has not implemented any of the Joint Committee on Taxation recommendations nor those of the Committee on Ways and Means. Despite this, it is clear that the immensely complex legislation and tracing rules have the unpleasant result of increasing compliance burdens (including costs) on non-corporate taxpayers as well as encouraging manipulation and uneconomic behaviour.

C. New Zealand

In New Zealand, laws pertaining to the deductibility of interest are contained in Section 106(1)(h) of the *Income Tax Act of 1976*. This provision sets down three discrete tests. In general terms, it provides that a deduction is not allowed for interest except in so far as the Commissioner is satisfied that interest is payable:

- in gaining or producing assessable income for any income year (Section 106(1)(h)(i)); or
- in carrying on a business for the purpose of gaining or producing assessable income for any income year (Section 106(1)(h)(ia)); or
- by one company included in a group of companies in respect of money borrowed to acquire shares in a group company (Section 106(1)(h)(ii)).

The Section was amended in 1987[22] to align it with Section 104,[23] the general deduction provision, so that any deemed interest under the accrual rules could satisfy the fundamental test of deductibility. In particular, this amendment encompassed deemed interest from financial arrangements (e.g. interest rate swaps) where there was no underlying principal amount. Formerly, Section 106(1)(h) provided that interest could be deducted only if it was "payable on capital employed in the production of the assessable income". Presumably this language was carried over from earlier legislation on the deductibility of interest and therefore employed a "tracing" approach[24] in order to determine whether interest was deductible. The amendment to Section 106(1)(h) was not intended to change the existing law, but rather to expand it to include interest payable from financial arrangements.[25]

On 3 November 1992, the Valabh Committee handed down its final recommendations concerning the taxation of income from capital.[26] Included in its report were certain recommendations on the deductibility of interest.[27] The committee suggested that Section 106(1)(h) should be replaced by a provision which makes it clear that all interest is deductible for resident taxpayers except to the extent that it is of a private or domestic nature. The committee noted that this recommenda-

19. Weiner, *supra* note 16, at 805.
20. Grace, *supra* note 16, at 737.
21. It was argued that the revised regulations would provide a simplified method under which taxpayers would allocate interest based on the predominant nature of expenditures made from a bank account rather than on a precise day-to-day basis. Besides, appropriate anti-abuse rules would be developed to guard against particular transactions designed to artificially increase the amount of deductible interest.
22. *The Income Tax Amendment Act (No. 2) 1987* enacted the current form of Sec. 106(1)(h) which had effect from the income year commencing 1 April 1987.
23. This Sec. provides that:
"In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it -
(a) is incurred in gaining or producing the assessable income of any year; or
(b) is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year – may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred".
24. See for e.g. *Pacific Rendezvous Ltd. v. C of IR (1986) 8 NZTC 5146*; *Eggers v. C of IR (1988) 10 NZTC 5153*; and *C of IR v. Brierley (1990) 12 NZTC 7184*.
25. New Zealand Inland Revenue Department, "Interest Deductibility", *Tax Information Bulletin*, Vol. 3, No. 9, (June 1992) at 15 and Appendix B.
26. The New Zealand Government, Valabh Committee: *"Final Report of the Consultative Committee on the Taxation of Income From Capital"*, (Wellington: Government Printer, October 1992).
27. Id. Chap. 7 at 60-67.

tion would codify to a large extent existing law, involve minimal revenue loss, and would avoid relitigation of well settled case law. The committee also considered that interest incurred by a non-resident branch of a business in New Zealand should only be deductible if the interest had a strong connection with the derivation of New Zealand source income. To date, the New Zealand Government is still contemplating the Committee's proposals on interest deductibility, with a decision probably some way off.[28]

D. Canada

The Canadian laws relating to the deductibility of interest are set out in the *Income Tax Act, R.S.C. 1985 (5th Supp.)*. Specifically, Section 20(1)(c) of the Act allows a taxpayer to deduct interest in four circumstances:

- on borrowed money used for the purpose of earning income from a business or property;
- on an amount borrowed to acquire property for the purpose of gaining or producing income from the property or from business;
- on amounts paid to a taxpayer under an *Appropriation Act* for the purpose of advancing or sustaining scientific research and development in the manufacturing industry, or for prospecting, drilling, and exploring for minerals; and
- on money used to acquire an interest in certain annuities.

The fundamental test utilized by the courts in determining whether or not borrowed funds are used for the purpose of gaining or producing income from business or property, relies on "tracing" the borrowed funds. The taxpayer must demonstrate that the borrowed funds have been used for a qualifying purpose by physically tracing the use of the funds.

An exception to the "tracing" test surfaced in the Supreme Court of Canada case of *Trans-Prairie Pipelines Ltd. v. MNR.*[29] In this case, the court held that interest was deductible on borrowed funds used to replace capital previously contributed by shareholders (so that the total capital employed by the corporation was not diminished) even though application of the "tracing" test to such an arrangement would prove otherwise. Revenue Canada's administrative practices sanctioned this exception.[30]

Considerable attention has focused on the issue of the deductibility of interest following the Supreme Court decision in *The Queen v. Bronfman Trust*.[31] The court's reasoning in this case was devastating for business taxpayers: the *Trans-Prairie Pipelines* exception to the general tracing rule for the deductibility of interest, and the administrative practices of Revenue Canada based upon that exception, could no longer be relied upon.

Revenue Canada's reaction to the *Bronfman Trust* decision was prompt. To comply with the Supreme Court's decision, it announced that Interpretation Bulletin IT-80, dealing with the deductibility of interest on money borrowed to redeem shares or pay dividends was withdrawn. Additionally, the Canadian Department of Finance introduced a "notice of ways and means motion".[32] This notice was intended to preserve Revenue Canada's administrative practices as they existed before the *Bronfman Trust* decision, pending an extensive review of the deductibility of interest. The notice was continued on three occasions so that Revenue Canada's administrative practices remained in force for borrowings up to the end of 1991.[33] Then, on 20 December 1991 the Minister of Finance introduced draft legislation.[34]

The draft legislation considers four situations in which the deductibility of interest in relation to Revenue Canada's administrative practices had been called into question as a direct result of the Supreme Court decision in the *Bronfman Trust* case. They are:

- amendments to paragraph 20(1)(c) with respect to certain interest-free loans to shareholders and employees;
- the addition of new paragraph 20(1)(qq) dealing with interest on money borrowed which is used to acquire fixed-dividend shares;
- the addition of new Section 20.1 dealing with interest on money borrowed by a corporation or partnership to make a distribution; and
- the addition of new sub-Section's 20(3.1) and 20(3.2) which consider interest on borrowed money used by shareholders and partners to fund corporations and partnerships.

The draft legislation confirmed that the Canadian government had rejected the "tracing" test as the only criterion for ascertaining the deductibility of interest. The legislation demonstrates that while the general test of interest deductibility based on directly tracing borrowed funds has been retained, so have the exceptions for those cases that were conceded as exceptions by Revenue Canada on an administrative basis before the Supreme Court handed down its decision in the *Bronfman Trust* case. Some tax commentators[35] questioned the need for such legislation since, for the most part, it simply restored the status quo which existed prior to the Supreme Court decision. Taxpayers, Revenue Canada and the Department of Finance were all reasonably content with the situation before this case. The general provision relating to the deductibility of interest and Revenue Canada's administrative practices worked. An advantage of the legislation is that it does provide legislative authorization for Rev-

28. Valabh Committee, *supra* note 26, accompanying statement by the Minister of Finance (Ruth Richardson) and the Minister of Revenue (Wyatt Creech), at 5, para. 20.
29. *70 DTC 6351*.
30. See for example, *Interpretation Bulletin IT-80*, "Interest on Money Borrowed to Redeem Shares, or to Pay Dividends", 27 November 1972.
31. *87 DTC 5059*.
32. B.J. Arnold, and T. Edgar, "The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis", *Canadian Tax Journal* (1992) at 271, citing *"Notice of Ways and Means Motion to Amend the Income Tax Act"*, Canada, Department of Finance, 2 June 1987.
33. Id. citing, Canada, Department of Finance, *"Notice of Ways and Means Motion to Amend the Income Tax Act"*, 29 September 1988; *"Notice of Ways and Means Motion to Amend the Income Tax Act"*, 24 November 1989; *Notice of Ways and Means Motion to Amend the Income Tax Act"*, 20 December 1990.
34. B.J. Arnold, "Is Interest a Capital Expense?", *Canadian Tax Journal*, (1992) at 539, citing, Canada, Department of Finance, *Release No. 91-141*, 20 December 1991.
35. See for e.g. Arnold, *supra* note 32, at 303.

enue Canada's long standing administrative practices and explains some facets of those practices. Whether the draft legislation, once it is enacted, is able to restore the status quo remains to be seen.[36]

III. COMPARISON OF THE LAWS GOVERNING THE DEDUCTIBILITY OF INTEREST

A summary of the laws concerning the deductibility of interest for the United Kingdom, United States, New Zealand and Canada is provided in Table 1. In addition, Australia is included in the comparison.

TABLE 1

Comparison of Laws concerning the Deductibility of Interest

Country	Provisions Dealing with the Deductibility of Interest		Tracing Test Directly Applied
	General Provision	Specific Provisions	
Australia	No	No	Yes
The United Kingdom	Yes	Yes	No
The United States	Yes	Yes	Yes
New Zealand	Yes	No	Yes
Canada	Yes	Pending	Yes

Of the countries considered in this article, Australia is the only country which does not have taxation legislation which considers the deductibility of interest. Rather, deductibility is determined according to general principles under Section 51(1) of the *Income Tax Assessment Act (1936)*.[37] This is at odds with the other nations who have, at the very least, a general provision covering the deductibility of interest.

Notwithstanding the situation in Australia, it seems that the deductibility of interest has been a contentious issue in the United States, New Zealand and Canada for some time and needs modification.

IV. INTERNATIONAL ASPECTS

The 48th annual congress of the International Fiscal Association (IFA), held in Toronto Canada from 28 August to 2 September 1994 recognized this need and made certain recommendations concerning the deductibility of interest in an international context. The recommendations of significance to this article include:[38]

- 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 the interest expense on debt used to produce exempt foreign-source income as fully deductible against domestic-source income has the effect of providing a financial incentive to encourage residents to invest abroad;
- where a country decides to limit interest deductibility, it may use either a tracing method or an allocation method to determine the quantum of interest to be deductible against domestic and foreign-source income respectively;
- for countries using a foreign tax credit system, a timing problem may arise if interest is deductible currently while the 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 subsidiary until the time of the imposition of withholding tax; and
- 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.

The third listed recommendation made by IFA is of concern for a number of reasons. Firstly, much disquiet has been raised by tax commentators in the United States with the application of such a tracing (or allocation) approach. Secondly, there are both conceptual and practical difficulties associated with tracing borrowed money to particular assets or uses. Thirdly, many countries[39] have already unsuccessfully employed such a tracing approach as part of their taxation legislation so that any further attempts are perhaps likely to be equally unsuccessful.

Conceptually, the tracing test assumes that certain assets and liabilities can be paired. Logically, however, assets and liabilities are viewed holistically. There is no economic or accounting significance for pairing particular assets and liabilities. This reasoning is supported when one considers the

36. Per the C.C.H., *1995 Canadian Master Tax Guide*, (Don Mills: CCH Canadian Limited, 1995), at viii; the draft legislation has remained unchanged and as yet, has not been enacted.

37. That is, for interest to be deductible in Australia, it must be either:
– incurred in gaining or producing the assessable income (the first limb of Sec. 51(1); or
– necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income (the second limb of Sec. 51(1).
However, even if interest expenditure does fall within either or both of the two limbs, it will be disallowed to the extent to which it is capital or of a capital, private or domestic nature or incurred in relation to the gaining or production of exempt income.

38. These recommendations were reported in the current notes of the *British Tax Review* (1994), at 549-551.

39. For e.g. see Table 1 above.

case of a large business with a range of assets and liabilities. On many occasions, borrowings are procured for general purposes rather than to fund specific assets or activities, while liabilities are constantly managed to minimize funding costs. On other occasions, large businesses may well raise specific finance to fund particular assets, although the ability of a business to raise debt is usually constrained by its ability to fulfil the financial criteria demanded by lenders of that debt. In turn, this depends upon the aggregate level of business debt and equity funding. For any particular asset, as long as the general lending criteria are satisfied, debt and equity funding are substitutable. If some assets are debt funded, then other assets may be equity funded. Thus, while in some circumstances it may be possible to trace a specific loan to a particular asset, there is little economic or even accounting significance in such pairing. In the context of small businesses with few assets, the fungibility of debt and equity may not apply to the same degree. Nevertheless, like a large business, a small business can only borrow money to fund a particular asset if it has a satisfactory credit rating. This in turn again normally depends on its existing debt / asset ratio. Hence the above comments pertaining to large businesses also generally apply to smaller businesses.

The tracing rules ignore the basic principle of the fungibility of money,[40] any attempt made by the legislature to deny deductions for interest can result in taxpayers engaging in manipulative behaviour to gain an interest deduction. For instance, where a deduction for interest is denied in a particular situation, a taxpayer may liquidate business or investment assets, use the proceeds from the sales for the otherwise non-deductible interest expense, then instantly use borrowed funds to finance assets which qualify for a full interest deduction. Only taxpayers who either fail to or cannot make these changes to their affairs because of lack of liquidity would be immediately affected by a tracing approach. Special anti-abuse rules might attack such manipulative behaviour.[41] However, these rules would have to be able to distinguish between abusive and non-abusive tax behaviour. This is likely to prove difficult in practice as is the administration of such rules. Furthermore, including special anti-abuse rules in the legislation to close the loophole may unnecessarily increase the complexity of the legislation.

Apart from tracing borrowed money, other methods have been suggested to limit or restrict the deduction for interest. A pro rata allocation[42] of interest to all assets held by a taxpayer as a means of avoiding the manipulative behaviour of taxpayers fitting borrowings within deductible as opposed to non-deductible categories does offer some conceptual appeal. This method recognizes that interest is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Nevertheless, this method has its share of problems. Firstly, there is no satisfactory theoretical (or practical) apportionment base. Apportionment based on fair market value requires burdensome and otherwise unnecessary annual valuations of assets. Secondly, the pro rata allocation of interest requires taxpayers to report either the basis or fair market value of all assets. Taxpayers may not identify all assets, especially those located offshore. Thirdly, unless some interest is allocated to non-capital expenditures such as current business expenses, distortions may occur and fourthly, a pro rata allocation method may distort certain economic decisions by ignoring the fact that such decisions are made by comparing the marginal cost of borrowing, the marginal return from an expenditure, and the opportunity costs of liquidating other assets in order to make the expenditure out of the sums so produced.[43]

Another suggested method[44] is that interest be allocated to the assets securing the debt. While this approach may mitigate some of the complexities of tracing, it suffers from its own inherent problems. Firstly, the method categorically ignores the issue of the requirement of a "nexus" between interest expenditure and assessable income for interest to be considered deductible. The collateral allocation approach was unanimously rejected by the High Court of Australia in *Munro v. FC of T*[45] Secondly, this approach would not operate in relation to unsecured debt. Other rules would have to be developed for such debt. Thirdly, several assets may secure a particular debt. The taxpayer would have the added complexity of allocating the debt amongst those assets. Fourthly, and perhaps more importantly, taxpayers may choose the particular collateral to secure certain loans thus manipulation of the rules is possible.

Finally, the method referred to in the tax literature as "matching",[46] is worthy of some consideration. This method is based on the accounting matching concept.[47] It operates, by specifying that interest payments are to be deductible only upon the taxation of the income associated with those payments. Thus, interest paid to earn tax-exempt income would not be deductible, while the deduction for interest paid to earn tax-deferred income would be postponed until the income became assessable. Matching is a unique concept devised to deal with perceived imperfections in the gross income rules of an income tax system. Defenders of "matching" believe that an interest payment is an inherently deductible expense in an ideal tax system. However, in an imperfect system in which some classes of gross income are not taxed, they argue that in certain cases a deduction for interest should only be given if it can be matched with taxable income. Matching does suggest a method of resolving certain timing issues in relation to tax on realized income, however, it suffers from a fundamental operational weakness in that it accepts that spe-

40. Block, *supra* note 16, at 740.
41. Id.
42. Id. at 740-741.
43. It can also be argued that such an approach could not cope with graduations between assets subject to full taxation of Haig-Simons income vis-à-vis those assets which produce income which is fully exempt.
44. See for e.g. Block, *supra* note 16, at 733-734.
45. *(1926) 38 CLR 153.*
46. See for e.g. M.J. McIntyre, "Tracing Rules and the Deduction For Interest Payments: A Justification For Tracing and a Critique of Recent US Tracing Rules", *The Wayne Law Review* (Fall 1992), at 83.
47. Defined in the *CCH Macquarie Dictionary of Business* (Sydney: CCH Australia Limited, 1993) at 357 as: "the offsetting of expenses incurred in earning particular revenues against those revenues in the appropriate accounting periods, so that relevant income and expenditure is matched. The matching concept is an essential part of accrual accounting".

cific interest payments can be linked with specific items of income without suggesting any advice on how to establish that linkage.[48]

V. THE NEED FOR LEGISLATION

Clearly legislation in one form or another on the deductibility of interest represents an important element of any country's taxation laws. McIntyre argues that "in the long run, a country that does not impose appropriate limitations on the interest deduction fails in its attempt to establish an effective tax system".[49] Likewise, Jenkins claims that "it is far less clear, however, that the question of interest deductibility can ever be resolved in a completely satisfactory manner by the courts ... ultimately, the only possibility for long-term resolution of the problems associated with the deductibility of interest for non-businesses may be for the legislature to take the lead, perhaps through prescription of a detailed statement of principles or the provision of a formula or formulae".[50] One might ask the question then, where do these assertions leave Australia on the issue of the deductibility of interest?

Presently, there appear to be two alternatives open to the Australian Government for establishing legislation governing the deductibility of interest. Firstly, it could provide a general provision for the deductibility of interest within its Income Tax Act. Such an approach is consistent with what has occurred in Canada[51] and New Zealand and appears to have worked in practice. Secondly, the Government could render detailed legislation, either restricting or denying the deductibility of interest in certain situations. In the United States such an approach has been widely criticized on the grounds of legislative complexity and the inherent problems of compliance, manipulation and uneconomic behaviour. Implementation of either alternative would depend upon taxation policy arguments which are considered in the following section.

VI. ANALYSIS OF TAXATION POLICY ARGUMENTS ON THE DEDUCTIBILITY OF INTEREST

At the forefront of any discussion regarding the taxation policy arguments[52] for either restricting or denying a deduction for interest where borrowed money is not utilized to derive assessable income, is whether such a notion is compatible with the conceptual basis of income tax. Many commentators[53] in the taxation policy literature generally identify the Haig-Simons[54] accretion model, ignoring compliance and administrative constraints, as the ideal tax base to which an equitable income tax system should aspire. Simons defines income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question".[55] Simons' definition is, from time to time, quoted along with one promoted by Haig: "income is the money-value of the net accretion to economic power between two points of time".[56]

Interest receipts represent growth in the value of property rights and are thus included as part of the second component of the Simons definition. As for interest payments, it is important to note that even under the Haig-Simons income accretion model, taxes are intended to be based on net income as opposed to gross receipts. Thus, costs of earning income must be subtracted to arrive at a proper measure of income. Furthermore, it can be shown in a general mathematical proof that notwithstanding the purpose of a borrowing, interest expenditure should be deducted in calculating Haig-Simons income.[57] Therefore, restrictions on the deductibility of interest must be supported on other grounds.

An argument that is typically raised for denying a deduction for interest is that non-deductibility compensates for the non-taxation of some forms of income. Where an activity or an asset produces non-taxed income or capital gains, taxpayers will be encouraged to engage or invest in that activity or

48. McIntyre, *supra* note 46, at 85.
49. Id. at 119.
50. P. Jenkins, "Brierley: A Fresh View", *CCH New Zealand Tax Planning Report* (May 1992), at 14.
51. This was the status quo in Canada before the Supreme Court of Canada handed down its decision in *The Queen v. Bronfman Trust 87 DTC 5059.*
52. The ensuing review of the taxation policy arguments for either restricting or denying a deduction for interest expenditure draws heavily on The New Zealand Government, Valabh Committee: *"Final Report of the Consultative Committee on the Taxation of Income From Capital"*, (Wellington: Government Printer, October 1992), Chap. 7 at 60-67.
53. See for example, M.J. McIntyre, "An Inquiry Into the Special Status of Interest Payments", *Duke Law Journal* (1981), at 768; McIntyre, *supra* note 46, at 70; Block, *supra* note 16, at 693-694; and C.O. Galvin,"The Deduction of Non-business Interest: An Exercise in Planned Confusion", *Tax Lawyer* (1988) at, 803.
54. See for e.g. R.M Haig, *The Concept of Income – Economic and Legal Aspects* reprinted in R.A. Musgrave and C.S Shoup (editors), *Readings in the Economics of Taxation* (London: George Allen & Unwin Ltd., 1959; and H.C Simons, *Personal Income Taxation The Definition of Income as a Problem of Fiscal Policy*, Third Impression, (First published in 1938), (Chicago Illinois: The University of Chicago Press, 1955).
55. Simons, *supra* note 54, at 50.
56. Haig, *supra* note 54 at 75.
57. For example, assume that a taxpayer's only wealth is the right to a payment of AUD 12,100 in two years time and that the market rate of interest prevailing during this period is 10% per annum. Taking into account the time value of money, the payment is worth AUD 10,000 at the beginning of year one and AUD 11,000 at the end of that year. If the taxpayer chooses to save the AUD 10,000 at the beginning of year one and decides to consume AUD 1000, he would have to borrow that sum at the beginning of year one at the prevailing interest rate of 10%. Assuming that actual consumption during year one is AUD 1000, the taxpayer's Haig-Simons income in that year is AUD 1000 plus the change in the taxpayer's wealth.

Wealth at the beginning of year one was AUD 10,000. At the end of the year it is the value of the asset of AUD 11,000 less the value of the debt outstanding (that is, principal of AUD 1000 plus interest of AUD 100), giving wealth of AUD 9900. Hence, the change in wealth over the year is AUD –100. Haig-Simons income in year one is therefore consumption of AUD 1000 less the change in wealth of AUD 100, giving income of AUD 900.

Contemplate now how income for tax purposes needs to be defined to get the same result. The taxpayer's only source of income is the income accruing on his savings. In year one, this is AUD 1000. To match the taxpayer's Haig-Simons income of AUD 900, a deduction has to be allowed for the taxpayer's interest expense of AUD 100, producing taxable income of AUD 900. Thus, the example symbolizes the general conclusion that the deduction of interest expense is fully consistent with the Haig-Simons definition of income, irrespective of the purpose of the associated borrowing.

asset. This action can reduce economic welfare by drawing investment into the tax-preferred area at the expense of investment in other activities which may yield a higher return to society. Hence, a basic objective of tax policy is to ensure that all forms of activity or investment are taxed in a neutral manner.

The most direct approach in following a neutrality objective is to remove the tax preferences available to taxpayers generally. If, this is not possible, economic welfare may be enhanced by denying claims for interest incurred on borrowed money used to invest in a tax preference on the grounds that this action would reduce the extent of over-investment in the asset. This approach is labelled a "second-best" policy since it is clearly inferior to the first-best policy of removing the tax preference. It is inferior because the approach targets only debt-funded investment, leaving equity investors unaffected. The second-best argument also has other drawbacks which are now considered.

The second-best policy of denying deductions for interest can be examined from a number of different angles. For example, whether it is internally consistent with a country's taxation legislation. If a tax preference is a deliberate act of Government policy, any attempt to deny interest deductions to taxpayers that borrow money to invest in a preference, can be seen as an act which is against the spirit of that policy. In Australia, an example is provided in relation to a number of incentives for capital expenditure incurred in producing an Australian film or by way of contribution by an investor to the cost of producing an Australian film.[58] For film expenditure incurred under contracts entered into on or after 25 May 1988, a 100% deduction is allowed in the year in which the expenditure is incurred.[59] Partly as a result of this taxation policy initiative, the income tax base applying to Australian films is far removed from Haig-Simons income concepts.

If the second-best argument was applied to the incentives provided by the Australian Government for expenditure incurred on Australian films, deductibility of interest on money borrowed to finance the film investment would be restricted. Such logic would be inconsistent with the Government's taxation policy, ostensibly underpinning the Australian film regime, to encourage investment in this industry.

Other examples of the Australian Government providing certain tax preferences to taxpayers, as a matter of policy, are in place in the *Income Tax Assessment Act (1936)*. Firstly, taxpayers in the mining industry obtain specific deductions in relation to certain expenditure of a capital nature incurred in mining activities.[60] Secondly, a number of concessions are granted to companies which incur expenditure on research and development activities.[61] Again, it would be inconsistent as a matter of Government policy to attempt to deny deductions for interest incurred on moneys borrowed to undertake "favoured" activities.

The three examples considered above illustrate that if exploitation of a tax preference is unacceptable as a matter of government policy, it must be unacceptable taken alone, not simply because taxpayers care to borrow money to invest in the tax preference.

In practice, tax systems generally depart from the Haig-Simons definition of income in at least two respects.[62] Firstly, they allow for the postponement of gains derived from the appreciation of assets until the gains are realized. Secondly, they afford a special tax regime for foreign source income, either exempting that income, postponing tax on it until repatriation or reducing the tax otherwise imposed on it through the allowance of a foreign tax credit. Of course, there are many other instances where, by intention or otherwise, a country's income tax base may depart from the Haig-Simons income ideal. For example, where tax depreciation rates differ from true economic depreciation, a tax system will either over- or undertax the income generated by the depreciable assets relative to a Haig-Simons income tax. Similarly, since changes in the market value of trading stock are not required to be included in assessable income each year, a tax system does not fully tax, in a Haig-Simons sense, the income produced from trading stock. Finally, the exclusion from the tax base of capital gains realized from the sale of a taxpayer's principal place of residence, and the exemption of imputed income from home ownership represent further examples of departures from the Haig-Simons model.

The above examples infer that where an income tax regime fails to tax all gains on an accruals basis, provides a special tax regime for foreign source income, and/or fails to provide deductions for all losses on an accruals basis, that tax regime departs from the Haig-Simons definition of income. Given the myriad of other departures, to attempt to compensate for these defects in a tax system by restricting the deductibility of interest in certain situations, particularly when that interest is incurred on borrowed money used to acquire assets which

58. See Division 10BA, comprising Secs. 124ZAA-124ZAP of the *Income Tax Assessment Act (1936)*.
59. The rate of deduction is different for certain years before 25 May 1988. Namely:
- 150% deduction if expended under a contract entered into prior to 24 August 1983;
- 133% deduction if expended under a contract entered into between 24 August 1983 and 19 September 1985; or
- 120% deduction if expended under a contract entered into after 19 September 1985 and before 25 May 1988.

60. See Division 10, comprising Secs. 122-122U of the *Income Tax Assessment Act (1936)*. Some examples of allowable capital expenditure in carrying on prescribed mining operations include:
- expenditure in preparing a site for the carrying on of prescribed mining operations;
- expenditure on buildings, other improvements or plant necessary for the carrying on by the taxpayer of prescribed mining operations; and
- expenditure in providing, or contributing to the cost of providing, water, light or power for, access to, or communications with, the site on which the prescribed mining operations are carried on.

61. In particular, see Sec. 73B of the *Income Tax Assessment Act (1936)*. Some examples of the concessions granted to companies in respect of expenditure incurred on research and development activities include:
- 150% deduction for wages, salaries, other labour costs and expenditure incurred directly on research and development activities;
- 100% deduction for expenditure incurred in obtaining rights to pre-existing core technology;
- 50% deduction for three years for expenditure incurred on plant and equipment which is entirely attributable to research and development activities, including the cost of pilot plant in certain circumstances; and
- 33.5% deduction for three years for expenditure incurred on research and development buildings where construction started or was contracted before 21 November 1987.

62. McIntyre, *supra* note 46, at 74-75.

produce or are expected to produce assessable income and capital gains would be arbitrary. For example, from 17 July 1985 to 1 July 1987, the Australian Government reduced the tax preferences available to taxpayers who received both income and capital returns from rental property investments, by placing limitations on deductions for interest on money borrowed to finance the investments.[63] In essence, the legislation limited the deduction for interest to the net rental income of a property, after taking into account all other expenses except building depreciation, and any taxable gains on the disposition of relevant rental property. To the extent that the interest exceeded the current deduction allowed, the interest was quarantined until the net rental income was sufficient to absorb it. The quarantined interest could have been carried forward indefinitely to offset against future rental property income or taxable gains on the disposition of rental property.

Due to the subsequent lack of investment in the rental property market, the legislation was amended to remove the limitation from 1 July 1987.[64] Thus, it could be argued that the Australian Government, on policy grounds, would not again wish to restrict the deductibility of interest on negatively geared investment property notwithstanding the tax preference received. Moreover, with the introduction of the capital gains tax legislation in the Act from 19 September 1985, any net capital gain[65] obtained from an investment asset (apart from several exceptions) is subject to tax.

Another taxation policy argument regarding the deductibility of interest, where borrowed money is not employed in gaining or producing assessable income, is associated with interest incurred for private or domestic purposes. Personal assets typically differ from business assets in that the return which they generate is partly pecuniary and partly non-pecuniary. This is evident when one considers the return for personal assets such as owner-occupied housing. Such assets generate the equivalent of partly pecuniary returns in the form of rent that would otherwise have to be paid, and partly non-pecuniary returns in the form of personal enjoyment or satisfaction that the owner gains from the property. Since neither form of return is taxed in Australia, owner-occupied houses and other personal assets such as cars, and the like, accord important tax benefits on their owners.

Returns which are non-pecuniary in form cannot be reduced by other taxpayers' investment in housing. Rather, they are exclusively retained by the owner and are independent of the non-pecuniary returns savoured by other home owners. Thus, the equilibrating effect of investment in other tax-preferred assets does not apply to this element of the return. Refusing a deduction for interest incurred in acquiring personal assets is consequently more likely to be effective in constraining investment than in the case of business and investment assets. Nonetheless, it may not be fully effective for at least two reasons. Firstly, denying a deduction for interest would only slow the rate at which taxpayers invest in housing.[66] Secondly, due to the fungible character of money, home owners who, in addition, own business enterprises will inevitably assign as much of the borrowings as possible to their business assets. Thus, as was discussed above, a tracing rule designed to deny deductions for interest may not be effective as against taxpayers who own business assets or for that matter, investment assets.

Of greater consequence would be the impact on Government revenue if deductions were allowed for interest expenditure incurred for private or domestic purposes. Research in the United States[67] found that in 1984, itemized claims for home mortgage interest deductions totalled USD 102 billion and that this amount represented 65% of the total itemized claims for interest expenditure. While it should be acknowledged that Australia may not have the same fiscal weight as the United States, allowing a wholesale deduction for all interest expenditure incurred for private or domestic purposes would still be costly and could hardly be regarded as a Government priority. Despite the economic arguments, the very high cost involved in allowing interest to be deductible on private or domestic borrowings represents a major hurdle to overcome. Furthermore, given the culture of the *Income Tax Assessment Act* where since its inception in 1915, a general deduction for expenditure incurred for private and domestic purposes has been categorically dismissed, any attempts made to allow a deduction for interest expenditure incurred for private domestic purposes becomes even more unlikely as a matter of taxation policy. For these reasons, it appears that a deduction for interest expenditure incurred for private or domestic purposes is unlikely to be allowed.

VII. TOWARDS LEGISLATION IN AUSTRALIA

Based on the review of the taxation policy arguments, it is clear that in a domestic context the only major restriction which should be placed on the deductibility of interest lies in the area of interest incurred for private or domestic purposes. Therefore a general provision could be included within the *Income Tax Assessment Act (1936)* which provides for the deductibility of interest in all circumstances where there is a nexus between the interest incurred and the gaining or producing of assessable income, except to the extent that the interest incurred is of a private nature. The fact that such a general provision has worked in New Zealand and Canada adds credibility to this argument.

63. See Secs. 82KZC-82KZK of the *Income Tax Assessment Act (1936)*. It should be emphasized that the restrictions in place regarding the deductibility of interest under this legislation were confined to rental property investments. Apparently, the Australian Government saw no need to restrict the deduction of interest with respect to borrowings for other types of investments. Thus, it could be argued that the legislative restrictions were, in fact, arbitrary and discriminated between different forms of income-producing investments.
64. An alternative ground for the removal of this limitation is provided by C. Sandford, *Successful Tax Reform: Lessons From an Analysis of Tax Reform in Six Countries*, (Bath: Fiscal Publications, 1993), at 85-86. Sandford argues that the Federal Labour Government reversed its decision on negative gearing because of pressure applied by the N.S.W. State Labour Government who were facing an imminent election. The legislation was believed to have reduced investment in rented property in Sydney which led to higher rents.
65. The cost base of the asset is indexed for inflation.
66. This is because ultimately, they will reach their desired level of investment.
67. Galvin, *supra* note 53, at 824-825.

Also of relevance for present purposes is the effect of the Australian Federal Treasurer's August 1992 Budget Speech on the issue of interest deductibility. The Federal Government announced that it had decided to introduce a comprehensive system for the taxation of financial arrangements on an accrual basis. In December 1993, the Government followed up on its Budget Speech by issuing a consultative document entitled: "Taxation of Financial Arrangements".[68] The consultative document provides for an accruals tax system which spreads the gain or loss from a financial arrangement[69] over its term. Three accruals methods are cited by the Government in the document, namely, straight-line accrual, compounding accruals and market value accounting.[70] While the consultative document provides for a comprehensive accruals system for the taxation of financial arrangements, it neglects to address the vital issue of determining the assessability of gains and more importantly for this study, the deductibility of losses including interest. Frost[71] argues that "the Code should, ideally, deal with the revenue/capital distinction, otherwise it will not really be a "Code" as one would be left to hunt through a considerable body of case law to work out what is or is not assessable or deductible".[72] It remains to be seen whether the Federal Government acts on its alleged failure to consider this issue.

VIII. CONCLUSION

Regardless of the situation in Australia, it appears that the deductibility of interest has been a controversial issue in international tax law for sometime. This conclusion was reached after examining the laws governing the deductibility of interest in the United Kingdom, the United States, New Zealand and Canada and the recommendations made at the 48th annual congress of IFA. [73]

Other approaches have been advanced in the tax literature to either limit or restrict the deduction for interest. They include:

- a pro rata allocation of interest;
- allocation of interest to assets securing debt; and
- matching interest payments to interest receipts.

Unfortunately, these further approaches have their own inherent problems and weaknesses.

Of the countries examined in this study, Australia is the only country which does not have taxation legislation which considers the deductibility of interest. In contrast, the other countries analysed have, at the very least, a general provision governing the deductibility of interest. Indeed the United Kingdom and the United States have elected to further restrict the deductibility of interest and Canada has draft legislation pending.

From international experience, legislation in one form or another on the deductibility of interest represents an important element of any country's taxation laws. Australia should consider this experience in drafting its own laws. In this regard, two alternatives seem to be open to the Australian Government for establishing legislation:

- to provide a general provision for the deductibility of interest within the Act; or
- to render detailed legislation within the Act, either denying or restricting the deductibility of interest in particular situations.

Evaluating taxation policy arguments for either restricting or denying a deduction for interest expenditure involved consideration of:

- compatibility with the conceptual basis of income tax;
- second-best arguments such as policy consistency and arbitrariness; and
- interest incurred for private or domestic purposes.

The review concluded that the only major restriction which should be placed on the deductibility of interest relates to interest expenditure incurred on borrowings for private or domestic purposes. With this in mind, a general provision could be enacted within the *Income Tax Assessment Act (1936)* providing for the deductibility of interest in all circumstances where there is a nexus between interest incurred and the gaining or producing of assessable income, except to the extent to which expenditure is of a private nature.

Finally, the effect of both the Australian Federal Treasurer's August 1992 Budget Speech and the consultative document issued in December 1993[74] on the issue of interest deductibility were considered. While the consultative document provides for a comprehensive accrual system for the taxation of financial arrangements, it seems to overlook the fundamental issue of determining when gains are assessable and more importantly for this study, determining when losses including interest are deductible. It remains to be seen whether the Government acts on its failure to consider this issue. In any case, it is submitted that the work carried out in this article goes some way towards supplying a basis for determining the deductibility of interest expenditure incurred on borrowings.

68. The Australian Government, *Taxation of Financial Arrangements: A Consultative Document* (Canberra: The Australian Government Publishing Service, December 1993).
69. The financial arrangements considered by the Consultative Document to be part of the new accruals tax system are (at 19):
- debt transactions and transactions that are in substance debt;
- the debt component of hybrid transactions;
- debt derivatives, together with non-debt derivatives based on the value of a group of commodities or equities; and
- transactions comprising the right to receive or the obligation to pay an amount in foreign currency, and any physical holdings of foreign currency.

70. These methods are not considered in detail here.
71. A.J. Frost, "Taxation of Financial Transactions", *Taxation Institute of Australia, National Convention Papers* (May 1993).
72. Id. at 38.
73. It should be noted however that IFA's recommendation dealing with the employment of a tracing or allocation method to determine the interest deductible against domestic and foreign-source income is of concern, especially when one considers the conceptual and practical difficulties associated with tracing borrowed money to particular assets or uses.
74. See *supra* note 68.

UNITED STATES

THE STRUGGLE AGAINST INTERNATIONAL FISCAL FRAUD: TAX AVOIDANCE AND TAX EVASION

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This paper was presented at the CIAT Technical Conference, Paris, France on 8 November 1995 by **John T. Lyons**, who is Assistant Commissioner (International), Department of the Treasury, Internal Revenue Service, Washington D.C.

I. INTRODUCTION & GENERAL COMMENTS

Before I begin my presentation on this topic of great importance to International Tax Administrators, I would like to acquaint you with the Internal Revenue Service by providing you with certain key (1994) statistics.

- The IRS has approximately 105,000 employees; however, we are continuing a downsizing of operations and staffing.
- Of the total figure, almost 700 staff are specialists that examine returns with international features; these specialists are called International Examiners.
- Total revenue collections of USD 1,276,466,766.
- Total recommended taxes and penalties of USD 23,925,598 (attributable to enforcement efforts).
- Our large case examination programme (called Coordinated Examination Programme) has 1,800 corporate taxpayers; each of these taxpayers has assets exceeding USD 100 million.
- Of the 1,800 large case taxpayers, about 1,200 or 67 percent have full-time IRS audit presence.
- We have an estimated overall compliance rate of 87 percent; our goal is 90 percent by the year 2000.
- Translated into dollar terms, each 1 percent increase in compliance translates to USD 7-10 billion.

In accomplishing our work, we must contend with statute of limitations considerations which place time restrictions on our audit reach for a particular year. Our normal statute of limitations is three years; however, if there is a 25 percent or greater understatement of gross income, the statute of limitations is six years. In the case of fraud six years applies; if a return is not filed, there is no statute of limitations. With this overview in mind, I will proceed with discussions as to the importance of having effective compliance and enforcement activities in place to combat tax avoidance and evasion.

The issue of fiscal fraud is one of the core issues of tax administration and may be known by various names. In the United States, we consider fiscal fraud to be more in the nature of "tax avoidance", as distinguished from "tax planning".

In more egregious cases, we call it "tax evasion". By whatever name, activities of taxpayers to avoid their proper responsibilities to fiscal authorities are of serious concern – and unacceptable.

Tax avoidance and evasion are of serious concern for a variety of reasons. They have serious budgetary effects. They distort international competition and capital flows. They come in a variety of disguises, making identification and correction difficult at best. And, they are contrary to fiscal equity.

For example, a base company, located in a tax haven country, can be used to redirect income from a high tax to a low tax jurisdiction. This has an obvious detrimental effect on the revenue of the country whose tax base has been diminished. The inequity which results from the opportunity that some, but not other, taxpayers have of taking advantage of such a manoeuvre is also clear.

There is a distinction between legitimate tax planning and tax avoidance or evasion of the kind we are considering here. Fraud is commonly defined as deceit or trickery – the *intentional* perversion of truth in order to induce another to surrender something of value. The key to the distinction is "intent", the mental purpose behind a tax activity, structure or transaction. The need to determine intent is what makes this area of tax administration so particularly difficult. How can we really tell what someone intended?

In the United States, for example, in order to obtain a criminal conviction we must prove not only the act of tax evasion but also the intent to evade taxes beyond any reasonable doubt. The cost of successfully meeting that burden of proof places an excessive drain on our limited resources. The need to invest these resources is, however, obvious because if tax evasion is not contained and kept to a minimum, the public's confidence in the fairness of our system will erode which, in turn, would cause an erosion in overall compliance.

Regardless of whether a country's tax system is source or residence based, whether it is dependent upon a credit or an exemption method of relieving double taxation, tax avoidance is important. In either situation, domestic taxpayers with foreign-derived income are tempted to divert their profits to offshore locations, to at least *defer* the imposition of a tax liability. In many cases the diversion mechanisms are truly artificial, for example, through the use of offshore mutual funds or tax haven subsidiaries (e.g. base companies). An obvious means to reduce international profits is through conscious use of transfer pricing on transactions between associated or related companies.

Although measures against international fiscal fraud have traditionally been justified in purely fiscal terms, i.e. the need to stop loss of tax revenues to national treasuries, there are strong economic arguments to support governments' protective actions. In particular, to the extent that enterprises operating internationally succeed in avoiding tax in ways not generally available to other businesses, they may have a competitive advantage over enterprises operating entirely within one country.

The United States has been involved in efforts to combat fiscal fraud for decades. High points of this effort include the development of "Subpart F" legislation in 1962, the issuance of the "Gordon Report" in 1981, and the 1993 White Paper entitled "Tax Compliance in a Global Economy: Statement of Policy and Action Plan". As a general principle, the direction of US tax administration is to increasingly supplement its enforcement activities, which routinely bear a high cost-benefit ratio, with non-traditional activities in areas of education, particularly with respect to the responsibilities of taxpayer representatives, and to constantly improve and enhance opportunities in the area of information reporting.

The following discussion will cover the topic of international fiscal fraud in three sections. First, certain structural issues affecting international tax administration will be discussed. Then counteractive measures that revenue authorities may utilize in combating international fiscal fraud will be reviewed. Finally, the US view of the utility of various measures will be discussed.

II. STRUCTURAL DIFFICULTIES

Let me begin my discussion of "Structural Difficulties" with an overview. The challenges faced by a tax administration in any case – domestic or international – begin with obtaining sufficient information to conduct an effective examination.

Put another way, being given sufficient and accurate information regarding a particular transaction would greatly reduce the complexity and thus, the cost of conducting enforcement-related activities.

The lack and possible unavailability of sufficient and accurate transactional information is particularly troublesome in the international setting. Nowhere is this more evident than in examining and understanding transactions between domestic and foreign related entities.

Our Congress has recognized this challenge over the last ten years enacting a statutory regime designed to, for example, require record maintenance in the United States for certain transactions between related parties. Examples include:

- IRC 6038A
- IRC 6662(e)
- IRC 982

This having been said, the major structural incentive for taxpayers to undertake fraudulent international activity is the existence of the "tax haven". While there is international agreement that there is no single, clear, objective test which identifies a particular country as a tax haven, the concept is understood in practice. In general, a tax haven is a country which serves to minimize tax liabilities arising in connection with some cross-border business or investment transaction. The concept in practice is a relative one – that is, any country can be a tax haven in relation to other countries.

Moreover, the practical effect of a tax haven is not necessarily created by juridical devices that are purely fiscal in nature. For example, bank secrecy and other information inhibitions, such as bearer shares, can serve certain purposes in limiting tax compliance. Furthermore, these structures can lead to abuses outside the area of taxation. For example, the resulting anonymity produced by bank secrecy and bearer shares can, and frequently does, encourage money laundering and also hinders the war against the narcotics traffickers.

Certain countries have traditionally been considered tax havens. These "classical" tax havens may be regarded as jurisdictions actively making themselves available for the avoidance of tax which would otherwise be paid in relatively high tax countries. Ordinarily, the aim of the legislation of such a country (including its non-tax statutes) is to attract income from activities which are to be carried on outside the territory of the tax haven.

The question that arises in many cases involving use of a classical tax haven is what are the real income-producing activities in the countries concerned. The principal difficulties are with passive income and income from services. These difficulties are increasingly problematic for the United States as our economic base grows more dependent on the application of information and knowledge activities.

The use of tax havens as a vehicle for international tax avoidance and evasion has been a long-standing concern to the United States. As far back as the 1920s, and at regular intervals since, the US Congress has attempted to address tax haven fraud through legislation. The most comprehensive and focused attempt was through the Subpart F legislation in 1962, which was intended to limit the use of "base companies" as a means of sheltering offshore income.

The base company concept has been an internationally popular strategy for taxpayers. For tax purposes, the most important function of a base company is to collect income which would otherwise go directly to the taxpayer and be taxable in the country of residence. Base companies can also serve non-tax purposes, being used to retain flexibility for financing international operations by avoiding domestic constraints and costly procedures (e.g. currency controls). They can also be used, and sometimes are, to avoid labour union problems.

The income of a base company is ordinarily sheltered because it is a viable entity with its own legal personality and is recognized as such in its state of residence. Thus, the income of the base company is not subject to tax in the taxpayer-shareholder's country of residence. Since the tax advantage exists only as long as the sheltered income is not distributed, taxpayers may claim that this is merely a deferral mechanism, not an avoidance technique. However, the distribution may be so indefinitely deferred as to lose any value under "time value of money" principles, or the character of the distribution may be effectively changed through other means such as shareholder loans – potentially resulting in a different tax base, or a different rate of taxation.

The enhanced role of information technology in financial matters is affecting governmental abilities to minimize fraud as well. Capital transfers have become exceedingly efficient through wire transfers and similar mechanisms, and capital transactions more and more focus on speed and timeliness. The difficulty for revenue authorities is the need to access documentation in order to assess propriety of transactions.

However, creation of documentation adversely affects the speed of completion of fiscal transfers. The tension between the need to ensure speed of transactions and the governmental requirement for accountability (and auditability) will be subject to major controversy for the foreseeable future.

III. WHAT COUNTERACTIVE MEASURES ARE AVAILABLE TO ATTEMPT TO DEAL WITH THE CHALLENGES JUST DISCUSSED?

Tax administrations have developed a number of standard tools for counteracting taxpayer fraud. Many of these tools have achieved a level of international acceptability, while others are still in something of a "test" stage. Generally, they may be categorized as juridical (either legislative or court-derived), treaty-based (and therefore cooperative), or indirect tools.

There are a number of initiatives which fit in the category of juridical tools. The most basic necessary legislation is a transfer pricing statute. This kind of law requires that prices established for transactions taking place between related or affiliated companies be priced at a level acceptable within international norms. Within the OECD, the standard for determining acceptable prices is the arm's length standard. That is, transactions taking place between related parties must be priced at a level comparable to similar transactions taking place between unrelated parties in similar economic circumstances.

The second major legislative tool would be "Subpart F"-type legislation, similar to that enacted by the United States in 1962. This would require that shareholders of foreign subsidiaries *immediately* include in income some portion of the earnings of those subsidiaries. Not all earnings are so included. Ordinarily Subpart F-type legislation applies to passive earnings and income derived from tainted business or structures – the kind of income routinely routed through tax haven jurisdictions.

Other legislative tools include:

- Immediate inclusion of earnings derived by passive income vehicles. These would include offshore mutual funds, offshore personal holding companies, captive insurance companies, and passive investment companies.
- Provisions that tax or minimize non-recognition of tax on transfers of assets to foreign companies. Such a provision could, for example, value assets immediately upon transfer and impose a tax on any gain between basis and that value.
- In some countries, control of transactions involving foreign exchange is necessary. Routinely applicable to banks and other financial institutions, these provisions would not usually be found in the tax laws of a country.
- Consistency rules may exist. For example, in the United States there is a law that requires that transfer prices established for income tax purposes in import transactions must be no higher than the transfer price reported for customs duty purposes.

In addition, the role of tax treaties and other fiscal agreements is of increasing importance to international tax administration. To the extent that such agreements minimize the level of residence based taxation, particularly for items of passive income, there is a disincentive to utilize mechanisms to obscure the reporting of this income in the country of residence. At the same time, however, there is a need to reduce the potential for "treaty shopping", that is, for taxpayers to use third-country treaties as a means of reducing tax obligations. This has led to the introduction of "limitation on benefits" clauses in a number of bilateral treaties. The United States has developed a standard text that is ordinarily sufficient to protect against base erosion in most treaties; however, for some countries the negotiation of mutually acceptable conditions has resulted in enormous complexity (e.g. the US–Netherlands treaty).

The development of "limitation on benefits" clauses came about largely as a result of the general international inadequacy of court-developed doctrines such as "substance versus form". In many countries, courts are prepared to look at the substance (i.e. the real economic content) rather than at the legal form of a transaction. In courts in some countries, transactions which are in the nature of a "sham" may be disregarded. Increasingly, courts entertain and sustain such arguments. However, historically this has not been a significant counteractive tool because the facts and circumstances are ordinarily unique and are not easily applied to other scenarios.

The major advantage of treaties and other international agreements in the war against international tax avoidance is the provision of bilateral cooperation in the form of exchanges of information. The most valuable form of such cooperation is probably the *specific request*, in which one country asks another for assistance in obtaining particularly identifiable data relevant to a tax examination.

There are other treaty based vehicles for exchanging information as well, but the point to be made is that without the ability to obtain and exchange tax related information between countries, the challenge of administering respective tax regimes becomes overwhelming.

These exchange programmes are regularly facilitated in provisions of full-scale tax treaties. However, more limited international agreements can operate to the same end, e.g. the Tax Information Exchange Agreements entered into by the United States with a number of Caribbean and Latin American countries. The creation and development of more such interactive, international programmes will be critical to improving administrative efforts to effect greater compliance by avoidance-prone taxpayers.

Apart from the commonplace juridical and treaty-based initiatives, tax administrations can use indirect means to prompt greater compliance by taxpayers, or otherwise minimize their incentives to engage in fiscal fraud. The development of standardized withholding mechanisms ensures a timely collection of tax revenues prior to income leaving the jurisdiction of a source country. Restrictions can also be placed on some of the electronic means of transferring funds (e.g. through use of wire transfers) if a source country so desires. The use of summons processes during audit reviews can serve as a personal incentive for corporate officers to undertake close compliance with revenue statutes and procedural requirements, rather than exposing themselves to needless or expensive litigation. Another technique that the United States has found particularly valuable in encouraging corporate compliance is the concept of "hot interest", which would charge corporate taxpayers a premium (in essence, a penalty) for substantial underpayment of taxes, as determined on audit. Finally, the tool of requiring taxpayer- or third party-reporting of information on taxable activities is of principal utility in ensuring appropriate compliance.

In general, information reporting is increasingly important to US tax administration, not just in respect of cross-border activities. As third party reporting on income and deductible items becomes more commonplace, the processing features of tax administration become increasingly streamlined, reducing taxpayer frustration at the same time accuracy of income is enhanced. And receipt of fiscal revenue is accelerated as third party withholding is implemented.

Now let me share the UNITED STATES PERSPECTIVE on these issues. As mentioned previously, the United States has sought to combat the use of tax haven base companies through its Subpart F provisions. These laws eliminate the use of deferral or avoidance by immediately taxing income earned by foreign subsidiaries of US taxpayers in certain defined circumstances. These circumstances usually involve passive income. Given the fact that other developed nations have enacted similar legislative structures, such anti-deferral mechanisms have achieved an apparent utility for their purpose.

In the US view, however, this legislation, despite regular modification to address new, perceived abuses, has proven insufficient. The latest consensual thinking of the US tax administrators is reflected in the 1993 White Paper mentioned in the Introduction above. This paper acknowledges the reality that international tax compliance must be a high priority in coming years and that it is imperative to continually re-examine tax policies, laws, treaties and administrative programmes in order to adapt them to developing international business practices. Thus, in an evolutionary sense, we will probably never enjoy the luxury of total victory over international tax evasion because we no sooner solve one problem when another scheme appears to take its place.

This paper identified certain substantive areas for review, three of which involve aspects of fiscal fraud – Transfer Pricing, Tax Treaties, and Individual Tax Compliance. The paper focused on four types of action that must be undertaken in order to promote sufficient compliance. Those actions are:

- Legislative Change
- Modernized Regulations
- Increased Administrative Enforcement Efforts
- Coordination with Trading Partners and Industry

Perhaps the bulk of the work the United States has done recently has been concerned with ensuring compliance in the area of Transfer Pricing. For several years now, the United States has been engaged in the process of substantially revising its regulations that apply to testing the validity of prices on cross-border transactions. After years of work internally, along with regular consultations with treaty partners, industry groups and other concerned parties, new regulations were issued last year, regulations which received general international approval.

In connection with the administrative work of revising the basic transfer pricing regulations, the US Congress established a statutory scheme which imposes severe penalties on taxpayers who use transfer pricing techniques to significantly understate their tax liabilities. Through the regulatory development process, the United States has worked to use these penalties as a means of obtaining sufficient taxpayer-developed information to adequately audit cross-border, related party transactions.

The United States has also undertaken two collateral procedural efforts to undergird its substantive work in this area. First is a complete review and revision of the major information returns that must be filed for transactions with related parties. Second is the development of the Advance Pricing Agreement programme, which is intended to provide a mechanism for working collaboratively with willing taxpayers to avoid transfer pricing disputes. In general, this programme fits a strategic assumption that the IRS has made, that some portion of non-compliance is not intentional but rather due to taxpayer ignorance or the US failure to adequately educate.

The United States has also had an active Treaty programme for many years, and in the last decade has significantly expanded the number of these relationships. The development of a particular treaty is dependent upon the economic and other relationships of the particular countries involved; however, there is an element of evolution in this scheme of administration. That is, certain concepts tend to develop over time, usually in response to third party (taxpayer) changes in behaviour.

The United States also remains committed to effective use of the exchange of information programmes facilitated through its treaty network. For example, the Tax Information Exchange Agreement Programme has received continuous expansion. Similarly, the United States has developed a Code of Good Practice relating to information exchanges, in which the United States and its treaty partners establish and commit themselves to quality standards in how they carry out their exchange obligations. Of course, the United States also remains active in international forums such as CIAT and the OECD.

The final substantive area addressed in the 1993 White Paper is perhaps the most significant area of fiscal fraud – tax compliance by individuals, principally those with high net worth. In this regard, the United States sees three areas that must be addressed: tax avoidance by US individuals, tax avoidance by non-resident aliens, and simplification for small investors.

Perhaps the most difficult area for the United States to address is compliance by its own residents. While the United States has extensive reporting systems, its programmes for matching, comparison and analysis of the information contained in these systems are in need of significant upgrades. In most cases, identification of international fraud by US individuals must take place through labour-intensive audits. Individuals who intend to defraud the Government usually are adept at hiding their assets and income, so the means that US revenue agents must undertake to ferret out such fraud are frequently time-consuming and arduous. It ordinarily takes a creative and highly-trained agent to catch suspect transactions. As a result, the biggest challenge the United States faces in this area is the internal recruiting and training function, as well as retaining a commitment to perform such labour intensive audits in the face of severely diminished budgets.

The US Internal Revenue Service formed a multi-functional task force to address non-resident alien compliance. The tax force had a number of goals – simplify and standardize information reporting, improve education of both taxpayers and agents, improve use of available data to enhance compliance, increase sharing of useful data among treaty partners, and adopt procedural changes to ensure that non-resident aliens receive correct treaty benefits. The consequence of this task force was three-fold. First was the creation of a Foreign Payments Division under the Assistant Commissioner (International) to coordinate development of educational and compliance programmes. Second is the revision of the withholding programme, which is being addressed through an ongoing review of the US regulatory provisions. Finally, the United States is developing an individual tax identification number for foreign investors who receive payments of US source income – this tax identification number will streamline the processing of information and tax returns relative to such payments and will attack an area of weakness – the temptation of non-resident aliens to file fraudulent refund claims.

Finally, with respect to small investors, the United States has recognized the individual implications of the international tax rules becoming increasingly complex in response to the increasing complexity of the corporate business world. This has adversely affected the capability of individuals to economically comply with the rules relating to international activities. The United States is reviewing the potential for legislative and regulatory changes to simplify matters for individuals who want to comply but cannot for purely economic reasons.

IV. CONCLUSION

International fiscal fraud is unfair and inequitable to compliant taxpayers, can have serious budget impacts, and may distort international competition. With increasing taxpayer sophistication, the difficulty of identifying and redressing such avoidance and evasion becomes more and more problematic. Tax administrations must be vigilant to strengthen, where possible, their legal, regulatory and administrative provisions, as well as their investigative powers. Moreover, they must be willing to share experiences, particularly their successes, in response to international fraud. Efforts must be continuously made to facilitate, improve and extend exchanges of information under existing international conventions, and to seek new arrangements of a bilateral and multinational character to fulfil unmet needs for government-level action.

UNITED KINGDOM

Capital Gains Tax Implications of an Individual Becoming Non-UK Resident

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I. INTRODUCTION

This article intends to outline the tax implications of an individual becoming non-resident for the purposes of UK capital gains tax (CGT). It commences by broadly outlining the scope of the tax. Next the principles determining an individual's residence and ordinary residence are analysed. The article concludes by examining the phenomenon of the claw-back of certain tax reliefs that may occur upon an individual becoming non-resident.

II. SCOPE

A. General

In general, CGT is chargeable on the disposal, by a UK resident or ordinarily resident person of chargeable assets[1] no matter where situated. If a person ceases to be resident or ordinarily resident he then normally would not be chargeable to the tax.

A person who is UK resident for any part of a year of assessment[2] is within the charge to CGT in respect of any chargeable disposals he makes during that year, regardless of whether he was in fact resident at the time of making the disposal.

Example 1
Michael emigrates from the United Kingdom on 5 May 1995. Subject to the provisions of any relevant tax treaty he is liable to CGT on the disposal of assets made in the period 6 April 1995 to 5 April 1996 even though he was non-resident for part of this period.

The harsh implications of this rule can in most circumstances[3] be mitigated either by the application of extra statutory concession D2 which effectively limits the taxpayer's liability to CGT to the period he was in fact resident in the United Kingdom,[4] or by tax treaty applying OECD model Articles 1, 4 and 13.

B. The remittance basis

Where an individual although resident or ordinarily resident is non-domiciled[5], the remittance basis applies to gains arising on the disposal of foreign situs assets. Under this basis the taxpayer is only chargeable to CGT on the disposal of foreign assets, if the proceeds of the disposal are remitted at any time to the United Kingdom.[6]

III. RESIDENCE AND ORDINARY RESIDENCE

A. General

The question of whether an individual is *resident* or *ordinarily resident* in the United Kingdom is determined under the rules applying for income tax purposes. In this regard it is important to note that neither term is defined in the legislation. As a consequence the rules relating to residence are derived to a considerable degree from case law and Inland Revenue practice.

Since the 1993/94 tax year (see below) normally a person is treated as resident in the United Kingdom for tax purposes if he:
1) is physically present in the United Kingdom for 183 days or more in a tax year. Or

1. In general, the gains arising on the disposal of all assets are potentially subject to CGT, apart from the gains arising on the disposal of sterling and a few other exceptions.
2. A year of assessment runs from 6 April to the following 5 April. Therefore the 1995/96 year of assessment runs from 6 April 1995 to 5 April 1996.
3. It is important to note that extra statutory concessions (ESC) do not apply where their application would facilitate tax avoidance. *R v. CIR (ex parte Fulford-Dobson) QIB 1987, 60 TC 168.*
4. ESC D2 applies "when a person leaves the UK and is treated on his departure as not resident or ordinarily resident in the UK".
IR 20(1993) para. 2.7 (an Inland Revenue information booklet) provides that an individual leaving the United Kingdom permanently may be treated as not resident or ordinarily resident from the date of their departure.
5. Domicile is a common law concept. It can be broadly interpreted as meaning an individual's permanent home.
6. If an individual remits after becoming UK domiciled then the remitted gain is not taxable, since the normal *arising* basis applies.

2) habitually makes substantial visits to the United Kingdom. Substantial is taken to mean on average over a four year period in excess of 90 days per year and visits become habitual after four years.[7] Or
3) is a Commonwealth or Eire citizen who is ordinarily resident in the United Kingdom, but leaves the United Kingdom merely for the reason of occasional[8] residence abroad.

B. Available accommodation

For 1992/93 and preceding years if an individual had accommodation *available* to him in the United Kingdom and visited the United Kingdom for no matter how short a period, he was held to be a UK resident for the tax year in which the visit was made. This rule no longer applies and hence it is now far easier for an individual to establish that he is no longer a UK resident.

Example 2 (ignoring the effects of tax treaties)
In 1980, Mr and Mrs Smith bought a house in Spain. They live there for 10 months each year. Their remaining time is spent visiting relatives in England. Whilst there they often spend time in their old matrimonial home, which is always available to them for their use.

For all tax years up to and including 1992/93 they would have been held to be UK resident. From 1993/94 onwards with the repeal of the available accomodation rule they would be treated as non-resident[9].

C. Ordinarily resident

Ordinary residence is not an easy expression to define. In *Levene v. IRC* it was commented that "ordinary residence connotes residence with some degree of continuity and apart from temporary and occasional absences abroad". The question as to whether or not a person is ordinarily resident is a question of fact. In a practical context if a person is normally resident in the United Kingdom, leaves the United Kingdom with the intention of returning and then returns to the United Kingdom after a period of say 30 months it is possible that he remains ordinarily resident in the United Kingdom throughout the entire period even though he is non-resident for a complete tax year. Notwithstanding this, in *Reed v. Clark* a taxpayer who left the United Kingdom for a period of just over a year was held not to be ordinarily resident for that period. This case underlines the importance of considering the individual's intentions and actions. The fact that the taxpayer intended to live and work in Los Angeles together with the fact that he did not visit the United Kingdom at all during the entire period of his residence abroad are highly significant, implying a *definite break* in the taxpayer's life.[10]

Where an individual emigrates permanently from the United Kingdom and does not fall foul of the habitual and substantial visits rule outlined above then the position is as set out in example 1. This is the case even though strictly the individual will only cease to be ordinarily resident from 6 April following the tax year in which emigration takes place.

D. Taking up full-time employment abroad.

Where an individual leaves the United Kingdom to take up full time employment abroad, it is revenue practice to treat that person as not resident or ordinarily resident from the day following the date of his departure until the day preceding the day of his return. In order to qualify for this treatment the following three conditions must be satisfied.
1) all the duties of the employment must be performed abroad[11];
2) the absence in respect of the employment must include one complete tax year; and
3) visits to the United Kingdom must not exceed six months in any one tax year, or three months or more on average.

It is important to note that as the above treatment is based merely on revenue practice, it may not be relied upon, to facilitate tax avoidance.[12]

E. Foreign expatriates and temporary visitors

Where a foreign expatriate comes to the United Kingdom to work for a period of two years or more, he is treated as non-resident from the date of his departure from the United Kingdom. It should be noted that since most expatriates are non-UK domiciled they should if possible refrain from remitting the proceeds of any "foreign" gains into the United Kingdom whilst UK resident. In this way they may mitigate any exposure to CGT arising on the disposal of non-UK assets.

On 29 January 1996, the Inland Revenue issued a revised extra statutory concession A11 relating to temporary visitors. The new concession amongst other things provides that the above split year treatment now applies to all those intending to stay in the United Kingdom for at least two years whether or not for employment.

F. Tax treaties

Even though an individual may under domestic UK law be held to be resident or ordinarily resident for the purposes of CGT it is important not to overlook the impact of tax treaties. Normally tax treaties contain a tie-breaker provision, which applies where an individual is deemed to be a resident of two treaty countries under the domestic laws of the countries concerned. The tie-breaker determines in which country the taxpayer is resident for the purposes of the treaty. Given that treaty law overrides UK domestic law, the treaty's determination is conclusive.

7. It is possible for an individual to be treated as resident and ordinarily resident from the first year, if his personal circumstances indicate that he intends to make habitual substantial visits from the outset. Otherwise the normal rule is that the individual is treated as resident from the earlier of either the start of the fifth year or the tax year in which he makes the decision that such visits will take place.
8. The term "occasional residence" is not defined in the legislation. It generally refers to short trips abroad. See *Reed v. Clark Ch D 1985, 58 TC 528.*
9. Although Mr and Mrs Smith habitually visit the United Kingdom, their visits do not fall to be treated as substantial.
10. *Whiteman on CGT* 4th edition at 690.
11. Incidental duties performed in the United Kingdom will not preclude the relief.
12. See *supra* note 3.

An example of a tie-breaker provision is found in Article 4 paragraph 2 of the Netherlands–United Kingdom treaty which provides that:

> "Where by reason of the provisions of paragraph 1[13] an individual is a resident of both States, then his status shall be determined as follows:
> a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
> b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
> c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
> d) if he is a national of both States or of neither of them, the competent authorities of the States shall settle the question by mutual agreement".

Example 3
John Smith who is ordinarily resident in the United Kingdom leaves the United Kingdom on 5 January 1994 to reside in the Netherlands. He returns to the United Kingdom on 7 July 1995. On the assumption he is ordinarily resident in the United Kingdom for the 1994/95 tax year[14] the tie-breaker provision of the United Kingdom–Netherlands tax treaty will be invoked since under Dutch tax law he will also be deemed to be a Dutch resident. On the assumption John sold his house prior to leaving the United Kingdom and has a permanent home available to him in the Netherlands then he falls to be treated as a Dutch resident by virtue of Article 4 paragraph 2 clause a) and is therefore not UK resident in the 1994/95 tax year.

It is important to note that although a tax treaty may determine the residence status of an individual, it may not always negate the individual's liability to UK CGT for the tax year in which the individual first becomes non-resident. This is because, as discussed above, an individual is liable to UK CGT for the complete tax year, even though he may only be resident or ordinarily resident for part of that year.

Turning to the above example, John's liability to CGT is determined by reference to Article 13 of the United Kingdom–Netherlands tax treaty. Paragraph 1 of that Article states that "Gains derived by a resident of one of the States from the alienation of immoveable property referred to in Article 6 and situated in the other State may be taxed in that other State". The United Kingdom therefore would be entitled to tax John in the period 5 January 1994 to 5 April 1994 on the disposal of immoveable property situated in the United Kingdom even if he was held to be a Dutch resident for that period.

From the above it is clear that the mere fact that an individual leaves the United Kingdom to reside abroad for a period does not necessarily signify the end of that individual's exposure to CGT. The question turns on the precise facts and circumstances of each case. Both subjective and objective factors are relevant e.g. the intentions of the individual and the length of time the individual was physically present in the United Kingdom. To make matters even more complicated the whole area of residence is intimately tied up with Inland Revenue practice which may on occasion be discretionary.[15] Finally, even if an individual is initially held to be a UK resident, it is possible that a tax treaty will apply to deem that individual to be non-resident.

IV. CLAWBACK

The general position for individuals becoming non-resident is as set out above. However in certain specific instances the event of becoming non-resident can trigger a charge to CGT. This occurs where an individual has availed of certain reliefs, and under the relevant provisions the relief previously granted is clawed back upon the individual becoming non-resident.

The reliefs affected by the clawback are hold-over relief for gifts of business assets and reinvestment relief.[16] Reinvestment relief enables an individual to defer a CGT liability arising on the disposal of an asset, by acquiring shares in a qualifying company. The relief operates by reducing the taxpayer's gain by the amount reinvested. As a counterpart the cost of the taxpayer's shares in the qualifying company is treated as being reduced by the amount of reinvestment relief granted. Hold-over relief applies to gifts of business assets used by the transferor in his business or by the transferor's family company. The relief operates by deferring the transferor's gain. The transferee's acquisition cost is reduced by the amount of the gain deferred.

In the case of hold-over relief the clawback occurs if the transferee becomes not resident or ordinarily resident within six years after the end of the year of assessment in which the *gift* was made (S168 (1) TCGA 1992). Under reinvestment relief the clawback only occurs if the individual becomes not resident or ordinarily resident[17] prior to the end of the relevant period.[18]

In both cases the mechanism employed by the clawback provision is to bring the gain previously deferred back into charge. The gain is treated as crystallizing immediately before the individual becomes non-resident. This point is extremely important, because it means that there is no possibility of arguing that due to the operation of a tax treaty the gain falls outside the charge to CGT.

13. Paragraph (1) provides that "resident of one of the States" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. ..."
14. That is the period 6 April 1994 to 5 April 1995.
15. See *supra* note 3.
16. Interestingly no clawback occurs in the case of "roll-over relief for the replacement of business assets".
17. S164F(2)(c) TCGA 1992.
18. In general, the relevant period is the period of three years after the acquisition of the qualifying investment, S164(12) TCGA 1992.

A. Non-resident employees

In the case of both reliefs there is an exception to the clawback provision that applies where employees go abroad and certain conditions are satisfied. This article proceeds by examining the reinvestment relief rules in some detail. It should be noted that similar considerations apply to hold-over relief.[19]

S164F(9) Taxation of Chargeable Gains Act 1992 (TCGA 1992) provides relief where the reason a person becomes neither resident nor ordinarily resident, is that he works in an office or employment all the duties of which are performed outside the United Kingdom. In addition to satisfying this condition, it is necessary that the employee again becomes resident or ordinarily resident within three years from the date of becoming non-resident, without meanwhile having disposed[20] of any eligible shares.[21]

Where a person satisfies the first condition, no assessment clawing back the relief will be made so long as the second condition may be satisfied.

Example 4
On 2 November 1994, Joe Smith, rolled over a GBP 100,000 capital gain by acquiring shares in Fresh Start Ltd., a qualifying company. On 2 November 1995, Joe left the United Kingdom to commence a five year contract of employment in Saudi Arabia.

S164F(9) prevents the Inland Revenue raising an assessment so long as there is the possibility that Joe will return within three years of ceasing to be resident. The Inspector may, therefore, only raise an assessment clawing back the relief on 2 November 1998, when it is no longer possible that the condition will be satisfied. The assessment can be raised even though Joe's relevant period expired in November 1997!.

The first condition is particularly onerous, as the performance of even incidental duties in the United Kingdom in respect of the relevant employment, would cause the relief to be clawed back. It is however, interesting to note that the performance of duties in the United Kingdom in respect of a separate employment, would not appear to prejudice the relief.

Thus, in situations where it is likely that the employee will be called upon to perform certain duties in the United Kingdom, it is important to consider whether it is possible to syphon off these activities, and make them the subject of a separate contract, held with a second employer.

Example 5
Jim has recently rolled over a GBP 1,000,000 gain via reinvestment relief. His employer XYZ Holdings plc, wants him to head up their fledgling Eastern European Division. It is envisaged that part of Jim's duties will be to return to the United Kingdom every three months to report progress to the company's board in London.

If XYZ Holdings plc merely draw up a contract, incorporating both Jim's United Kingdom and overseas duties, Jim's reinvestment relief will be clawed back when he becomes non-resident.[22]

To avoid the clawback of Jim's relief, perhaps XYZ Holdings plc could arrange for a subsidiary to employ Jim exclusively in respect of duties to be performed outside the United Kingdom. XYZ Holdings plc would then enter into a separate contract, covering the performance of the UK duties. As Jim's employment with the subsidiary would pertain exclusively to overseas duties, and would be the reason for him becoming neither resident nor ordinarily resident, the employment would appear to satisfy the requirement imposed by S164F(9)(a).

It is of course possible that the Inland Revenue might argue that the two employments should be looked at together, i.e. that in effect, the separate contracts of employment were a sham, there being in essence, a mere single employment. Or alternatively, that the subsidiary, when entering into its contract of employment with Jim, was merely acting as an agent for its parent company. In order to counter the Revenue's arguments it would be necessary to show that each employment contract was legally enforceable, and that the duties to be performed as set out in each contract were sufficient to independently constitute an employment.

B. Enforceability

Few countries are willing to enforce foreign tax judgements. It is therefore very hard for a country to compel a non-resident to comply with their tax obligations unless that individual has assets located within their jurisdiction. In situations where an individual permanently emigrates from the United Kingdom, the Inland Revenue may have to rely on the good conscience of the individual to collect any tax liability arising out of the clawback charge.[23] This is hardly an ideal situation.

C. European Union issues

The whole area of the taxation of non-residents raises important issues of discrimination under EC law. For example, it is an interesting question as to whether the crystallization of a charge to tax on the event of an individual becoming non-resident constitutes discrimination.[24] It may well do, but not against foreign citizens or foreign residents, the discrimination if it exists is aimed solely at persons whom at the time of the charge to tax were UK resident individuals. An argument a taxpayer might consider using would be that the clawback

19. Readers are advised to pursue the relevant legislation.
20. S164F(10) TCGA 1992 stipulates that for the purposes of subsection 9 a person shall be taken to have disposed of an asset if there has been such a disposal as would, if the person had been a UK resident, been a disposal on which the whole or any part of the held over gain would have been charged.
21. Eligible shares are shares which qualify for reinvestment relief, S164(1) TCGA 1992.
22. N.B S164F(9) only provides relief in the event of an employee becoming non-resident, if all the duties of the employment are performed outside the United Kingdom.
23. Of course where the individual has plans to eventually return to the United Kingdom, they may have an incentive to be more mindful of their UK tax obligations.
24. For a study of the issues concerning discrimination see *Wielockx C-80/94, Bachmann C-204/90* and *Schumacker C-279/93.*

impedes the freedom of movement guaranteed by the EC treaty.[25] Certainly an individual faced with the prospect of a large CGT liability might be deterred from emigrating to take up employment in another Member State. The matter is however far from clear and may only be satisfactorily determined if the EC Court is called upon to consider the issue.

V. CONCLUSION

In conclusion, an individual's residence is determined by his intention and actions. In this regard care should be taken not to over look the implications of any relevant tax treaty. From a CGT perspective, it is highly advantageous to establish non-residence, as this removes the individual from the scope of CGT. However individuals should be aware that in certain specific instances the event of becoming non-resident can actually trigger a charge to CGT!

25. *Case 81/87* considered an analogous issue concerning corporations becoming non-resident. However it was held that a company could not rely on *Council Directive 73/148 of 21 May 1973* on the restrictions on movement and residence within the Community for nationals of Member States.

CUMULATIVE INDEX – 1996

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

MARCH 1996

International Tax Planning for Groups of Companies, Omni Marco Polo, Singapore, 21-22 March 1996 (English):

IBC Technical Services Ltd, 268 Orchard Road #18-02, Singapore 238856, Tel.: 65-732 1970, Fax: 65-733 5087.

Tax Compliance Issues for US Subsidiaries in Europe, London, 22 March 1996 (English):

The American Tax Institute in Europe, 1 Falmer Court, London Road, Uckfield, East Sussex, United Kingdom, Tel.: 44-1825-760 901, Fax: 44-1825-760 903.

The 3rd IBC Annual International Death and Taxes Conference, London, 25-26 March 1996 (English):

IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

How Can Charities Operate Effectively Across Borders?, Hotel Okura, Amsterdam, the Netherlands, 29 March 1996 (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.

APRIL 1996

International tax planning techniques, Amsterdam, 11-12 April 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MALAYSIA

A Review of the 1996 Budget and Other Recent Tax Developments

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I. INTRODUCTION

Sustaining economic growth and controlling or reducing inflation has been a recurrent theme of the Budget strategy in recent years. For the eighth consecutive year, the Malaysian economy sustained growth rates above 8 per cent. Per capita income increased to MYR 10,068 or USD 4,027 while the unemployment rate of 2.8 per cent effectively means a state of full employment. Inflation was contained at 3.4 per cent for the first nine months of 1995 and for the third successive year there was a balanced budget. Despite the deficits in the current account and the services account of the balance of payments, it is expected that a balanced budget will again be achieved in 1996.

The deficit in the current account should be viewed in the context of an economy that is rapidly expanding and in need of modernization and the further development of its infrastructure. The deficit is the result of increased imports of capital and intermediate goods and it should be reduced when various investment projects come on stream in the near future. The deficit in the services account is due to a net outflow of investment income and increased payments abroad for services. Thus, measures have been proposed to develop the services sector so that such outflows can be curtailed.

Rapid economic growth inevitably leads to some strains on the economy i.e. inflationary pressures, labour shortages and a current account deficit. The 1996 Budget clearly indicates that efforts are under way to prevent an overheating of the economy. As a consequence, Malaysia's growth is expected to ease to 8.5 per cent for 1996.

This paper examines the various measures introduced in the Budget and the Finance (No. 2) Bill 1995 with regard to direct and indirect taxation as well as other recent developments in the Malaysian tax system.

II. THE 1996 BUDGET CHANGES

The 1996 Budget, presented by the Minister of Finance on 27 October 1995, focuses on the following areas:

- sustaining growth with low inflation;
- strengthening the capabilities of the services sector;
- upgrading the development of human resources and technological capabilities; and
- continuing the agenda for social development.

A. Business taxation

1. Corporate tax rate

The tax rate remains at 30 per cent. There was no proposal to lower it and neither was there any hint that it would be lowered in the future. Revenue constraints are the reason for this. In this Budget, tax rates for individuals and cooperatives were lowered instead.

The 1995 Budget changed the scope of charge for resident companies (except for banking, insurance and sea/air transport businesses) to exclude foreign-source income received in Malaysia. Unfortunately, no provision was made to allow dividends declared from such exempt income to be exempt in the hands of the shareholders (i.e. such dividends still need to be franked). There were indications from dialogue sessions after the 1995 Budget that this issue would be addressed. However, the 1996 Budget is again silent on this issue.[1]

2. Cooperative societies

With effect from year of assessment 1996 (Y/A 1996), the graduated income tax rates ranging from 1 per cent to 32 per cent have been reduced to a range of 0 percent to 30 per cent.[2]

The tax rates were also lowered in the last Budget. However, now the top rate is in line with the corporate tax rate.

3. Contributions to approved pension and provident fund schemes

Currently, such contributions by an employer (up to a maximum of 16 per cent of the employee's remuneration) are tax deductible against gross business income. It is proposed that from Y/A 1996, the limit be increased to 17 per cent.[3] The statutory contribution rate to the Employees Provident Fund

1. The reason for suggesting such an exemption is to achieve consistency with other incentives for foreign-source income such as from overseas construction projects and operational headquarters where such income can be passed on to shareholders as tax exempt dividends.
2. Amendment to Part IV of Sch. 1 of the ITA 1967.
3. Amendment to Sec. 34(4)(a) of the ITA 1967.

(EPF) by an employer remains at 12 per cent. This proposal is aimed at encouraging employers to contribute more to the EPF or to approved schemes as a form of savings for employees.

4. Accelerated depreciation allowances (ADA)

In a move to promote the usage of computers, develop information technology and ensure protection of the environment, it is proposed that from Y/A 1996, capital allowance rates in respect of the following assets will be increased as follows:

	Initial Allowance	Annual Allowance
Computer and information technology equipment	20%	40%
Environmental protection equipment	40%	20%

Thus, computers and other information technology assets will enjoy an accelerated write-off of the capital expenditure over a two year period, instead of the current five year period. This is more reflective of the useful life of these assets. For environmental protection equipment, the write-off period is three years.

5. Contributions to approved charity and community projects

Currently, cash donations to the government, state government, local authority or an institution or organization approved by the Director General of the Inland Revenue under Section 44(6) of the Income Tax Act 1967 (ITA 1967) qualify as a deduction against aggregate income.

With effect from 1 January 1996, contributions to any approved charity or community project in the fields of education, health, housing, infrastructure and public amenities will also qualify as a deduction. This is intended to widen the scope for more active participation by the private sector in community development. However, the relevant community projects still need to be approved. It is expected that some guidelines will be issued soon to set out the qualifying conditions that have to be met before a deduction is granted.

6. Research and development

Currently, local universities are not classified as approved research institutes for purposes of the claim for double deduction (see C. 5. below) by companies making cash contributions or making payments for the use of the services of such institutions for research and development activities.

The Minister announced that local universities will be recognized as approved research institutes.[4] This announcement is long overdue considering that universities are actively involved in research. What is more significant is that this is coming at a time when local universities are to be incorporated and thus have a greater degree of autonomy. The universities should therefore be able to commercially exploit the fruits of their research.

7. Industrial building allowance

(a) *Approved service project*

It is proposed that a building used by a person solely for the purpose of the provision of services and modernization of operations in relation to an approved service project be regarded as an industrial building from Y/A 1996.[5] An "approved service project" means a project in the service sector in relation to transportation, communications, utilities or any other sub-sector approved by the Minister. The industrial building allowance is to be given at the rate of a 10 per cent initial allowance and a 2 per cent annual allowance.

(b) *Education and training*

At long last, it is agreed that with effect from Y/A 1996, capital expenditure incurred on the construction or purchase of a building used:

- as a school or an educational institution approved by the Minister of Education or other relevant authority;
- for industrial, technical or vocational training approved by the Minister of Finance;

will qualify for an industrial building allowance of 10 per cent annually.[6] This rate is more attractive than that applying to other buildings which normally receive an initial allowance of 10 per cent and an annual allowance of 2 per cent.

Prior to this proposal, buildings used as schools or educational institutions were not eligible for any allowance. This proposal is certainly an additional incentive for the private sector to be involved in education.

8. Deduction for pre-operating training expenses

Currently, training expenses incurred by manufacturing companies prior to the commencement of business under:

- a training programme approved by the Malaysian Industrial Development Authority; or
- a training programme conducted by approved training institutions;

qualify for double deduction provided such companies do not contribute to the Human Resource Development Fund (HRDF). With effect from 1 July 1993, large manufacturing companies were required to contribute to the HRDF and hence were not eligible for the double deduction. Consequently, only small and medium scale manufacturing companies were able to enjoy the incentive.

It is proposed that, with effect from Y/A 1996, training expenses incurred prior to the commencement of business by companies (other than those already qualifying for a double deduction) be granted as a single deduction for tax purposes. This would be an exception to the normal tax principle that pre-operating expenses are not deductible. It should also be

4. The definition of an approved research institute indicates that an institute must be approved by the Minister to mainly carry out research in an industry specified in the approval.
5. Via introduction of para. 37E to Sch. 3 of the ITA 1967.
6. Via introduction of paras. 42B and 42C to Sch. 3 of the ITA 1967.

noted that the deduction is only for training expenses and not for staff salaries/remuneration. It is not clear whether prior approval is required for the expenses to be deductible. This may be clarified through a gazette notification.

9. Interest income exemption

Currently, interest earned by non-resident individuals and companies from banks licensed under the Banking and Financial Institutions Act 1989 is exempted from tax under Schedule 6 of the ITA 1967.

It is proposed that from Y/A 1996, this exemption be extended to include interest earned from finance companies licensed under the Banking and Financial Institutions Act 1989.[7] It would have been logical to effect this change from 1 January 1996 instead of the year of assessment 1996 because non-resident recipients receiving interest which suffered withholding tax in 1995 will now be entitled to file refund claims.

In addition, it has been proposed that from Y/A 1996, interest earned by unit trusts (whether Malaysian or foreign) and listed closed-end funds from specific bonds will also be exempted from tax.[8] This is in line with the existing exemption available to individuals. The proposal will assist in the development of the private debt securities market and is in keeping with the government's efforts to create a strong and sound financial and capital market.

10. Exemption for KLOFFE and MME

Currently, the income derived from futures trading activities by the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Malaysian Monetary Exchange (MME) is subject to income tax at the corporate rate of 30 per cent.

The Minister has announced that he has granted tax exemption to KLOFFE and MME.[9] This exemption should boost the activities of the two Exchanges. The success of both KLOFFE and MME is vital to the development of the Malaysian capital market. Such an exemption should also encourage investment in training and research both of which are crucial if Malaysia is to be transformed into a regional financial centre.

11. Life insurance business

The taxation of life insurance business was changed in Y/A 1995 so that the income of the life fund and that of the shareholders' fund of a life insurance business were treated as separate sources of income.[10] The current legislation does not allow for any deduction should an amount be transferred from the shareholders' fund to the life fund to make good any actuarial deficit arising in the life fund. This results in the taxation of shareholders' capital when the actuarial surplus is transferred from the life fund to the shareholders' fund in subsequent years.

To rectify this anomaly, it is proposed that with retroactive effect from Y/A 1995, a deduction is to be allowed in respect of an amount transferred from the shareholders' fund to the life fund as is equal to the actuarial deficit for that period arising from the life fund.[11] The actuarial deficit is subject to any adjustment that the Director General of the Inland Revenue may think fit to make in accordance with the provisions of the ITA 1967.

12. General insurance business

Currently, where an insurer carrying on a general business has:

- reinsured the risk or part of the risk with a reinsurer who either does not carry on the business of insuring risks of that kind in Malaysia or does not reinsure the risk through a branch in Malaysia, or
- reinsured the risk or part of the risk with an insurer licensed under the Offshore Insurance Act 1990,

the deduction in respect of reinsurance premiums is restricted to 95 per cent of the amount which would otherwise be deductible.

To enhance the level of premium retention in Malaysia, it is proposed that with effect from Y/A 1996, the restriction applying to the deduction in respect of reinsurance with an insurer licensed under the Offshore Insurance Act 1990 (i.e. operating in Labuan) be removed.[12]

The Minister also announced the establishment of the "Malaysian Re-International Insurance (Labuan) Limited" with an authorized capital of USD 200 million. This offshore reinsurance company is expected to undertake the reinsurance of domestic risks, to enhance the level of premium retention and to exploit business opportunities in the Asia Pacific region.

These changes are likely to encourage the reinsurance of risk with Labuan companies instead of reinsuring such risks with foreign companies outside Malaysia. It is also likely to assist in cutting down the deficit in the services account.

B. Personal taxation

1. Income tax rates

Currently, resident individuals are subject to income tax at graduated rates from 0 per cent to 32 per cent. With effect from Y/A 1996, the top marginal rate of 32 per cent is to be lowered to 30 per cent (in alignment with the corporate tax rate) whilst all other marginal tax rates will be reduced by either 1 per cent or 2 per cent.[13]

7. Amendment to para. 33 of Sch. 6 of the ITA 1967.
8. Amendment to para. 35 of Sch. 6 of the ITA 1967.
9. This will be gazetted soon by way of a statutory order.
10. The adjusted income of the shareholders' fund is ascertained by taking the aggregate of the income from investments made out of the shareholders' fund, gross proceeds from realization of investments less cost of acquiring and realizing those investments plus an amount of the actuarial surplus for that period arising from the life fund as is apportioned to the shareholders' fund.
11. Amendments to Secs. 60(3A)(b) and 60(4A)(b) of the ITA 1967.
12. Amendment to Sec. 60(7) of the ITA 1967.
13. Amendment to para. 1 of Part 1, Sch. 1 of the ITA 1967.

With this change (together with other reliefs discussed below), approximately 525,000 taxpayers or 37 per cent of total taxpayers will fall out of the tax net. The Inland Revenue Department (IRD) will then be able to concentrate on high income taxpayers as well as on anti-evasion activities. With the change in tax rates,[14] the Schedular Tax Deduction tables applicable to tax deductions in Y/A 1996 will be revised.

2. Contributions to the employees provident fund (EPF)

As a measure to increase savings, the rate of contribution by employees to the EPF is to be increased from 10 per cent to 11 per cent of remuneration with effect from January 1996. However, the relief to a resident individual for life insurance premiums and approved provident fund contributions has remained at MYR 5,000.

3. Reliefs[15]

(a) *Medical expenses for parents*

It is proposed that, with effect from Y/A 1996, the maximum relief in respect of medical expenses incurred for parents is to be increased from MYR 1,000 to MYR 5,000. This is in line with the government's policy of promoting a caring society.

(b) *Basic supporting equipment*

With effect from Y/A 1996, the maximum relief available to a resident individual for expenditure on the purchase of basic supporting equipment for his own use (if he is a disabled person) or for the use of his wife, child or parent (if they are disabled) is to be increased from MYR 3,000 to MYR 5,000.

(c) *Child relief*

In line with the caring society concept and in recognition of the fact that the care of a disabled child involves a high amount of expenditure, the relief for a physically or mentally disabled child (who is unmarried) is to be increased from MYR 1,600 to MYR 5,000 with effect from Y/A 1996.

Currently, a wife who is living together with her husband and whose income is assessed separately is not eligible to claim child relief. With effect from Y/A 1996, a wife will be able to elect in writing for the child relief[16] to be wholly allowed to her for a relevant year of assessment. This proposal will be helpful in specific instances where the husband may not be working or his total income may not be sufficient to utilize the relief. However, there are no provisions for a husband and wife to share the relief.

(d) *Insurance premiums*

Currently, the maximum relief in respect of contributions to approved provident/pension funds and life insurance or *takaful* premiums is MYR 5,000. For life insurance premiums, the relief is restricted to premiums paid by an individual on a life insurance policy contracted for the individual and/or the spouse.

With effect from Y/A 1996, an additional relief of up to a maximum of MYR 2,000 has been proposed to be given to a resident individual in respect of premiums paid for education or medical insurance contracted for by the individual for himself, his wife or child or in the case of a wife, for herself, her husband or child.[17]

This proposal is aimed at encouraging savings for education and health care purposes and by implication to promote the development of the education and health care industries.

4. Exemption of interest income

Currently, interest income earned by a resident individual from savings and fixed deposit accounts is subject to a 5 per cent withholding tax. However, certain types of interest income are exempt (including deposits with Bank Simpanan Nasional, etc.).

With effect from 1 January 1996, in order to further encourage savings, tax exemption is to be given on interest income received by resident individuals on savings and fixed deposit accounts with financial institutions as follows:
- savings accounts up to MYR 100,000;
- fixed deposits of less than 12 months; up to a maximum of MYR 100,000;
- fixed deposits of 12 months or more; no restriction on the amount of deposit.

The exemption also applies to gains on savings and investment accounts under the Interest Free Banking Scheme. In addition, non-resident individuals are not subject to tax on interest income paid or credited by licensed Malaysian finance companies (discussed earlier).

C. Investment incentives

1. Operational headquarters company (OHQ)

Income derived by an approved OHQ from the provision of qualifying services is taxable at the rate of 10 per cent. Qualifying services include the provision of treasury and fund management services to its offices outside Malaysia or its related companies outside Malaysia.[18]

In the 1995 Budget, it was announced that OHQs were allowed to borrow freely in foreign currency or in *ringgit* up to MYR 10 million for any use in Malaysia. In line with the OHQ guidelines issued by the Ministry of Finance, it is now proposed to legislate, with effect from Y/A 1995, that the funds for providing credit facilities may be obtained from

14. It should be noted that Malaysia's personal tax rates are comparable with other jurisdictions in the Asia Pacific region.
15. Amendments to Secs. 46, 48, 49 and 50 of the ITA 1967.
16. It is proposed that the definition of a child (for purposes of child relief) be extended to include a legitimate child, step-child and adopted child of a wife.
17. Where a wife makes an election for combined assessment, a further deduction of up to the lower of MYR 2,000 or the actual premiums paid by the wife will be allowed to the husband. However, if the wife does not have any total income, the deduction for her and her husband's education or medical insurance premiums is limited to a maximum of MYR 2,000.
18. Where such services include the provision of credit facilities, the funds for providing such facilities must be obtained from outside Malaysia.

sources outside or within Malaysia. However, the funds obtained from within Malaysia cannot exceed MYR 10 million.[19]

Currently, a related company is defined to include a company in which the OHQ has a 20 per cent shareholding or one which owns at least 20 per cent of the issued share capital of the OHQ. This definition is to be revised,[20] with effect from Y/A 1995, to only cover

- a company which controls or can control the OHQ;
- a company which the OHQ controls or can control; or
- a company which is or can be controlled by a company which controls or can control the OHQ.

2. Foreign fund management company[21]

Currently, fund management companies in Malaysia are subject to the normal corporate tax rate of 30 per cent. In view of Malaysia's desire to attract foreign fund management companies here, it is proposed that with effect from Y/A 1996, a foreign fund management company[22] will be subject to a reduced rate of 10 per cent on its chargeable income derived from the provision of fund management services to foreign investors.

Where a foreign fund management company provides fund management services to both foreign[23] and local investors, the income derived from the provision of those services to each of these categories of investors will be treated as arising from separate and distinct business sources.

The chargeable income from the source consisting of the provision of fund management services to foreign investors for a year of assessment is the statutory income (after capital allowances) from that source after deduction of brought forward business losses relating to that source.[24]

The chargeable income from the provision of fund management services to foreign investors after deduction of the 10 per cent tax thereon will form the exempt account of the company from which tax free dividends can be declared on a two-tier basis.

The above proposals are part of a package of measures designed to promote the fund management industry and the capital market. The Securities Commission has already issued guidelines on the establishment of foreign fund management companies.

3. Incentives for the wafer fabrication industry

Recognizing that wafer fabrication represents a strategic step in the development of a high technology sector, the following incentives and concessions to develop the industry have been proposed:

- pioneer status or investment tax allowance for a period of 10 years or more;
- special grants for the training of Malaysian engineers and scientists;
- provision of special resources; for instance the uninterrupted supply of electricity, clean water, toxic waste storage facilities and the construction of electric sub-stations;
- recruitment of foreign engineers and scientists as required; and
- other fiscal incentives (to be specified later).

4. Incentives for reconditioning heavy machinery and equipment

Currently, the Malaysian construction sector continues to depend heavily on the import of new machinery and equipment such as bulldozers, excavators, pile-drivers and tower cranes.

The government's aim is to reduce this dependence and revitalize old machinery and equipment. In an effort to encourage the use of the reconditioned machinery and equipment as well as to promote the development of domestic machinery and engineering industries, the 1996 Budget proposes to include the activity of reconditioning heavy machinery and equipment as one of the promoted activities under the Promotion of Investments Act 1986.

The companies undertaking such activities will be eligible for either Pioneer Status or the Investment Tax Allowance for a period of five years.

5. Double deduction on promotion of export of services

Currently, the double deduction incentive applying to expenses incurred for the promotion of exports is available to manufacturing companies, hotels and tour operators.

It is proposed that, from Y/A 1996, this double deduction incentive be extended to the entire service sector. The expenses eligible for double deduction are as follows:

(i) export market research;

(ii) preparation of tenders for the supply of services overseas;

(iii) supply of technical information abroad;

19. Amendments to Sec. 60E(7) of the ITA 1967.
20. Id.
21. Via introduction of Sec. 60G and Part IX to Sch. 1 of the ITA 1967.
22. A "foreign fund management company" means a company:
- incorporated in Malaysia and licensed under the Securities Industry Act 1983; and
- (i) where the issued share capital is wholly foreign owned and provides fund management services to foreign investors only; or
- (ii) where the issued share capital is mainly foreign owned and provides fund management services to foreign and local investors.

23. "Foreign investors" is defined to mean:
- individuals who are not resident and not citizens of Malaysia;
- companies where the entire issued share capital is beneficially owned, directly or indirectly, by persons who are not resident and not citizens of Malaysia: and
- trust funds where the entire interest in the fund is beneficially held, directly or indirectly by foreign investors, where;
- (i) the fund is created outside Malaysia; and
- (ii) the trustees of the fund are not resident and not citizens of Malaysia.

24. The chargeable income derived from a source or sources other than the provision of fund management services to foreign investors shall be the statutory income from that source or the aggregate of the statutory income from each of those sources, reduced by brought forward and current year losses relating to those sources, other relevant allowances and approved donations. In this connection, an adjusted loss, if any, from the source consisting of the provision of fund management services to foreign investors will not be deductible in arriving at the chargeable income of the other source or sources.

(iv) fares incurred in respect of overseas business travel by company' employees;
(v) accommodation and the cost of food incurred by Malaysian businessmen going overseas for business, subject to MYR 200 per day for lodging and MYR 100 per day for food; and
(vi) the cost of maintaining an office overseas for the purpose of promoting services.

It is expected that the IRD will approve and monitor claims for the double deduction. This incentive is aimed at encouraging local service providers to be more dynamic and to compete with foreign service providers.

6. Reinvestment allowance[25]

Currently, reinvestment allowance (RA) is given to resident manufacturing companies undertaking expansion, modernization and diversification activities. The current rate of RA is 50 per cent of qualifying capital expenditure. The allowance is given at the adjusted income level (before capital allowances) and can reduce adjusted income to nil. The amount of RA utilized is transferred to an exempt account from which tax exempt dividends can be paid.

To rationalize this major incentive and align it to the provisions relating to the pioneer and investment tax allowances, it is proposed that from year of assessment 1997:
- the rate of RA be increased from 50 per cent to 60 per cent;
- the RA deduction be granted from the statutory income (after capital allowances) i.e. no longer at the adjusted income stage;
- the utilization of RA for each assessment year will be restricted to 70 per cent of statutory income. The balance of statutory income will be taxed at the prevailing rate. Any unabsorbed RA will be carried forward for set off in future years until it is fully utilized;
- qualifying projects in designated areas, that is the eastern corridor of Peninsular Malaysia,[26] Sabah and Sarawak, are not subject to the 70 per cent ceiling for each year of assessment and may deduct RA of up to 100 per cent of statutory income.

To encourage local food production and thus assist in increasing supply, it is proposed that RA be extended to the agricultural sector. Where on or after 1 January 1996, a Malaysian-resident company has incurred capital expenditure in relation to a qualifying (agricultural) project[27] in Malaysia, it is entitled to RA. However, no entitlement to RA is available if the company has been granted a deduction against aggregate income under Schedule 4A (expenditure on an approved agricultural project) in respect of capital expenditure or if it has been granted pioneer status, investment tax allowance or industrial adjustment allowance.

A qualifying project within the agricultural sector is an agricultural project undertaken by a company for the purpose of expanding, modernizing or diversifying its cultivation and farming business.

7. The services sector

Currently, selected activities in the services sector are granted tax incentives e.g. the hotel and tourism sector are eligible for pioneer status and investment tax allowance. As the services sector contributes significantly to the economy and can play a vital role in reducing the services deficit, the government has extended tax incentives to approved service projects (ASP) with effect from Y/A 1996. ASP are projects in the services sector in relation to transportation, communications, utilities or any other sub-sector as approved by the Minister. The emphasis on these sub-sectors is consistent with the government's privatization policy.

Resident companies undertaking ASP qualify for either income tax exemption under Section 127 or Investment Allowance (IA) under Schedule 7B of the ITA 1967. These two incentives are mutually exclusive.

The tax exemption under Section 127 for companies undertaking ASP is summarized in the table below:

	Exemption period	Percentage of statutory income exempt from tax	Percentage of statutory income subject to tax
Companies Undertaking ASP	5 years	70%	30
Companies undertaking ASP in Sabah, Sarawak and designated eastern corridor of Peninsular Malaysia	5 years	85%	15%
Companies undertaking ASP of national and strategic importance	10 years	100%	NIL

The statutory income exempt from tax is credited to an exempt income account from which tax-free dividends can be distributed to the shareholders.

Capital allowances on expenditures incurred on qualifying plant and buildings have to be utilized during the exemption period i.e. any unutilized capital allowances cannot be carried forward to the post exemption period. In addition, any unabsorbed losses existing at the end of the exemption period cannot be carried forward for set-off against the profits of the post exemption period.

A company undertaking ASP may apply for an IA[28] instead of exemption of income. The following table summarizes aspects of this incentive.

25. Amendments to Sch. 7A of the ITA 1967.
26. The eastern corridor of Peninsular Malaysia refers to the States of Kelantan, Terengganu, Pahang (not including the Districts of Lipis, Raub, Jerantut and Cameron Highlands except for the industrial areas approved by the state government), and the District of Mersing in the state of Johore.
27. Capital expenditure in relation to an agricultural project means capital expenditure in respect of the clearing and preparation of land, the planting of crops, the provision of irrigation or drainage systems, the provision of plant and machinery, the construction of access roads including bridges; or the construction or purchase of buildings (including those provided for the welfare of persons or as living accommodation for persons) and structural improvements on land or other structures for the purpose of cultivation of rice and maize, cultivation of vegetables, tuber and roots, cultivation of fruits, livestock farming, spawning, breeding or culturing of aquatic products, and any other activities approved by the Minister.
28. Via introduction of Sch. 7B of the ITA 1967.

	Qualifying period	Rate of IA on capital expenditure	IA utilized against percentage of statutory income exempt from tax	Percentage of statutory income subject to tax
Companies undertaking ASP	5 years	60%	70%	30%
Companies undertaking ASP in Sabah, Sarawak and designated eastern corridor of Peninsular Malaysia	5 years	80%	85%	15%
Companies undertaking ASP of national and strategic importance	5 years	100%	100%	NIL

The statutory income exempt from tax is credited to an exempt income account from which tax-free dividends can be distributed to the shareholders. The exemption is a two-tier one like most other exemptions. Any unutilized IA remaining at the end of the qualifying period can be carried forward to subsequent years until it is fully utilized.

The capital expenditure which qualifies for IA in relation to an ASP is capital expenditure incurred on plant, machinery, fixtures, premises, buildings, structures or works, of a permanent nature.[29] Any expenditure incurred prior to the date of commencement of business is deemed to be incurred on the day the business commences.

In addition to the above incentives, companies undertaking an ASP can also enjoy the following additional incentives:

(i) industrial buildings allowance on capital expenditure incurred on the construction or purchase of a building wholly or partially used solely for the purpose of the provision of services and modernization of operations in relation to an ASP; and

(ii) exemption from customs duties and sales tax on imported materials and machinery which are not available locally as well as exemption from sales tax and excise duty on locally purchased materials and machinery so long as such items are direct inputs in the implementation of an ASP.

8. Labuan[30]

A Labuan offshore company that carries on an offshore business activity is liable to tax at the rate of 3 per cent on its net profits. The company may, by election, limit its tax liability to a maximum of MYR 20,000. Currently, a Labuan offshore company that is engaged in petroleum operations does not enjoy this preferential tax treatment as petroleum operations are not regarded as an offshore business activity.

In a move to enhance the position of Labuan as an international offshore financial centre and to attract oil exploration companies to use Labuan as a base for their regional oil exploration and other activities, petroleum operations will be regarded as an offshore business activity with effect from Y/A 1996.

Further, the definition of "offshore business activity" will also be amended to allow offshore companies that have been approved by the Minister to invest in domestic Malaysian companies (i.e. invest in Malaysian securities) even if such transactions are transacted in Malaysian *ringgit*. This move to allow investments in domestic companies through portfolio and collective investment schemes is intended to encourage the establishment of offshore investment funds in Labuan.

D. Petroleum income tax[31]

1. Contributions to approved schemes

Currently, the maximum deduction for contributions to the EPF and other approved schemes is 16 per cent of the employees' remuneration.

With effect from Y/A 1996, the maximum deduction is to be increased to 17 per cent. This is in line with the maximum rate proposed under the ITA 1967.

2. Equipment for disabled employees

It is proposed that, with effect from Y/A 1996, expenditure incurred on the provision of equipment necessary to assist any disabled employee in the carrying out of his duties be allowed as a deductible expense against gross income in the year the expenditure is incurred.

This proposal is intended to be consistent with the provisions in the ITA 1967 where such expenditure was deductible from year of assessment 1992.

E. Real property gains tax

1. Tax Rates[32]

Currently, a chargeable gain arising on the disposal of a chargeable asset by an individual (including a non-citizen and non-permanent resident) or others is subject to real property gains tax (RPGT) at rates ranging from 5 per cent to 20 per cent depending on the period of ownership. However, disposals by individuals in the sixth year and thereafter is not subject to RPGT.

In an effort to curtail speculative real property transactions, it is proposed that the RPGT rates be increased with effect from 27 October 1995 as follows:

29. It does not include capital expenditure incurred on buildings, plant or machinery which are provided for the use of a director or an individual who is a member of the management, administrative or clerical staff.

30. Amendment to Sec. 2 of the Labuan Offshore Business Activity Tax Act, 1990.

31. Amendments to Sec. 16 of the Petroleum (Income Tax) Act, 1967.

32. Amendment to Sch. 5 of the Real Property Gains Tax Act, 1976.

	Existing Rates %	Proposed Rates %
Disposal within two years of acquisition	20	30
Disposal in the third year	15	20
Disposal in the fourth year	10	15
Disposal in the fifth year	5	5
Disposal in the sixth year and thereafter:		
Companies	5	5
Others	0	0

Individuals who are not citizens and not permanent residents in Malaysia will be subject to a flat rate of 30 per cent on gains arising from the disposal of chargeable assets acquired after 27 October 1995. For properties acquired before that date, such individuals will be taxed based on the proposed scale rates set out above.[33]

The position of non-citizens and non-permanent residents is now similar to that which existed in the period from 17 October 1980 to 23 October 1986 where a flat rate of tax (40 per cent) was imposed on the disposal of a chargeable asset acquired after 17 October 1980.

2. Levy on property acquisitions

In mid-1995, the Foreign Investment Committee announced that foreigners would not be permitted to invest in residential properties costing MYR 250,000 or less subject to a variation in the ceiling limit for certain areas such as Kuala Lumpur, Penang and Johore.

Loans for the purchase of houses and apartments costing more than MYR 150,000 and shop lots costing over MYR 300,000 are subject, since October 1995, to a margin of financing not exceeding 60 per cent of the price of the property.

In a move to further dampen speculation in real property, it is proposed that, from 27 October 1995, a levy of MYR 100,000 be imposed on every purchase of real estate by foreign interests. The collection of the levy would be by state governments. It is expected that foreign interests will include companies controlled by foreigners.[34]

F. Stamp duty[35]

1. Adjudication fee

With effect from 1 January 1996, the adjudication fee in respect of an executed instrument is to be increased from MYR 1 to MYR 10. This is purely a proposal to produce additional revenue. An adjudication fee is payable when a person seeks the opinion of the Collector of Stamp Duty as to the quantum of duty chargeable on an executed instrument.

2. Contract notes

The rate of stamp duty applicable on contract notes relating to the sale of any shares, stock or marketable securities in companies incorporated in Malaysia or elsewhere has been decreased from MYR 1.50 to MYR 1.00 for every MYR 1,000 or part thereof of the value of the shares, stock or marketable securities. This change is effective from 1 July 1995.[36] This proposed amendment is to give legal effect to the announcements (including lowering of stamp duty) made in mid-1995 by the Minister when he introduced a package of measures to promote Malaysia as a regional financial centre.

3. Syariah financing schemes

Currently, the instruments executed for the purpose of converting from conventional housing financing to Syariah-based financing are exempted from stamp duty. However Syariah hire-purchase agreements attract duty at *ad valorem* rates whereas conventional hire purchase agreements are only liable to a fixed duty of MYR 3.

In order to standardize duties and to increase the attractiveness of converting to Syariah financing schemes, it is proposed that from 1 January 1996:

(i) all instruments executed in connection with the conversion from conventional financing to Syariah-based financing be exempted from stamp duty; and

(ii) stamp duty on hire-purchase agreements for the purchase of consumer goods based on the Syariah be restricted to MYR 3.

G. Indirect taxation

1. Import duties

With effect from Budget day, import duties on some 800 items of raw materials/components and equipment have been abolished. As a measure to control inflation caused by rising food prices, these exemptions from import duties include specific equipment and inputs that are directly used in the production of food. Duties on around 710 items were also reduced in line with the objective to reduce tariff protection in order to enhance the efficiency of local manufacturers.

In addition, duties on specific items were reduced in line with Malaysia's commitment to the World Trade Organization and the ASEAN Free Trade Area to progressively reduce tariffs.

Duties on all basic medical equipment were abolished so as to promote better health care. It was also announced that exemption from duties on broadcasting equipment and production/post production equipment for the film and music industry will be given so as to promote the local broadcasting industry.

33. This change in the rates is a good move which many felt should have been introduced a year ago when property prices were already moving upwards rapidly. It is felt that once the property market has stabilized, the rates would be lowered.
34. Further details should be forthcoming soon.
35. Amendments to Sec. 36(1) and the First Sch. to the Stamp Act, 1949.
36. The lower stamp duty has been collected by stockbrokers since 1 July 1995.

2. Export duties

As a measure to ensure that the export of processed palm oil continues to be competitive in the international market, it is proposed that export duty on this product be suspended for a period of one year from 1 November 1995.

3. Sales tax

As an incentive to encourage the use of computers by the private and public sectors so as to modernize their operations, sales tax on computer hardware and software has been abolished as from Budget day. Further, sales tax on basic medical equipment has also been abolished. In addition, sales tax on around 250 items was removed so as to minimize the cost of construction and packaging.

4. Entertainment duty

It has been proposed that admissions to stage plays organized by local theatre groups in the Federal Territories of Kuala Lumpur and Labuan be exempted from entertainment duty. The Minister expressed the hope that state governments would extend the same exemptions in their respective states.

5. Sales and service tax (SST)

The much talked about SST was given a miss again this year. Once again, the service tax base was not widened. No mention was made in the Budget about SST. Thus, no time frame for its introduction is available. However, the Finance Ministry is working on the draft legislation and held a dialogue session in July 1995. It is being speculated that 1997 will be the year in which SST is implemented. Meanwhile, the suspense continues!

H. Other changes

1. Foreign workers levy

In order to stem the inflow of foreign labour, it is proposed to increase the levy on foreign workers, with effect from 1 January 1996, by more than 100 per cent. The levy on unskilled workers is increased from MYR 360 to MYR 840 per year and for semi-skilled workers from MYR 540 to MYR 1,200 per year. This increase does not apply to domestic helpers and unskilled workers in the agricultural sector. Where the foreign workers are subject to income tax, the levies paid will be refunded by the Immigration Department.

This move is aimed at trying to reduce the dependence on foreign workers and to accelerate the shift from labour intensive to high technology and capital intensive processes.

2. Goods vehicles levy

In order to promote the utilization of domestic ports, the levy on goods vehicles whether laden or empty leaving the country will be increased from MYR 100 to MYR 200 per vehicle with effect from 1 January 1996. However, goods vehicles transporting perishable goods are excluded from the increase. The 1996 Budget also proposes to impose a levy of MYR 100 on goods vehicles entering Malaysia other than empty goods vehicles. However, goods vehicles carrying exempted goods mentioned in Schedule II of the Goods Vehicle (Exemption) Order 1983 will be exempted from the levy. The number of exempted goods as mentioned in Schedule II has been substantially reduced from 94 items to 27 items.

3. Road tax

For cars above 2,000 cc, there will be a 25 per cent increase in the road tax with effect from 1 January 1996. Road tax on company owned petrol engine cars will be increased from two to three times the rate applying to privately owned cars. As for company-owned diesel passenger cars, the rate remains at two times the current road tax applicable to privately owned diesel cars. However, for the new generation diesel engine cars, the rate is 50 per cent of that currently chargeable on diesel engine cars.

4. Airport tax

Currently, the airport tax on overseas travel through Malaysian airports is MYR 20. With effect from 1 January 1996, the tax will be doubled to MYR 40. Besides being a revenue generating proposal, this is also intended to encourage Malaysians to visit local tourist destinations rather than to travel abroad for holidays.

III. OTHER DEVELOPMENTS

A. Assessment of rental income derived from real property

Rental income from buildings may be regarded as income from a business or non-business source depending on the facts and circumstances. Where income from the rental of real property is considered as business income, capital allowances in respect of qualifying expenditure may be claimed.

Based on the guidelines recently issued by the IRD, income derived from the rental of properties in the circumstances shown below will be treated as income derived from a business source:

(a) Commercial buildings
  i. 3 units and above; and
  ii. total area of 92,9 square meters (1,000 square feet) or more.

  Examples of commercial buildings are factories, warehouses, shopping complexes and office buildings.

(b) Shops
  i. 2 units and above; and
  ii. located in a commercial area.

(c) Dwelling houses/Apartments/Condominiums
  i. 4 units and above; and

ii. the dwelling houses/apartments/condominiums rented out[37] are always properly maintained.

(d) Mixture of residential houses and shops/Commercial buildings

Should the requirements of any one category above not be met, the rental income would be treated as non-business income.

A "unit" means an ordinary/standard lot of the type found in shopping complexes and office buildings.

These guidelines do not preclude appeals from taxpayers against assessments raised in accordance with the guidelines.

B. Double tax agreements

As at the end of Y/A 1995, Malaysia had concluded 42 double tax agreements (inclusive of the limited agreement with the United States). The three new agreements that were signed during the period were with Jordan, Mongolia and Turkey.

C. Interest restriction

In the case of *P Securities Sdn Bhd v. Director General of Inland Revenue* [(1995) 2 MSTC 2256], the taxpayer had financed the acquisition of shares with a loan. The taxpayer was assessed to income tax on dividends received from share investments on the basis that each share investment counter constituted a separate source of income. A deduction was allowed by the IRD only for the portion of interest expense attributed to income (dividend) producing counters.

The Special Commissioners held that the IRD was not empowered to treat each counter as a separate source of income and that the total interest incurred was deductible against the dividends received. This decision, goes against the interest restriction guidelines introduced some time ago. However, this case is currently on appeal to the High Court.

D. Inland Revenue Board

Although the necessary legislation has been enacted, due to a number of technical issues the proposed Inland Revenue Board has still not been formed as at 31 December 1995. The middle of 1996 is now a more likely date for its formation.

E. Labuan

To promote the development of Labuan as an international offshore financial centre, the government has proposed the following measures:

- permitting money broking houses to be set up on the island and allowing local fund managers to form joint ventures with their foreign counterparts. These moves will facilitate the establishment of an international financial exchange in Labuan;
- establishing a single authority to regulate Labuan as a financial centre;
- extending the deadline for offshore banks and insurance companies which currently operate from Kuala Lumpur to move to Labuan from 31 December 1995 to 31 March 1996;
- permitting offshore banks and insurance companies in Labuan to have marketing offices in Kuala Lumpur;
- allowing offshore banks to receive fees and commissions in *ringgit* arising from *ringgit*-denominated transactions; and
- allowing offshore life insurers to sell foreign currency denominated policies to high net worth Malaysian individuals.

F. Service tax

With effect from 20 July 1995, an amendment to the Service Tax Act provides that service tax is only due to the authorities when the payment for the services or goods is received (and not when the services or goods are provided). Where the amount receivable is outstanding for six months from the date of issue of the invoice, the service tax is due on the day following that six-month period, and the taxable person must remit the service tax to the authorities within 28 days following the end of the taxable period within which that day falls.

IV. CONCLUSION

Overall, the 1996 Budget can be described as a pragmatic and substantive budget which has an impact on almost all sectors of the economy. The Budget's main objective is to provide a framework in which growth may be managed successfully. The estimated loss of MYR 437 million through the various tax reductions is expected to be made up through increased tax revenue due to the buoyant economy. The Budget was noteworthy in the sense that the service sector received much attention. A lot more should be done in the future if the deficit in the services account is to be reduced.

Given the strong fundamentals and the reasonable growth in other economies, it is expected that 1996 will be another good year for the country. However, subsequent budgets will probably involve some attempts to slow down growth to more sustainable levels.

REFERENCES

1. 1996 Budget Speech
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3. MACPA, *1996 Budget Commentary & Ready Reckoner*, Kuala Lumpur, 1995.
4. Ministry of Finance, *Economic Report 1995/96*, Kuala Lumpur.

37. Dwelling houses/apartments/condominiums rented out exclude those rented out to staff and directors of the company.

AFRICA

African Development Bank Workshop on Tax Reforms in Africa

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I. INTRODUCTION

The African Development Institute (ADI) of the African Development Bank (ADB) organized a workshop on Economic Management and Tax Administration for policy makers in Nairobi, Kenya from 4th to 15th September 1995. The seminar was organized[1] for tax administrators from English-speaking African countries.[2] The workshop was in two major parts: part 1 comprised introductory lectures by facilitators[3] who led the discussions, while in part 2 the participants from each country presented country papers on various subjects. It emerged from the presentations made that tax reform was an important element of the economic reforms which virtually all of the countries represented at the Workshop were implementing. As such, there were a number of common features in the programmes which most of the delegates present were personally involved in administering.

II. TAXATION AND FISCAL MANAGEMENT

The papers presented on macroeconomics dwelt on the relevance of taxation for efficient fiscal management on the continent. The discussions in this area centred mainly on the causes and consequences of central government fiscal deficits. In particular, these deficits were observed as fuelling increases in money supply as well as causing the high rate of interest in many Sub-Saharan African (SSA) economies. The alternative method of financing the deficit through money market operations was also identified as causing distortions in interest rates as well as adversely affecting the availability of credit to the private sector.[4] Finally, participants agreed that the reliance on monetary institutions to finance the deficit could contribute to a false sense of fiscal security on the part of governments and consequently lead to the undue postponement of important fiscal measures, including tax reforms.

It was generally agreed that some African countries engaged in extravagant expenditure patterns which aggravated their fiscal crises. Often, the criticisms of the excessive level and pattern of expenditure resulted in compliance problems for tax administrators. This is because the perceptions about waste tend to adversely affect the willingness of the citizens of a country to contribute their fair share of taxes. The general view among participants was that in most cases, these excessive levels of government expenditure could be curtailed by restricting the activities of government to the provision of pure *public goods*. It was observed that this recommendation need not *unduly* diminish the role of SSA governments in acting as catalysts for development.

Notwithstanding the validity of the points raised regarding the level and pattern of expenditure, the critical fiscal situation in most SSA countries could also be attributed to difficulties encountered in raising domestic tax revenue. The main factors include the inefficient structure of the tax regime, its very narrow base, weak tax administrations and the tendency in many of the SSA countries to rely excessively on external aid and grants. Finally, in line with the current democratization of political systems on the continent, participants expressed the need for tax administrators in Africa to contribute to responsible and effective public sector management practices. This would not only improve the accountability of governments but enhance the relationship which taxpayers develop with revenue agencies.

III. THE PATTERN OF REVENUE GENERATION

The review of the sources of revenue clearly indicated that most African countries derive their revenue from the known traditional sources – income tax, international and domestic trade taxes, excise duties and non-tax revenue (user charges, aid and grants). The few exceptions were the oil-producing states such as Nigeria and countries such as Malawi which rely heavily on external assistance. In a review based on the IMF International Financial and Government Statistics i.e. IFS and GFS (1986 to 1992), it was observed that African

1. The Japanese Government gave assistance in organizing the workshop.
2. The countries represented include Nigeria, Ghana, Kenya, Uganda, Lesotho, Zimbabwe, Sudan, Ethiopia, Eritrea, Egypt, Tanzania, Swaziland, and Zambia.
3. The facilitators included Seth Terkper, Ghana; Gini Mbanefoh, Nigeria; Mike Obadan, Nigeria; Graham Glenday, Economic Adviser, Kenya; P.O. Andah, Ghana and R.E. Ubogu, African Development Bank.
4. This is because it diverts loanable funds from the private to the public sector.

countries generated over 6 per cent of GDP or 35 per cent of total taxes from import and export duties alone. This compared with less than 1 per cent and 4 per cent respectively for OECD and non-OECD Asian and Western Hemisphere countries. On the other hand, for most African countries, the broad based revenue sources such as income tax and VAT contributed only 5.7 per cent and 3 per cent of GDP respectively. The total tax/GDP ratio for Africa was 17.7 per cent, compared with the OECD's 30.4 per cent and 27.3 per cent for Eastern Europe/Former Soviet Union (FSU) countries. The non-OECD Asian and Middle Eastern countries were, however, observed to have low tax/GDP ratios viz. 14.1 per cent and 13.6 per cent.

There were significant differences in the pattern of revenue generation among the African countries themselves. Botswana (31.4 per cent), South Africa (25.5 per cent) and Zimbabwe (29 per cent) had the highest tax/GDP ratios. The rest of the countries had ratios which hovered around the 17.7 per cent average for the continent. A remarkable point about the general statistics was the gradual elimination of export duties by many SSA countries. Only a few countries such as Ghana (2.9 per cent of GDP) and Ethiopia (1.6 per cent of GDP) continue to rely on exports for a significant share of total tax revenue.

Over half of the sample of countries used in the survey derived over 5 per cent of GDP from corporate taxes. This is because nearly all of the countries surveyed relied on the formal sector for raising a large proportion of revenue. This trend reflected clearly in the level of income tax raised from the corporate sector – on average 17.1 per cent of total tax revenue, compared with only 11.4 per cent from individual income taxes (predominately wage taxes).[5]

As noted above, nearly all SSA countries rely on income tax on wages and corporate profit and international trade and excise taxes for a substantial share of their revenues. In contrast, the contribution of property, social security and payroll taxes is relatively insignificant. These taxes were only recorded in Ethiopia, Gambia, South Africa and Zambia and in all cases brought in less than 1 per cent of GDP. Non-tax revenue featured differently among the countries. For example, Botswana derived over 25 per cent of GDP from this source, compared with only 3.4 per cent and 1.4 per cent of GDP for Zimbabwe and Ghana respectively. The average amount raised from non-tax revenue for the whole continent was 4 per cent.

IV. REVIEW OF TAX REFORMS

Currently, almost every country in Africa is implementing economic reforms which incorporate extensive reviews of the tax structure. The involvement of institutions such as the IMF and the World Bank has contributed to similar principles being applied to the reform process in most countries. At the ADB seminar in Nairobi, most attention was focused on the restructuring of indirect tax regimes. This could be attributed to the reliance of most of the countries represented on trade and excise taxes for a substantial share of their revenues. Another reason was the relative importance of Value Added Tax in current tax reform programmes on the continent.

A. Value Added Tax (VAT)

Virtually all the countries represented either had converted or were in the process of converting their sales tax regimes to VAT. However, the change was not just about replacing the "suspension" or deferral of tax (the "ring") system with a "credit" mechanism. Many of the SSA tax systems were being broadened by extending what used to be manufacturing stage sales taxes to the retail and service sectors. This measure is intended to make the domestic indirect tax regime more buoyant and equitable. Furthermore in general, the introduction of VAT often removes economic distortions because it eliminates the "cascade" element from existing Sales Tax regimes.[6] Thus, VAT contributes to making the tax structure more efficient.

Kenya which had a VAT system running for almost five years[7] was the group's obvious flag bearer. VAT in Kenya was described as being "about 90 per cent complete", implying that the tax could become fully operational in about three years time. The tax officials who represented that country, were optimistic that the implementation of VAT had helped diversify and improve the tax system in their country. Its contribution to revenue had gradually outstripped the collections from both income tax and customs duty. However, the piecemeal approach to the design and implementation of the tax in Kenya over a period of nearly five years contrasted with the relatively more comprehensive programmes which countries like Ghana, Uganda, Zambia and Tanzania had either adopted or were in the process of implementing.

Participants had the opportunity to discuss the merits and demerits of the piecemeal and comprehensive approaches to implementing VAT. The case of Ghana which suspended the implementation of a comprehensive VAT in June 1995 after only three months clearly suggested that there could be massive political and social risks to a swift and all-inclusive overhaul of any tax regime. Interestingly, Ghana's abortive attempt at introducing VAT could also be subscribed to a lack of comprehensiveness in tax reform. The main reforms, other than the introduction of VAT, took place in the 1980s. Thus, the benefits of a low tax burden derived from many of these changes (e.g. the general reductions in direct and indirect tax rates) became too remote to make any major impression on a sceptical population.[8] Notwithstanding Ghana's experience, it was the view of participants that provided that there was enough public education and political will to support these

5. The other component of the formal sector is the taxes derived from wages and salaries. It is well established that the bulk of the revenue from individual income taxes comes from wages and salaries, with very little contribution from the self-employed sector. However, the revenue from individual income taxes (11.4 per cent) from the IFS statistics was not desegregated to show the more difficult self-employed sectors e.g. distribution and services.
6. These regimes are partial turnover tax systems.
7. Kenya introduced the VAT on 1 January 1990.
8. For a general review and reasons for the failure of VAT in Ghana, see Seth Terkper, VAT In Ghana: Why it Failed, *Tax Notes Int'l*, forthcoming.

comprehensive reform programmes, the social upheavals which led to the suspension of the tax in Ghana could be averted.

The striking thing about the content of all the VAT programmes which were reviewed in Kenya was their similarity. The main features include a conversion of the "ring" system to a credit mechanism, the adoption of a single positive rate of VAT, zero-rating of exports, providing for only a minimum number of exemptions and the broadening of the tax base to incorporate the retail and service sectors. However, not surprisingly most of these components were found to be difficult to implement in practice. This is particularly so with the reforms which were faced with pressure from political, social and economic lobbies. For example the policy of zero-rating exports of taxable supplies was implemented in many of the countries, however in Kenya and Uganda the laws suggest that a number of domestic supplies were also to be zero-rated.

Also noted was the fact that although Kenya began with a multiple rate VAT structure, the majority of goods were now covered under the standard 15 per cent rate. Nigeria's VAT rate of 5 per cent was found to be the most tolerable from the point of view of marketing the tax. However, participants were of the view that few countries, if any, could afford to emulate such a low rate of VAT.[9]

The aspect which posed the most difficulty for many SSA countries in their design of a comprehensive VAT regime was the tendency for most legislatures to include a large number of supplies and charitable organizations in the *exempt* schedule. It defeated the desire of most of these countries to consciously use VAT as an instrument for expanding the tax base for domestic indirect taxes. For countries such as Lesotho, Sudan and Eritrea which were yet to carry out any major review of domestic indirect taxes, a simple structure incorporating all the features previously discussed, was recommended. For example in the case of Zimbabwe which already had a workable retail-cum-service-stage sales tax[10], the main task for the future was identified as converting from the "ring" to the invoice-credit mechanism.

Various potential problems with implementing VAT in SSA countries were also highlighted. As noted earlier, the most remarkable case was Ghana which had to suspend its entire programme after only three months. It was noted that the decision to revert to the sales tax regime in Ghana had more to do with harnessing a consensus on the future trend in general economic reforms than any real problems associated with the technical design of VAT. The problem most countries faced was pressure to implement a low rate of VAT whilst retaining the large number of exemptions which existed under previous sales tax regimes. Provided it was feasible in the countries contemplating the move, then Nigeria's low federal VAT rate was often cited as a good strategy for easing the pressure which politicians were likely to face in introducing VAT.

There was little doubt at the end of the seminar that contemporary tax reform programmes in SSA relied on VAT to diversify the tax base, improve record-keeping and enhance efficiency by eliminating much of the cascading associated with turnover and sales tax regimes. It was also agreed that the major problems of illiteracy and lack of record-keeping could be effectively minimized by fixing a VAT *registration threshold* which was high enough to exempt most small-scale retailers from the tax. However, it was the consensus that this should not distract from the need to consciously implement programmes designed to gradually improve the tax systems of the developing countries.

B. Tariffs and excise duties

The dependence of almost all SSA states on tariff and excise duties to generate substantial amounts of revenue was identified as one of the critical factors underlying their inability to reduce the level of rates for these taxes. Of late, however, many of the SSA countries have been compelled to reduce the level of such taxes because of the need to liberalize trade and therefore open up their economies to external competition. These tariff reduction measures are indispensable to the trade liberalization programmes which seek to improve the efficiency of domestic industries. Thus the usefulness of tariffs as convenient "tax handles" for raising revenue appears to be threatened by the measures taken to liberalize trade. This pressure to reduce tariffs is probably a major factor influencing the increasing importance of VAT as a viable alternative for raising revenue in many developing countries.

Participants also reflected on the emerging use to which excise duties could be put, notably to control pollution. This was felt to justify the increasing importance of petroleum excise duty in many countries. However, the delegates realized that the recent reductions in the world market price for crude oil appear to make the petroleum excise tax policy in many SSA countries expedient rather than the well-considered "green" tax which pertains in developed economies. In this regard, the forum felt inclined to caution countries to avoid substituting the petroleum excise tax for the declining single-commodity taxes (such as export duties). It is important for all countries to aim at gradually improving broad-based consumption expenditure and income taxes.

The conclusions of the workshop clearly indicate that many SSA countries have been reducing the rates of tariffs and excise duties in addition to eliminating a number of ad hoc international trade taxes which are now considered obsolete. A typical example being the measures taken to abolish the import licence and super sales taxes in Ghana. Finally, participants observed that in the long run, emerging institutions on the African continent, e.g. the Economic Community of West Africa States (ECOWAS) and the Southern Africa Development Cooperation Council (SADCC) could add to the pressure from global organizations like the World Trade Organization (WTO) in calling for the harmonization or possible elimination of many tariff regimes in SSA.

9. Unlike the countries which implemented a relatively higher rate (e.g. Ghana's VAT rate was 17.5 per cent), Nigeria relied heavily on the production and supply of crude oil for a substantial share of its revenue.
10. Uganda also has a business tax on services.

C. Income tax

The objectives and strategies for individual and corporate income tax reform did not differ significantly among the various countries. The general trend pointed to significant reductions in the burden of tax imposed on a small minority of taxpayers – usually the formal wage and corporate sectors. In this regard, most countries have reduced the top individual marginal rate to approximately 35 per cent. In a few of the country programmes reviewed at the seminar, the individual top marginal rate was made equal to the corporate rate.[11] Also a conscious effort was being made to apply a single individual tax schedule to all incomes in order to eliminate the *schedular* regimes which had made the adminstration of individual and corporate taxes complex. It was also observed that certain countries felt the need to reduce the number of tax brackets as another means of lowering the burden of taxation. This measure is complemented by the widening of income tax bands in order to mitigate the phenomenon commonly referred to as "bracket creep": the gradual erosion of the real value of the original tax bands as a result of inflation.

There was widespread use of presumptive, withholding and tax clearance certificate (TCC) schemes in many SSA countries. The main examples of the use of the withholding scheme were, PAYE, taxes deducted from amounts payable on contracts and tax withheld on dividend payments. However, in Nigeria the withholding scheme had been extended to the VAT which is chargeable on supplies made by state and federal government organizations. The TCC scheme is primarily used to ensure that enterprises are cleared of their income tax obligations prior to entering into business and financial transactions for an ensuing tax period. Nonetheless, the rampant use of TCCs in many SSA countries to guarantee specific transactions was found to undermine the need for taxpayers to file annual tax returns reflecting the total incomes actually earned. In effect, the practice tends to undermine the growth of effective administrative strategies which promote or even compel compliance among taxpayers. It was also identified as a source of corruption in many of the income tax institutions of the countries concerned.

Even though there were different types of *presumptive* schemes on the continent, Ghana's presumptive *daily* income tax scheme for small-scale businesses was the one debated at length. It is a system whereby trade or business societies or associations are appointed as agents for collecting a standard amount of tax from each member periodically e.g. daily, weekly or monthly.[12] The conditions for operating the scheme effectively include a well-organized business group and the computation of a periodic (i.e. weekly or monthly) presumptive amount which reasonably reflects the annual tax liability for similar income groups. The amount of tax payable by each member is determined annually from samples of income and expenditure compiled for the various trade associations. Once the amount to be paid is determined, the society or group is appointed as an Internal Revenue Service (IRS) agent responsible for collecting the tax from its members. An agreed commission based on the actual amount collected is paid to the society.

The tax authorities in Ghana take the view that this small-scale business tax scheme enables the income tax department to identify potential taxpayers. However in practice, the amount assessed is considered final by most entrepreneurs who do not bother to file their tax returns at the end of the fiscal year. Thus, like all presumptive schemes, its merit in terms of equity and efficiency depends on the ability of the IRS to bring the amount assessed close to the actual liability of the taxpayers. The general view of participants was that in the long run, presumptive, withholding and tax clearance certificate schemes should be used basically as compliance measures. They should be regarded as one of the several means available of improving tax administration.

D. Administrative reforms

The tax reform programmes which were analysed at the seminar each had components designed to reform the tax administration. Kenya had just passed a law giving effect to the establishment of a Revenue Authority. These Boards or Authorities which already exist in Zambia, Tanzania, Uganda and Ghana[13] have two primary objectives. First, to enhance tax professionalism by removing the revenue institutions from the Civil Service and making them autonomous under an executive umbrella institution (i.e. the Revenue Board)[14] and secondly to facilitate the harmonization of the formulation of tax policy, operational research and general conditions of service among the individual revenue agencies. The improvement in conditions of work and employment for the revenue agencies under this strategy has improved the professional competence of most revenue institutions.

The consolidation, codification and review of existing laws was identified to be an integral part of both structural and administrative reforms. The most important element of these reviews appears to be the revising of old and often archaic provisions relating to tax incentives. Some countries such as Uganda and Lesotho have policies for vigorously promoting uniform tax treaties to replace the different domestic regimes of incentives applicable to specific firms or sectors. The merits and demerits of tax incentives were discussed at length and a consensus reached that whilst they may not be completely eradicated by SSA countries seeking to attract foreign investment, care should be taken to avoid unnecessary revenue loss and the negative flow of resources from developing to developed economies.

Most of the countries with Revenue Boards had used the opportunity of implementing VAT to consolidate the admin-

11. This was seen to be an anti-avoidance measure aimed at preventing wealthy taxpayers from sheltering their income in companies.
12. The scheme is called *Daily Income Tax* because it began with associations of commercial car and vehicle drivers who paid their presumptive charges daily.
13. In Ghana, the role of the Revenue Board is played by the National Revenue Secretariat, an autonomous unit of the Ministry of Finance. However, unlike the other countries listed, the Income Tax, Customs and the now-defunct VAT units have separate Boards of Directors.
14. This measure allows the government to focus on the manpower and material resources needed to run these agencies as professional institutions.

istration of *domestic* indirect taxes, including in some cases excise duties. Thus VAT Departments have been established in Uganda, Zambia, Kenya and Tanzania. However, the collection of import VAT remained with the Customs Administration in all these countries. Even though a VAT Unit was established in Ghana, the repeal of the VAT Act meant that its functions reverted to the Customs and Income Tax Administrations. VAT administration in Nigeria is established as a completely separate unit under the Federal Inland Revenue Service.

The influence of the Brussels-based Customs Cooperation Council (CCC) was felt by many countries in instances where tariff reviews also covered changes in the procedure for clearing goods. Most of the countries represented had adopted the Harmonized Systems (HS) commodity classification published by the Council. Another phenomenon in administrative reforms was the appointment of international firms to carry out specific *pre-shipment* inspection (PSI) assignments with regard to the importation of goods into SSA countries. Under a PSI contract, an agent, usually a firm specializing in international trade practices, is appointed to inspect goods in countries where imports originate. The main tax interest in the PSI contracts is the prevention of fraud (and the consequent loss of revenue) through valuation malpractice. Most countries including Kenya, Ghana and Uganda had appointed PSI companies to assist their Customs Administrations in properly assessing the value of imported goods.

V. INTER-GOVERNMENTAL RELATIONSHIPS

The relationships between central and local governments were also examined at the workshop. Nigeria provided the sole exception to the rather weak relationship which currently existed between these levels of government in many of the countries represented. This is because of its long established federal structure. The states in that country observe a relatively advanced fiscal system in comparison with the powerful role of the central governments in countries with a unitary political system. Sudan and Ethiopia were the other countries with an emerging federal structure.[15]

The whole of VAT in Nigeria is collected by the federal government but in accordance with an agreed revenue-sharing formula, 80 per cent of the proceeds is distributed among the states. Thus the federal government retains only 20 per cent of the VAT collected. Another revenue-sharing arrangement which came in for scrutiny was the provision in Ghana's Constitution which requires that 5 per cent of the national revenue should be disbursed to the local government authorities for the purpose of development. This ceded amount is commonly referred to as the District Assemblies Common Fund. It is distributed among the 102 local government areas in accordance with specific factors which include population, need (to redress current imbalances in development), responsiveness (to motivate the districts), equalization (to ensure that each district has access to a minimum amount from the fund), service pressure (to assist in improving existing services) and contingency (to cater for unforseen developments in the districts). The conclusion of the workshop was that the ceding of national revenue to districts could be regarded as a grant from the central government – a very vital source of revenue to most local authorities in both federal and unitary states.

The importance of property taxes to local government authorities was found to be waning in most SSA countries. It emerged that most local government authorities lacked the expertise to update the values of the property held in their jurisdictions. Unfortunately, the limited resources placed at the disposal of specialized central government agencies often did not allow them to provide the requisite technical assistance to local governments. Participants felt that technical assistance should be made available in this area since property taxes could for the foreseeable future continue to generate a large share of local authority revenues.

In virtually all SSA countries, the power of local authorities to either borrow directly from financial institutions or issue instruments such as bonds on the open market was severely limited. In the past, the lack of performance and weak financial position of most local governments usually meant that such operations are guaranteed by the central government. Consequently, the lending activities of local government institutions normally form part of the quasi-fiscal operations of the central government itself. However, the trend in many countries is to tighten central government's control over local government borrowing in order to bring their large budgetary deficits under control.

VI. CONCLUSION

At the end of the workshop, the Director of the ADI, Mr G.R. Aithnard, emphasized that a similar seminar would be organized for the French-speaking countries in Africa. The Bank would then carry out a review to enable it to organize the workshop as an annual event geared towards evaluating tax and fiscal performance on the continent. The seminar appears to have been the first conscious effort to bring tax administrators together for such a valuable evaluation programme. Finally the Bank has plans to provide expertise for, and organize seminars in, SSA countries which might require assistance in tailoring the workshop to fulfil their specific needs.

15. For example, a number of Nigerian states retained their state-level income tax system even after the introduction of VAT had changed the revenue significance of this tax.

EUROPEAN UNION

EU Cross Border Mergers: a Dutch Perspective

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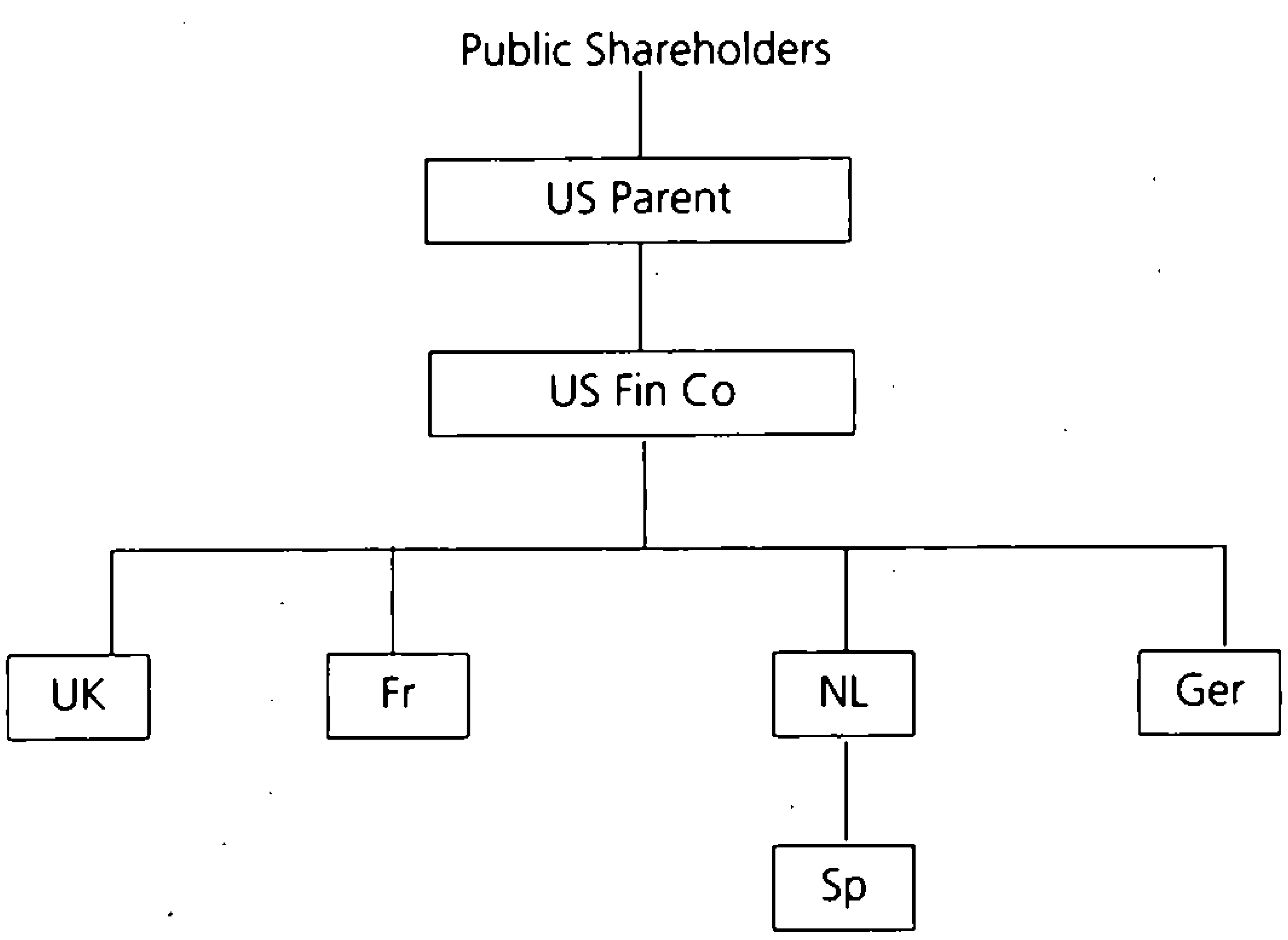
I. CASE DESCRIPTION

A US manufacturing company intends to reorganize its European finance companies in order to benefit from recent revisions to the EU rules applicable to banking and finance activities. The finance companies are engaged in various financial arrangements in support of the Group's sales and leasing activities.

Present Structure



The market value of the United Kingdom, French and German finance companies amount to USD 200 million, USD 100 million and USD 600 million respectively. The market value of the Netherlands finance subsidiary is USD 100 million. Its assets consist of *inter alia* a Spanish subsidiary (SpainCo) with a market value of USD 50 million. The book value of each of the subsidiaries is zero.

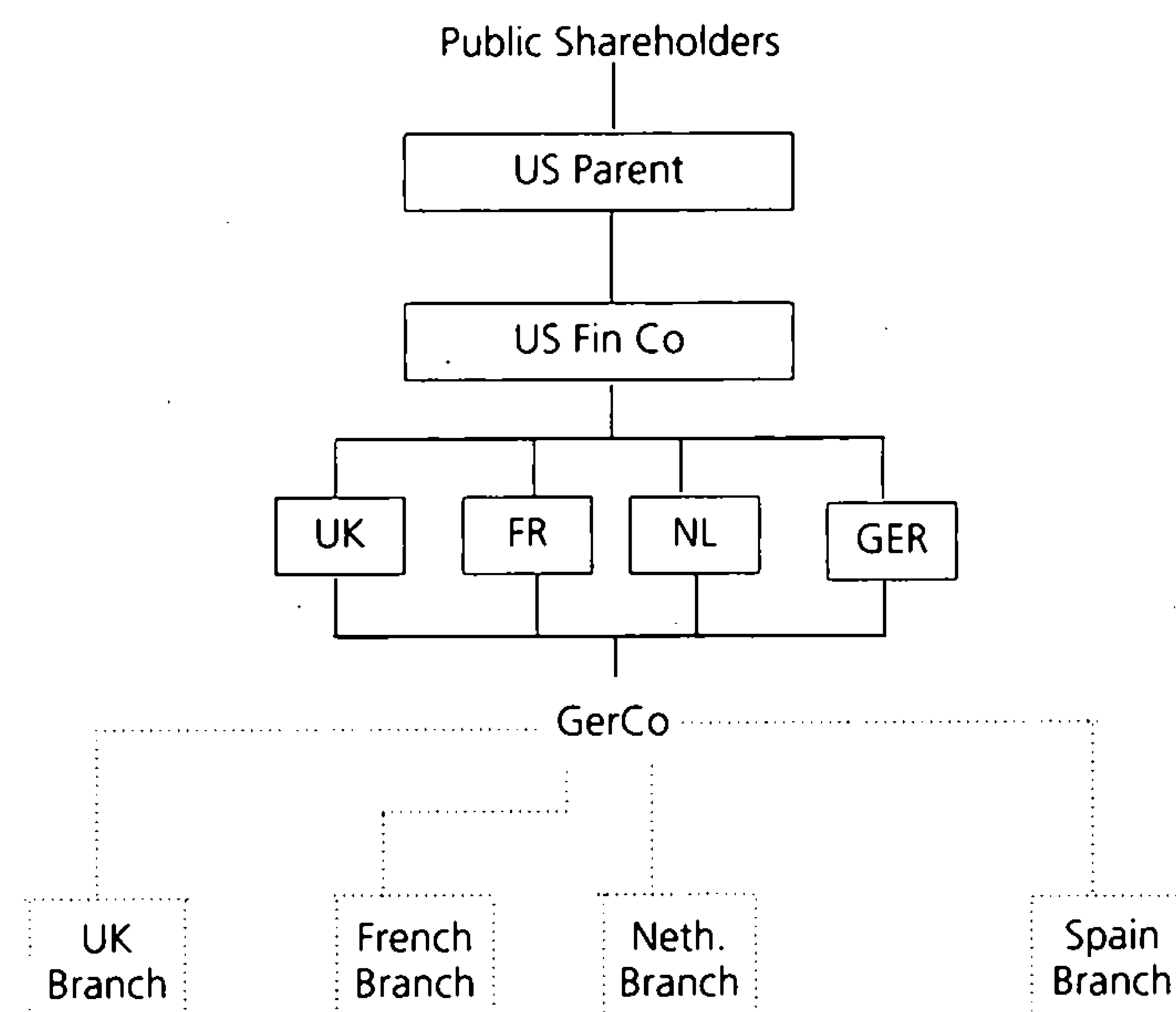
- Under the proposed reorganization transaction the finance activities are to be concentrated in Germany.
- The transaction must take a form that avoids US tax.

With the above in mind two alternatives have been proposed. This paper proceeds by analysing each of the alternatives from the perspective of Dutch taxation.[1]

II. ALTERNATIVE I

Under this alternative DutchCo contributes all of its assets to a German company (GerCo) in exchange for shares. The Dutch subsidiary will remain in existence. SpainCo will be merged, liquidated or dissolved into Gerco after the merger.

Alternative Structure I



The capital gain realized upon the transfer of the shares of SpainCo to GerCo is pursuant to Article 13 of the Dutch Corporate Income Tax Act (CITA) exempt under the Dutch participation exemption. Thereto, in general the following conditions must be met:

– DutchCo must own at least 5 per cent of the nominal paid-up capital of SpainCo;
– the shareholding must not be a portfolio investment;

1. At the conference papers were presented by a UK, French, German and Dutch tax expert setting out the tax consequences of the alternative proposals, from the viewpoint of their respective countries. This paper confines itself to analysing the Dutch tax implications of both of the alternatives proposed.

- the activities of SpainCo should be in line with and complementary to the activities of DutchCo;
- the shares should not be stock in trade; and
- SpainCo should be subject to a profits tax in Spain (at a national level).

If the shareholding in SpainCo is considered a portfolio-investment the capital gain may be exempt under Article 13g CITA provided the following conditions are met:

- SpainCo takes a legal form as listed in the Annex to the Parent-Subsidiary Directive[2] and SpainCo is subject to taxation on its profits as mentioned in Article 2, paragraph c of the Directive, without being exempt and without the application of a special regime; and
- SpainCo is not, under the terms of a tax treaty concluded with a third state, resident for tax purposes outside the European Union (EU);

The capital gain realized upon the transfer of the remaining assets would in principle be subject to corporate income tax.[3] The taxation of the capital gain arising on the remaining assets can be deferred by applying for the *assets for shares merger exemption* under the EC Merger Directive as implemented in Dutch tax law.

Under the assets for shares merger exemption laid down in Article 14 CITA the transfer of DutchCo's assets to GerCo is exempt, provided the following conditions are met:

- the transfer of the assets of DutchCo to GerCo can be *characterized* as the transfer of an active business enterprise[4] or an independent part thereof;
- the transfer of the assets takes place within the framework of a "merger" as defined by Article 14 of the CITA;
- GerCo has no Dutch tax losses it can carry forward;
- GerCo has for Dutch tax purposes to value the acquired assets at the same book value as DutchCo and the contributed assets have to form a permanent establishment of GerCo in the Netherlands;
- GerCo has to acquire the assets against the issue of shares; a one per cent tolerance with a maximum of NLG 10,000, is allowed for payment other than in shares;
- the profits of DutchCo and the Dutch profits of GerCo must be determined pursuant to the same standards; and
- the shares must not normally be transferred within three years after their acquisition[5] (otherwise the exemption will be withdrawn with retroactive effect).

The notion "enterprise" in the first requirement is interpreted by the Ministry of Finance as meaning an *active* business enterprise. DutchCo will not be considered to be an active business enterprise, if its activities are restricted to mere asset management. The fact that DutchCo forms part of a group which is engaged in entrepreneurial activities is not relevant in determining the character of the activities of DutchCo as the Dutch Supreme Court recently ruled that a "stand alone test" is to be applied in determining the character of the activities of a company (Dutch Supreme Court, 27 September 1995, VN 1995/3581).

DutchCo will be considered to be an active finance company if its activities extend beyond group asset management, i.e. if it is actually involved in active cash-management. Indeed as of 26 January 1996, a draft on a favourable tax regime applicable to Dutch finance companies has been proposed.[6]

Each Dutch limited liability company (*besloten vennootschap*) is deemed to be conducting an enterprise by virtue of Dutch tax law. Further it has been argued that based on a systematic interpretation of the CITA the notion "enterprise" in Article 14 CITA also encompasses an enterprise by legal fiction.[7] However, the Dutch tax administration will deny the exemption if DutchCo is not considered to be actually engaged in carrying on entrepreneurial activities, even if the notion "enterprise" indeed encompasses an enterprise by legal fiction. Thus the transfer of the assets of DutchCo to GerCo would not result in GerCo having a permanent establishment in the Netherlands, if it were to be considered to be engaged in entrepreneurial activities merely by reason of this legal fiction. Consequently, there is no guarantee that the enterprise will be subject to Dutch taxation in the future as required for application of the exemption.

The subsequent merger, liquidation or dissolution of SpainCo into GerCo has no consequences under Dutch tax law, although capital duty may become due if SpainCo was contributed to DutchCo exempt from capital duty under the share for share merger exemption and the liquidation of SpainCo takes place within five years after the contribution.

Distributions by GerCo to DutchCo are subject to German dividend withholding tax at a reduced treaty rate of 15 per cent. The zero rate (applying from 1 June 1996) as provided for in the Parent-Subsidiary Directive for dividend distributions by a qualifying German company is not applicable as DutchCo will own only a 10 per cent interest[8] in the capital of

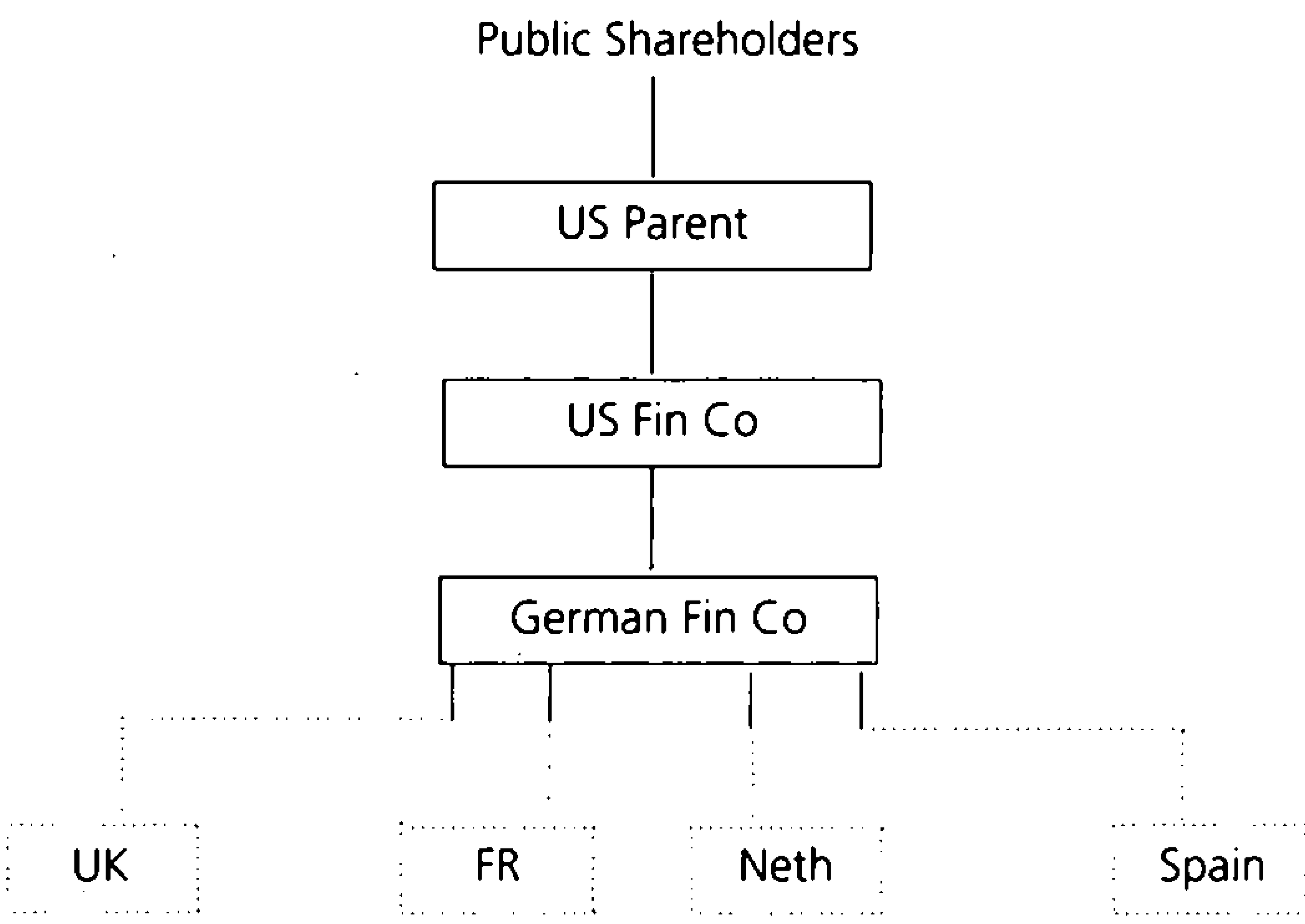
2. The Parent-Subsidiary Directive is a set of EC rules on distributions of profits received by companies of a Member State which came from their subsidiaries resident in other Member States and on distributions of profits by companies of a Member State to companies of other Member States of which they are subsidiaries.
3. The rate as at 1 January 1996 is 37 per cent on the first NLG 100,000 of profit and 35 per cent thereafter.
4. A company receiving active income not merely passive income.
5. Provided certain conditions are met, transfer to a group company is allowed, e.g. the shares are transferred without (or against nominal) consideration or against the issue of shares by the acquiring company. Transfer of the shares to a third party is under certain conditions also allowed, e.g. the third party acquires the shares solely against the issue of its own shares within the framework of a merger.
6. On 26 January 1996, the Dutch Council of Ministers agreed with a legislative proposal presented by the Under-minister of Finance, Mr W. Vermeend, which purports to create an advantageous regime for Dutch finance companies. Provided certain conditions are met Dutch finance companies may make a yearly transfer to a reserve of up to a maximum of 80 per cent of the income derived from financing activities and from short-term investments retained for possible acquisitions. The reserve can be added back to profit either in a taxable or non-taxable way. Furthermore, certain amounts may be deducted from the reserve free of taxation in order to finance the acquisition of a participation.
7. H.G.M. Dijstelbloem, "Fiscale faciliteiten bij interne reorganisaties van naamloze en besloten vennootschappen", *Deventer,* 1984, at 120.
8. The reason why DutchCo will only own a 10% interest in GerCo relates to the fact that the transaction must be seen in the overall context of the restructuring of the entire European group i.e. the other finance companies will each own shares in GerCo after contribution of their respective assets.

GerCo, whereas a minimum ownership of 25 per cent[9] is required.[10]

III. ALTERNATIVE II

The US Finance Company transfers all of its shares in DutchCo to German FinCo against the issue of voting shares. Subsequently, DutchCo is liquidated; SpainCo will be liquidated, dissolved or merged into German FinCo.

Alternative structure II



.... = finance branches

Pursuant to Dutch tax law the transfer of shares which form part of a substantial interest[11] is subject to corporate income tax, if these shares are not part of the assets of an enterprise, even if the seller is not a Dutch resident. Consequently, the transfer of the shares of DutchCo to German FinCo could be subject to Dutch Corporate Income Tax. This liability does not arise if the US parent is entitled to the benefits of the 1992 US–Netherlands tax treaty, e.g. if the shares of the US parent company are listed on a recognized stock exchange and substantially and regularly traded on one or more recognized stock exchanges.

The subsequent liquidation of DutchCo gives rise to a liability to Corporate Income tax. The taxable amount is equal to the difference between the market value and the book value of DutchCo's assets.

Furthermore, the distribution of the liquidation proceeds by DutchCo to German FinCo would be subject to Dutch dividend withholding tax at a rate of 25 per cent. The rate is reduced to 10 per cent if German FinCo is entitled to the benefits of the Germany–Netherlands tax treaty. The rate is further reduced to zero if German FinCo holds the shares of DutchCo for an uninterrupted period of at least twelve months, provided the set-up does not constitute a fraud or an abuse under the Directive. In the case of fraud or abuse the Dutch tax administration would then deny the zero rate by appealing to the *fraus legis* doctrine. Pursuant to this doctrine the fisc may substitute a fact pattern that leads to taxation for a fact pattern that does not lead to taxation if (i) the taxpayer has created a situation that approximates to one in which tax could be imposed, but in which tax cannot be imposed, (ii) tax avoidance is the predominant motive of the taxpayer and (iii) the purpose and intent of the tax law would be frustrated if the non-taxable fact pattern was allowed to stand. Thus, the scope of *fraus legis* enables the fisc to ignore legal acts and transactions when faced with fraud or an abuse of the law.

If the German FinCo was consolidated for tax purposes with a German parent, the question arises whether the distributions to the German FinCo by DutchCo can benefit from the Parent-Subsidiary Directive. Under the profit and loss assignment agreement (*Gewinn- und Verlustabfuhrungsvertrag*) German FinCo has to transfer its profits to its parent. Consequently, it is arguable that German FinCo is not subject to taxation as required for exemption under the Parent-Subsidiary Directive.[12]

In order to avoid taxation on the capital gain arising upon liquidation as well as the possible liability upon transfer of the shares of DutchCo and also to reduce the risk of *fraus legis*, the desired structure could also be achieved by adding two extra steps to alternative I.

The steps to be added would be the following:

- transfer of factual seat of DutchCo to Luxembourg; and
- liquidation of DutchCo three years after the contribution of its assets to GerCo.

The Dutch do not levy an exit charge for dividend withholding tax purposes. The distribution of the liquidation proceeds to the US FinCo would not be subject to Luxembourg dividend withholding tax.

9. Under the Parent-Subsidiary Directive Member States have the option of replacing by means of a bilateral agreement the criterion of a holding in the capital by that of a holding of voting rights. The Netherlands and Germany have however not entered into such an agreement.

10. In a mirror-position, i.e. a German company owns less than 25 per cent in a Dutch company, the zero rate would be applicable if the German company owned the shares of the Dutch company indirectly via another Dutch company of which it owned at least 25 per cent of the shares. No additional Dutch corporate income tax or dividend withholding tax liability arises on account of the intermediate holding company. The contribution of the shares of DutchCo to the intermediate holding company is subject to a 1 per cent capital duty; although an exemption from this duty may be available. From a Dutch perspective this seems a good solution, however it should be noted that the set-up may be susceptible to an attack under an abuse of law provision.

11. A substantial interest is deemed to exist if a shareholder owns (or has owned at any time during the past five years) either directly or indirectly at least one third of any class of the nominal paid up share capital of a corporation.

12. The same argument may be invoked by the German tax administration if in a mirror position dividend income is distributed by a German subsidiary to a Dutch company (BV A) which is consolidated for Dutch tax purposes with its parent (BV B), i.e. the grandparent of the German company. As a consequence of the consolidation BV A is deemed to have merged into BV B; for the purposes of Dutch corporate income tax BV B is the sole tax payer. This gives rise to the question as to whether BV A itself is subject to taxation as required in order to be able to benefit from the Parent-Subsidiary Directive. Even if BV A can be considered subject to taxation, it is arguable whether distributions by the German company qualify for exemption under the Parent-Subsidiary Directive, as the profit of BV A is only subject to taxation at the level of BV B.

It can be deduced from the case law of the Dutch Supreme Court on Article 8(9) of the Ireland–Netherlands tax treaty that the distribution of liquidation proceeds by DutchCo after the transfer of its factual seat to Luxembourg is not subject to Netherlands dividend withholding tax. In this regard it should be noted that Article 10(6) of the Luxembourg–Netherlands tax treaty is uniform with Article 8(9) of the Ireland–Netherlands tax treaty.

Article 8(9) of the Ireland–Netherlands tax treaty provides as follows:

> "Where a company which is a resident of one of the States derives profits or income from the other State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State ... even if the dividends paid ... consist wholly or partly of profits or income arising in such other State".

In a judgement given on 2 September 1992 (BNB 1992/379), the Supreme Court rendered a decision on the application of Article 8(9) of the tax treaty in a situation where a BV resident in Ireland for the purposes of the Ireland–Netherlands tax treaty as of its incorporation, paid a dividend to its parent company, a Delaware corporation. The payer of the dividend had not derived any income from the Netherlands. The Court decided that the Netherlands could not levy dividend withholding tax in respect of the dividend, because (i) where the provision prohibits the levy of withholding tax if profits or income are derived from the Netherlands such levy is a fortiori prohibited if no profits or income are derived from the Netherlands and because (ii) the scope of Article 8(9) also encompasses the resident of a state other than the contracting states.

There is a possibility that the shift of its tax residence by DutchCo to Luxembourg could be ignored under the *fraus tractatus* doctrine. This doctrine is the international equivalent of the *fraus legis* doctrine. The Dutch Supreme Court does not in principle reject the doctrine of *fraus tractatus*. However, neither the text of the Netherlands–Luxembourg tax treaty nor the legislative history thereof indicates that the Netherlands and Luxembourg had the mutual intention of denying the application of Article 10(6) of the treaty in the contemplated situation. Furthermore neither the text nor the explanations suggest that non-taxability of the dividend in the Netherlands would frustrate the purpose and intent of the Netherlands–Luxembourg tax treaty.

At the same time it must be mentioned that the application of such doctrines as *fraus tractatus* seems to be gaining momentum, which is evidenced by the Commentary to the 1992 OECD Model Convention (Commentary to Article 1, par. 24) and it seems likely that the Dutch Supreme Court will increasingly be inclined to apply *fraus tractatus*, even in respect of pre-1992 tax treaties, such as the Netherlands–Luxembourg tax treaty. Furthermore, it is submitted that the Netherlands and Luxembourg may agree that the principle of abuse of law can be applied to the Netherlands–Luxembourg tax treaty. Consultations between the competent authorities of the Netherlands and Spain have resulted in such an agreement in August, 1989.

If the fisc's appeal for *fraus tractatus* was successful, the distribution of the liquidation proceeds by DutchCo would be subject to 25 per cent Netherlands dividend withholding tax. The rate is reduced to five per cent if US FinCo is entitled to the benefits of the 1992 US–Netherlands tax treaty.

IV. CONCLUSION

The reorganization of the European finance companies can be achieved without Dutch taxation by contributing the assets of the Dutch finance subsidiary (DutchCo) to a German company (GerCo) against the issue of shares. This transaction would be exempt from Dutch corporate income tax under the participation exemption for the shareholding and under the assets for shares merger exemption as regards the remaining assets. In order to arrive at the desired structure DutchCo is liquidated three years after the contribution of its assets to GerCo. Preceding liquidation Dutchco should transfer its tax residence to Luxembourg to avoid Dutch dividend withholding tax on the distribution of the liquidation proceeds. There is a risk that the Dutch tax administration will appeal to *fraus legis* or to *fraus tractatus*. If either doctrine were applied, the distribution of the liquidation proceeds would then be subject to a 25 per cent dividend withholding tax (or if applicable the reduced treaty rate). This risk does not apply to profits that have arisen after the transfer of the residence of DutchCo to Luxembourg.

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CANADA

DEPARTURE TAX – COMPANIES

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I. POLICY

The Canadian Government seeks to impose tax on emigrating companies for the same reason it levies such a tax on physical persons. Resident companies are taxed on worldwide income. Some categories of income are not taxed as they accrue, but only upon some specified realization event. The most obvious and common example is a gain on the disposition of a capital asset. If the taxpayer, corporate or individual, extricates itself from the Canadian tax system before the income is realized, then special rules may be considered desirable to capture that income upon or after departure. The policy objective is the same as for individuals: to protect the integrity of the domestic tax base by taxing deferred income.

However, this similarity conceals some important differences. The first relates to the meaning of "residence" and the ability of an incorporated company to change its fiscal domicile. It is obvious how individuals move from place to place. It is less obvious how legal entities do so, or indeed whether they can. If domestic tax law does not permit a resident company to adopt some other tax residence, no departure tax considerations arise. However, in some cases, and this was the experience in Canada, either corporate law or tax treaties may effectively permit emigration even if the domestic tax system does not contemplate it.

A second difference between individuals and incorporated entities relates to motivation. Individuals change their residence for a host of reasons, mainly unrelated to taxation. A legal entity may also have non-fiscal motives for shifting its seat, place of incorporation or place of effective management,[2] but national tax administrations are, perhaps with some justification, rather more likely to suspect a tax avoidance rationale.

A third important difference between corporate and individual taxation which has implications for the design of a departure tax system arises from the fact that corporate taxation normally involves two bites at the fiscal apple: mainstream tax on profits and a separate tax on corporate distributions. For individuals, it is sufficient if the exit tax plugs the hole created by deferral of income. It should do that too for incorporated companies, but in addition, the government may also wish to prevent the usual tax consequences arising from a distribution of assets to shareholders being avoided by virtue of the emigration of the company.

II. TAXATION OF INCORPORATED COMPANIES IN CANADA

Canadian tax and company law refer to incorporated companies as "corporations", and that usage will be adopted in the rest of this article.

A. Taxation of resident and non-resident corporations

A corporation is a "person" for Canadian income tax purposes. If that person is resident in Canada, it is subject to Canadian income tax on worldwide income.[3] The taxable income of a corporation includes the profits from a business carried on by it and, as in the case of individuals, three quarters of its realized capital gains. A corporation which is not resident in Canada is only subject to Canadian income tax on prescribed sources of income which are considered to be Canadian.[4] This includes income from carrying on business in Canada[5] and gains from the disposition of certain types of property, referred to as "taxable Canadian property". That definition was briefly considered in the earlier article, and I will not revert to it here.[6] In addition, of course, non-resident withholding tax is imposed on non-residents, either corporations

1. This article dealing with incorporated companies complements the author's earlier article on departure taxation for individuals.
Robert Couzin, "Departure Tax – Individuals," 49 *Bulletin for International Fiscal Documentation*, 11 (1995), at 532.
2. The most likely non-tax reason would be asset protection. One need only look at the flight of companies from Hong Kong in anticipation of 1997. Another reason could be simple business efficiency. Some Canadian companies have found that their centre of gravity, either in terms of business activity or shareholder base, has shifted to the United States and it would be convenient if the legal entity could follow.
3. Subsec. 2(1) of the *Income Tax Act, RSC 1985* (5th supp.), to which reference will hereafter be made as the "ITA". In general, the taxation of corporations is not accompanied by any system of "transparency" as applies, for example, to partnerships. There are limited exceptions, mainly applicable to certain types of collective investment vehicles organized as incorporated companies.
4. Subsec. 2(3) and Sec. 115 of the ITA.
5. Where a bilateral tax treaty applies, income is only taxable to the extent that it is attributable to a permanent establishment in Canada.
6. Save to note a modification to the proposed legislation which was referred to in footnote 7 of the earlier discussion, *supra*, note 1, at 533. In a press release dated 14 December 1995, the Government announced that the proposed extension of the definition of "taxable Canadian property" referred to in that footnote 7 would be confined to indirect interests in Canadian immovable property and resource properties.

or individuals, who earn certain types of income from Canadian sources, such as interest, dividends and royalties.[7]

Thus, as is the case for individuals, the Canadian tax system draws a sharp dividing line between resident and non-resident corporations. The test for determining residence is, of course, different.

Until 1965, the residence of corporations was determined under a factual test developed mainly by the English courts relating to the "central management and control" of the entity, the locus where the basic underlying decision-making process was to be found. In principle, although not always in practice, this was where the board of directors of the company met and managed its affairs. In 1965, Canada adopted a place of incorporation test. Corporations incorporated in Canada after 25 April 1965, are irrefutably deemed to be resident in Canada. In an effort to make transitional cases disappear over time, corporations incorporated in Canada before that time also fall within the deemed residence rule if, at any time thereafter, the corporation is resident in Canada (under the central management and control test) or carries on business in Canada.

Corporations not incorporated in Canada, but which are managed and controlled in Canada, may qualify as Canadian residents as well. Those corporations can cease to be resident in Canada merely by relocating their central management and control. The corporation deemed resident in Canada due to its place of incorporation would appear, at first sight, immovably rooted in the Canadian tax jurisdiction. However, subsequent developments challenged this simple conclusion. Those developments came from two disparate sources: corporate law and tax treaties.

Canadian company law legislation may permit a Canadian corporation to be "continued" under the laws of another jurisdiction.[8] Once the proper procedures have been followed, the corporation is "discontinued" in Canada. The result is that the corporation is no longer governed by the Canadian statute under which it was incorporated, but rather by the laws of the other jurisdiction "as if it had been incorporated under the laws of that other jurisdiction".

The appropriate tax result of such a corporate continuance was, for some years, a source of considerable debate in Canada. The tax administration determined that, even after its discontinuance, a corporation which was originally created by incorporation in Canada could still be described as a corporation "incorporated in Canada", notwithstanding that it had legally departed from the jurisdiction and was no longer governed by Canadian corporate law.[9] The expression "incorporated in Canada" was taken as an empirical statement. That is, a corporation was either incorporated in Canada or it was not. If it was, no subsequent act could change that historical fact. This administrative position appeared to solve the problem of corporate emigration, at least for companies incorporated in Canada after 26 April 1965 (or before that date and caught by the deemed residence provision), simply by refusing to accept its possibility.

The second source of instability in the conclusiveness of corporate tax residence was the definition of fiscal domicile in certain double taxation conventions. Even if it were true, as the tax authorities believed, that "once incorporated in Canada always incorporated in Canada", and therefore resident in Canada, this might not be the case for purposes of a bilateral convention. The corporation incorporated in Canada could, under the domestic tax law of the treaty partner, be considered resident in that jurisdiction, perhaps because of the place of effective management. The consequences under the treaty would then depend upon the existence and application of a tie-breaker rule to deal with dual resident corporations.

Thus, while one might have thought that departure tax rules were unnecessary for corporations incorporated in Canada, that proved not to be the case.

B. Taxation of corporate distributions

One particular aspect of the corporate taxpayer, which distinguishes it from the individual taxpayer, is the taxation of corporate distributions to shareholders. This distinction is central to the system of departure taxation.

Canada does not have a fully integrated system under which all of the corporate tax is imputed to shareholders and refunded to them. Where the shareholder is a Canadian resident corporation, there may be no such distribution tax,[10] and where the shareholder is a Canadian resident individual, a dividend tax credit provides partial relief against the double taxation of corporate profits.[11] If the shareholder is not Canadian resident, Canadian withholding tax applies to any dividends paid.

Obviously, distributions by non-resident corporations to non-resident shareholders are difficult to tax and, therefore, one key element in departure taxation must be a system to deal with corporate distributions.

III. CANADIAN DEPARTURE TAXATION OF CORPORATIONS

The tax treatment of emigrating corporations is a highly technical matter and the system has undergone major changes in

7. The lengthy list is found in Sec. 212 of the ITA. While the concept is to seek out Canadian source income, the statutory charge is not always limited to what one might colloquially regard as income having its source in Canada.

8. Corporations may be incorporated in Canada under federal law or under the law of any of the provinces. Most of the applicable statutes now provide for a continuation procedure. See, for example, Sec. 188 of the federal *Canada Business Corporations Act*.

9. *Interpretation Bulletin IT-451R*, 25 March 1987, Para. 19.

10. This is because there is a full deduction for inter-corporate dividends. However, portfolio investment dividends are subject to a special refundable tax, which is recouped when the investing corporation redistributes the income to its shareholders. There are numerous restrictions on the deduction for inter-corporate dividends which need not concern us here.

11. The dividend tax credit is analogous in some respects to an imputation of corporate taxation, but there are important differences. For one thing, it is unfunded. There is no ACT or *précompte mobilier* equivalent. For another, the credit is not equal to the full corporate tax, nor is it intended to be (save for active business income of Canadian-controlled private corporations).

recent years. My goal is to communicate the essential elements of the system so that its consequences may be comprehensible and comparisons with other jurisdictions and alternative approaches may be made.[12]

A. A brief history

The basic departure tax provision which applied to individuals has always applied to corporations as well. However, it was eventually found to be deficient in at least three respects. First, the departure tax system was limited in scope, covering only accrued gains on capital property. This was inadequate to address the mischief of corporate emigration, since corporations have businesses and the departure tax was unlikely to capture all forms of deferred business income. Second, there was nothing to deal with the taxation of corporate distributions. Third, the departure tax applied only where there was a change of residence within the meaning of the Canadian domestic income tax legislation. In the case of corporations, the position taken by the Canadian tax administration, as described above, led to a perverse result (from their perspective). If, as they believed, once incorporated in Canada, always incorporated in Canada, then a corporation moving its place of effective management abroad would not be subject to departure tax because, as a matter of domestic law, it was still resident in Canada.

The potential tax leakage caused by corporate emigration came strikingly to the attention of the Canadian government with the 1979 court decision in *Hunter Douglas Ltd.*[13] At that time, the Canada–Netherlands tax convention (since replaced) defined fiscal domicile solely by reference to the place where a company's effective management was located. A Canadian incorporated company which removed its effective management to the Netherlands could therefore become a Dutch resident for treaty purposes. A dividend paid by such a corporation would escape Canadian withholding tax, being protected by the provisions of the convention which prohibited a tax imposed by one State on dividends paid by a company resident in the other State. *Hunter Douglas Ltd.* therefore moved its effective management to the Netherlands and successfully avoided Canadian withholding tax on a subsequent liquidating distribution.

The immediate legislative response was to leave the existing departure tax in place and enact a new, additional anti-avoidance rule addressed specifically to corporations. Where a corporation incorporated in Canada became resident in a foreign jurisdiction and, by virtue of such residence abroad, would be exempt from Canadian tax on any foreign source income under the terms of a double taxation convention, the statute provided that there would be immediate taxation not only of accrued capital gains but of accrued gains in respect of all forms of property. In addition, a further special tax was imposed on the corporation equal to 25 per cent of the excess of the fair market value of its property over its paid-up capital and indebtedness.[14] The theory of this latter tax was that it was meant to be a surrogate for non-resident withholding tax on dividends (also imposed at the rate of 25 per cent), since the excess of fair market value over paid-up capital and indebtedness represents the assets of the corporation available for distribution, and would be the amount on which non-resident withholding tax would apply if the corporation, still resident in Canada, were liquidated and its assets distributed to a non-resident parent corporation.[15]

The same consequences were also extended to the other potential method of extracting a corporation from the Canadian taxing jurisdiction, namely continuation under the laws of a foreign country. This was the case notwithstanding the official position that such continuation would not enable the corporation to escape ongoing Canadian taxation thereafter. Indeed, the result of the combined statutory and administrative rules meant that a corporation continuing to a foreign jurisdiction was subject to departure tax and yet still remained liable to Canadian taxation on its income! Since continuation abroad was generally frowned upon, the taxation authorities were not terribly troubled by the apparent inconsistency and inequity.

Meanwhile, another parallel response to the problem caused by *Hunter Douglas* type emigration was to embark on a programme to modify certain tax treaties. In all of the newer double taxation conventions, and replacements or protocols to the older treaties, Canada has adopted a fiscal domicile rule based on the OECD Model. The tie-breaker, in the case of dual corporate residency, varies somewhat from treaty to treaty, but in none of the recent conventions is there an absolute priority to central control or effective management. In some cases, where a corporation would be considered resident in both treaty partners, the competent authorities will endeavour to resolve the question, the treaty not generally proving any guiding principles for such resolution. In the important Canada–US tax convention, the corporation which is considered resident in both jurisdictions under domestic law is deemed, for treaty purposes, to be resident in the jurisdiction in which it was "created", which means the jurisdiction of original incorporation.

Unfortunately, the Canadian administrative view that corporations which sought to emigrate would be stuck with one foot in Canada was not always to the benefit of the fisc. Their position inadvertently created a class of dual resident companies. The Canadian incorporated company which became resident abroad for purposes of a treaty, for example, might find itself in the enviable position of gaining treaty protection in respect of certain types of income and yet still able to claim Canadian resident status where this would suit, for example, when it was in receipt of income which would otherwise be subject to non-resident withholding tax. Specific legislation was therefore enacted to deal with this problem as well. The statute was amended to provide that, notwithstanding the usual deemed residence rule, a corporation is deemed *not* to be resident in Canada if, by virtue of a double taxation con-

12. For an excellent detailed analysis, see Allan L. Lanthier, "Corporate Immigration, Emigration and Continuance", *Corporate Management Tax Conference 1993* (Toronto: Canadian Tax Foundation, 1994) at 4:1 – 42.
13. *Hunter Douglas Ltd. v. The Queen*, [1979] CTC 424.
14. These rules are found in former Secs. 88.1 and 219.1 of the ITA.
15. Subsec. 84(2) of the ITA.

vention, it would not be subject to Canadian income tax on foreign source income.[16]

The next problem the legislator sought to resolve was the overlap between departure tax and the continuing deemed residence of corporations. This was accomplished by inserting a new provision which recognized continuation of a corporation as an event which broke the factual place of incorporation test. A corporation continued outside of Canada is now treated as if it had been incorporated in the foreign jurisdiction.[17]

Finally, the draftsmen eventually took it upon themselves to integrate the corporate and the individual departure tax into a more cohesive system. As noted in the earlier article, the individual departure tax was recently extended to property other than capital property, bringing it into line with the corporate departure tax. Given the new treatment of continuation, it was not an enormous step to provide that the departure tax would apply to a corporation, as to an individual, simply upon a change of residency. The special anti-avoidance departure rules aimed at corporate emigration were therefore repealed in favour of a unified system.

B. The current regime

Under the current law, therefore, a corporation may, indeed, emigrate. Should it find a bilateral tax treaty which permits it to become resident for treaty purposes in a foreign jurisdiction, and does so, it will thenceforth be considered a non-resident of Canada. That act would, thus, constitute ceasing to be resident in Canada and the departure tax would apply. If a corporation continues out of Canada, it will no longer be considered incorporated in Canada and it may therefore become a non-resident. I say "may" become a non-resident because, of course, even after continuing abroad the corporation's central management and control could remain in Canada. However, if the corporation both continues to a foreign jurisdiction and removes its central management and control to that (or indeed any other) foreign jurisdiction, it will cease to reside in Canada. Once again, departure tax will apply.

The departure tax provisions themselves are similar to the system described in respect of individuals, but there are some important differences. To achieve the proper technical result, the emigrating corporation is deemed to have terminated its fiscal year immediately before departure. This ensures that income can be computed for a completed fiscal period. Of particular importance are some differences in the tax base for the departure tax applicable to corporations and individuals. Recall that individuals are treated as having disposed of all property other than property which is considered to be "taxable Canadian property". I explained in the earlier article that this is logical because the individual, even once a non-resident, remains subject to Canadian tax on dispositions of such property. The logic may be the same for corporations, but the result is not. The corporation which emigrates is deemed to dispose of *all* of its property, including taxable Canadian property. Individuals can elect to be treated as not having disposed of certain property, on condition that they agree to treat the property as taxable Canadian property in future. No such election is available to the corporation. Indeed, the corporation is not even allowed to spread the tax payment over a number of years, as can an individual. Finally, the individual is not treated as having disposed of property on emigration if it was owned at the time the individual last became resident in Canada and the period of residence was not greater than 60 months within the last 10 years. No such exemption applies to corporations.

While the tax base is, therefore, broader, the basic principle is still the same. As I noted in the case of individuals, corporations, since they are deemed to dispose of property on leaving Canada, are also given a fresh start with respect to the cost of property on immigrating to Canada. In this way, only gains accrued during the period of Canadian residency are taxed.

When a corporation emigrates from Canada the first consequence, therefore, is a deemed disposition of all its property at fair market value.[18] The second relates to distribution tax. If the emigrating Canadian corporation had distributed its property to a non-resident shareholder, say on liquidation, that distribution would have attracted Canadian non-resident withholding tax at a statutory rate of 25 per cent, subject to a lower rate specified in a bilateral tax treaty. Thus, the statute provides[19] that where the basic departure tax is triggered upon a change in corporate residency, the corporation is required to pay a special tax equal to 25 per cent of the excess of the proceeds of disposition deemed under the departure tax rules to have been received by the corporation over the corporation's paid-up capital and indebtedness. This is effectively the same surrogate distribution tax as previously applied under the old rules.

Since the intention is to mimic the application of non-resident withholding tax, it is appropriate that the statute should reduce the 25 per cent to the rate which applies under any applicable double taxation convention. However, this presents a conundrum. What convention? The response in the statute is that the special tax is levied at the rate specified in any bilateral treaty which applies to the departing corporation on the first day of the taxation year after the year in which it left. Thus, for example, if a Canadian corporation ceases to be resident in Canada and becomes resident in the United States, the rate of surrogate distribution tax is the dividend withholding rate specified in the Canada–US convention. In many conventions, more than one rate is specified, with a lower rate applicable to substantial participations. In that case, the lower rate is adopted for the surrogate distribution tax.[20]

16. Subsec. 250(5) of the ITA.
17. Subsec. 250(5.1) of the ITA.
18. This is not the only consequence. As noted in the case of individuals, various reserves can no longer be claimed.
19. Actually, the description in this text is based upon draft legislation released on 26 April 1995 which makes some substantial changes in the current version, although the overall concept remains the same.
20. Sec. 219.3 of the ITA.

IV. INTERNATIONAL COMPARISONS

The purpose of the following is not to present the rules of any foreign tax system in detail, but rather to see what those rules, in very broad outline, may tell us about how the emigration of corporations can, has and might be treated.

One simple approach would be to treat emigration as a deemed liquidation. This is the general rule which applies in Germany where a domestic corporation transfers its principal place of management abroad.

A second simple approach would be to prevent emigration altogether by adopting a strict place of incorporation presumption as the test of tax residence. Indeed, a number of countries have replaced factual residency tests with the place of incorporation criterion. As just noted, Canada did this in 1965. Others include the United Kingdom and the Netherlands. Yet, for the reasons already noted, there remains a possibility of corporate departure.

The UK historically determined residence by reference to the situs of the central management and control. In 1988, an irrefutable presumption of residency was established based on the place of incorporation, so that a UK incorporated company can no longer, for purposes of domestic tax law, cease to be a UK resident. A UK incorporated company might still establish itself as resident in another country under the terms of a double taxation convention. The solution appears to be a simplified and partial version of the Canadian departure tax. The emigrating company is deemed to dispose of its assets, other than UK branch assets, immediately before becoming non-resident. The exception for local branch assets is sensible, it is unfortunate that the Canadian system does not include such an exemption.

The Netherlands[21] has also moved from place of effective management to place of incorporation as the test of tax residence for domestic companies, although place of effective management remains the test for companies incorporated abroad. Dutch companies which attempt to depart from the Netherlands and thereby terminate their business activities there would be subject to a kind of departure tax on reserves and accrued gains, but if the Netherlands company held only cash, or participations in other companies which qualify under the participation exemption rules, there is no effective mainstream tax on departure. The question would then be: what happens to subsequent corporate distributions?

The Dutch courts, like the Canadian tax authorities before the Canadian law was changed, have affirmed that a locally incorporated company which removes its effective management abroad remains resident in the Netherlands as a matter of domestic tax law, even if it may be considered domiciled elsewhere under the tie-breaker rule in a double taxation convention. However, such a company may claim protection from Dutch tax under the applicable treaty. For example, dividends paid by a Netherlands incorporated entity which was found to be resident in another country under the tie-breaker test in the relevant bilateral convention were held to be free of Dutch withholding tax where the usual article concerning dividends was part of the convention. It is, I suppose, ironic that the country to which the Canadian company emigrated in the *Hunter Douglas* case should, itself, have suffered the same fiscal fate upon what amounts to the same scheme, adopted by one of its own taxpayers. No attempt has been made to remedy the situation with a Canadian style surrogate distribution tax, and such emigration to avoid Dutch withholding tax may be possible under certain treaties.

An interesting departure tax twist in the case of the Netherlands is a recent proposal to amend the special tax arrangement with the Netherlands Antilles and Aruba. Netherlands companies which emigrate to the Antilles would, under certain circumstances, be denied the protection of the special tax arrangement and thus continue to be subject to Dutch taxation, including withholding tax on distributions, for a period of five years. This is an interesting approach to corporate exit taxation, but it probably has practical application only in a special case such as that obtaining within the Kingdom of the Netherlands.

The United States adopts the place of incorporation as the fiscal connecting factor. Nonetheless, it also recognizes the possibility of corporate continuance. Such continuance, usually described as reincorporation, is common between the states of the United States and normally qualifies as a tax-free reorganization. Where a domestic corporation continues to a foreign jurisdiction, the US corporation engaging in such an "outbound" reorganization ("Oldco") is considered to have transferred its assets to a new foreign company ("Newco") in exchange for shares of Newco, and then to have distributed the Newco shares to its own shareholders. These shareholders are considered to have exchanged their shares of Oldco for shares of Newco. The result is that both Oldco and its shareholders may realize taxable gains. The "may" in the preceding sentence is inserted in recognition of some potential exceptions. For example, the gain to Oldco is deferred if its assets consist of shares of another corporation incorporated in the same jurisdiction as Newco, provided certain requirements are met. Another potential exception may apply where the assets of OldCo are used in the active conduct of a foreign business.

A comparison of the US and Canadian approaches is instructive. For example, the US system provides a more equitable result where OldCo owns shares of a foreign affiliate carrying on business in the foreign jurisdiction. In Canada, as in the United States, such shares could normally be exchanged for shares of another foreign affiliate without realizing the accrued gain. The US recharacterization allows the emigrating corporation to claim the same roll-over relief while the Canadian system does not, since it bluntly taxes accrued gains.

One obvious message is that where a tax system recharacterizes corporate emigration as something else, the consequence will depend on the "something else". While the Canadian model is not, as such, based upon a recharacterization of the transaction, the statutory consequences could be described as

21. I am indebted to Ronald Wijs of Loyens & Volkmaars (Paris) for his helpful comments on Netherlands taxation; however, I take full responsibility for any errors in this summary.

those which would apply if the shareholders of OldCo, the Canadian corporation, had exchanged their OldCo shares on a tax-deferred basis for shares of a new foreign corporation,[22] NewCo, OldCo then being liquidated. On such a liquidation of a Canadian corporation into a foreign parent, there would be a realization of accrued gains on assets[23] and a dividend withholding tax on the distribution applied to the excess of the value of the assets over OldCo's paid-up capital.[24] The rate of withholding tax would depend upon the applicable treaty, and the recharacterization assumption is that NewCo is resident in the jurisdiction to which the emigrating corporation has emigrated. This is, of course, a very different result from the US model (or the German notional liquidation) in that the surrogate for distribution tax does not depend upon the character or place of residence of the actual shareholders.

V. COMPLIANCE

As in the case of individuals, one theory behind the departure taxation of corporations is that the alternative of seeking to impose tax after the taxpayer has left the jurisdiction is difficult to apply in practice. Enforcing compliance with the departure tax itself is no easy matter either, but the situation is a bit different with corporations.

Given changes in treaties over the years, it is less likely that emigration would be accomplished by moving the effective management of the corporation. In most cases, emigration means corporate continuance. Corporate continuance requires a corporate act. This brings the matter to the attention of a government authority, albeit not necessarily a tax authority. The tax administration may, where it suspects that a taxpayer has left or is about to leave Canada, demand payment of taxes, and can take remedial action if payment is not received.[25] While this rule applies to individuals as well as corporations, it would normally be quite difficult for the authorities to know that an individual is about to emigrate. Because of the steps required to effect a corporate continuance, advance warning is somewhat more likely in this case.

One might have expected that another difference between corporations and individuals as regards compliance could be the potential liability of directors. This does not appear to be the case. The emigration of a corporation may trigger a liability to mainstream corporate tax, but that liability cannot be visited upon the directors merely because they are directors. There is a general provision in the statute which fixes liability on a person, such as the administrator of an estate, for taxes owing by the estate where the administrator has distributed the property without obtaining a tax clearance certificate in advance. While the matter is not free from doubt, the Canadian tax authorities take the view that this provision can apply to corporate directors distributing property, particularly in the case of a liquidation.[26] Whether or not the authorities are correct, the possibility of personal liability for corporate tax is probably sufficient to get the attention of the directors, especially if they are Canadian. Personal liability, however, requires a "distribution", and the fact that tax is imposed on emigration in a manner analogous to the taxation of a liquidation does not turn emigration into liquidation.

There is another provision which deals specifically with taxes required to be withheld at source. In this case, the corporate directors are liable jointly and severally with the corporation unless they can show that they exercised appropriate diligence and skill to prevent the failure to withhold.[27] However, neither the mainstream tax nor the special surrogate distributions tax is required to be withheld at source.

VI. APPLICATION

A. Mainstream departure tax

It is worth recalling the potential gaps identified in the earlier article which arise where an individual moves from one country to another and the two jurisdictions are at odds regarding departure taxation. We noted, firstly, that a taxpayer who emigrates from Canada and suffers departure tax may end up with a double tax problem if his new home does not provide a stepped up cost base for the assets. This same problem arises with corporate emigration. If the new corporate home treats the emigration (from its perspective) as a kind of reincorporation, it is possible that a new tax base for the assets will be available. If not, the Canadian tax on departure will certainly give rise to economic double taxation.

In the reverse situation a taxpayer may emigrate to Canada from a jurisdiction which does not have departure tax rules. We noted that an individual could avail himself of the step-up provided under the Canadian system to avoid tax on an accrued gain if the jurisdiction from which he emigrates does not levy an exit tax. Once again, the same rule applies to corporations. The Canadian system permits (indeed requires) a revaluation of assets when the corporation becomes resident in Canada. Where corporate emigration is possible under the local tax system, and there is no departure tax, this represents a possible method of realizing accrued gains free of tax altogether.[28] Of course, the situation is a bit more complicated for corporations than individuals because it is not always possible, as a legal matter, for the corporation to move. Many jurisdictions do not have continuation legislation.

22. This tax-deferred roll-over does not, in fact, exist in Canadian tax law.
23. Subsec. 69(5) of the ITA.
24. The deemed dividend results from Subsec. 84(2) of the ITA and would be subject to non-resident withholding tax like any other dividend.
25. Sec. 226 of the ITA.
26. Subsecs. 159(2) and (3) of the ITA. See *Interpretation Bulletin IT-368*, 28 March 1977.
27. Sec. 227.1 of the ITA.
28. I am greatly simplifying some complex provisions. On immigration, the shares of the corporation which are owned by non-residents of Canada are treated as having a cost, for Canadian tax purposes, limited to the lesser of the cost otherwise determined and the corporation's paid-up capital: Subsec. 52(8) of the ITA.
The paid-up capital is reduced to the extent it would otherwise exceed the (stepped-up) cost of the corporation's properties: Subsec. 128.1(2). Normally, these rules would not prevent the benefit described in the text, but caution is needed.

One tantalizing plan available to individuals resident in Canada was emigration followed, perhaps after a cooling off period, by a treaty protected sale of the asset. This is possible because certain assets (taxable Canadian property) are not subject to departure tax and, moreover, the individual can elect that other properties also be excluded from the deemed realization and thereafter treated as taxable Canadian property. With the exception of direct or indirect interests in Canadian real property, these assets can normally be sold free of Canadian tax if the individual resides in a treaty country and has been outside Canada for a prescribed period, generally five years. The trick is to find a new tax home which will not tax the gain either. Unfortunately, this plan does not work for corporations. The departure tax applies to all property, without exception and without election. It may well be that the reason why the rule is quite so broad is precisely a concern about corporations claiming treaty protection on sale after departure. However, it is odd that assets in respect of which Canada invariably retains the jurisdiction to tax, in particular immoveables and branch business assets, are also subject to departure tax.[29]

B. Surrogate distribution tax

As already noted, the special tax payable by an emigrating corporation is intended to function as a substitute for tax which might otherwise be payable on a distribution of assets by the corporation, effectively as if emigration were a kind of liquidation where the parent is a corporation resident in the jurisdiction to which the emigrant has moved. However, the methodology adopted is quite different from a deemed liquidation. This presents both potential advantages and disadvantages.

The main issue is the question of rate. If the emigrating corporation had actually been liquidated, the tax payable on the liquidating distribution would have depended upon the character and residence of the shareholders. If, for example, the emigrating corporation were a wholly owned subsidiary of a Canadian parent, there would have been no distribution tax. If the shareholders were Canadian resident individuals, there would have been ordinary income tax, subject to a dividend tax credit. If the shareholders were non-residents, there would have been non-resident withholding tax at the rate of 25 per cent or any lower treaty rate applicable to the shareholders. In response to this diversity, the Canadian statute provides a simple and somewhat arbitrary rule. The rate of surrogate distribution tax is the treaty dividend rate applicable to the emigrating corporation itself after it has emigrated.

This is an odd rule, and it engenders surprising results. A Canadian corporation all of whose shareholders are Dutch which becomes resident in the Netherlands Antilles would be subject to the special departure tax at the rate of 25 per cent, even though an actual dividend or liquidating distribution would only have been taxed at 6 per cent.[30] Conversely, a Canadian corporation all of whose shareholders live in Bermuda which moves to the United States would be subject to a surrogate distribution tax of 6 per cent whereas a dividend would have been taxed at 25 per cent.

In certain cases, it is clear that the departure tax system imposes two taxes in lieu of none, if a different form of transaction had been chosen. Assume Parent, a Canadian corporation, owns all the shares of CanSub, also a Canadian corporation, whose sole asset is all of the shares of USCo, a foreign affiliate carrying on business in the United States. Parent decides it would be better to have an interposed US holding company rather than a Canadian holding company, because of some non-tax consideration, and determines to accomplish this by causing CanSub to continue to the United States. This would entail a deemed disposition of the shares of USCo at fair market value, with a consequent realization of accrued gains,[31] and a surrogate distribution tax of 6 per cent of the value of the USCo shares in excess of CanSub's paid-up capital. Yet, if Parent had, instead, caused CanSub to exchange its shares of USCo for shares of a new US HoldCo, and then liquidated CanSub, there would generally be no tax at all.[32] Of course, only unusual circumstances would drive Parent to engage in the former transaction rather than the latter, but it is noteworthy that the statute puts such a premium on tax planning. In effect, in order to keep the rate of distribution tax to the minimum, the participants to the transaction must consider the alternatives and choose either a reorganization or an emigration having regard to the tax consequences.

Aside from the tax rate, there seems to be little scope for planning in connection with the surrogate distribution tax. There are some arguments which might be available, because of the particular statutory text, in certain circumstances. For example, it is not self-evident that the tax would apply in respect of assets of the emigrating corporation in the form of Canadian currency. This is because the statute, which used to refer to the fair market value of the assets, now refers to the deemed proceeds of disposition under the departure tax. Perhaps there are no deemed proceeds of disposition for domestic cash. Similar arguments might be raised in connection with shares of foreign affiliates with accumulated surpluses. These surpluses can be accessed on sale as notional dividends and therefore should not be treated as part of the proceeds of the disposition.[33]

29. As pointed out earlier this is different from the rule in some other countries which have corporate exit taxation.

30. Some Canadian treaties have a split rate of 15 per cent for portfolio dividends and 10 per cent for dividends received by a company which has a substantial interest, usually 10 per cent, of the payer. Recent treaties have adopted a 5 per cent rate instead of 10 per cent, but with a phased reduction over a period of a few years. The 6 per cent referred to in the text is this year's rate with The Netherlands.

31. Under the Canadian foreign affiliate system, the gain can be avoided to the extent it reflects accumulated active business earnings of USCo, the so-called "exempt surplus": Subsec. 93(1) of the ITA. Nonetheless, this is still a potentially taxable deemed sale.

32. The exchange of shares of one foreign affiliate for shares of another can be accomplished on a tax-deferred basis under para. 95(2)(c) of the ITA, and the liquidation of a wholly owned Canadian subsidiary is normally tax-free under Subsec. 88(1).

33. This argument, a bit of a stretch in my humble view, is referred to, although not necessarily endorsed, by Lanthier, *supra*, note 12 at 4:30.

FRANCE

Towards a New Definition of Tax Residence in France

A Critical Analysis of the Larcher Case[1]

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I. INTRODUCTION

The French territorial principle as it applies to companies operating in France was reviewed by the author in a previous article.[2] The French Supreme Court decision given in the *Larcher* case provides an opportunity to examine the basis of the taxation of individuals in France and in particular the definition of residence for income tax purposes.

In the *Larcher* case, the French Supreme Court narrowed the domestic definition of tax residence, and put an end to the broad interpretation of this provision given by the French tax authorities. Before examining this decision and its consequences, it is necessary to review the traditional approach of residence in France and the interpretation of this concept by the French tax authorities and its interaction with treaty law.

II. TRADITIONAL DOMESTIC DEFINITION OF RESIDENCE

A. The legal provision

The current territorial rules of French income tax result from the Law No. 76-1234 of 29 December 1976. This law, which entered into force on 1 January 1977, provides for a major distinction as regards the income tax liability of individuals, depending on whether or not they are French residents. French residents are subject to income tax on their worldwide income, whereas non-residents are only subject to tax on their French source income.[3] The scope of wealth tax as well as gift and inheritance taxes is also determined by reference to the individual's residence status. The definition of residence is therefore of prime importance. The French domestic definition of tax residence for individuals is embodied in Article 4 B CGI, which provides that the following are considered to be French tax resident for the purposes of Article 4 A:

1. a) people whose home (*foyer*) or principal abode (*lieu du séjour principal*) is in France,
   b) those who carry out a professional activity in France, as an employee or otherwise, unless such activity is proven to be only accessory,
   c) those who have in France the centre of their economic affairs.
2. Civil servants who exercise their duties or perform a specific mission in a foreign country and who are not liable to personal income tax in such a country on their global income are also considered as French tax residents.

In this article we limit our analysis to the central definition of French residence set out in paragraph 1 of Article 4 B. We do not examine the particular situation of French civil servants seconded abroad.

For the definition of tax residence France includes metropolitan France, the coastal islands, Corsica and the four overseas departments (Guadeloupe, Guyana, Martinique and Réunion). French overseas territories such as French Polynesia, New Caledonia, Wallis and Futuna, the Indian Ocean islands and the Antarctic zone are not part of France for tax purposes, neither are the other possessions with special status (St. Pierre and Miquelon and Mayotte Island). The French Tax Code does not apply in such territories and possessions, and people residing in these territories are considered to be non-resident for French tax purposes.

The criteria of Article 4 B apply alternatively, which means that it is sufficient to meet one criterion only in order to be considered as a resident of France. The residence status of spouses is determined separately for each spouse.[4] Since married couples are in principle taxable in France on a joint basis, they are taxable in France when either of them is a resident of France. However, when one of the spouses is not considered to be a French tax resident (under domestic or treaty law), the tax liability of the couple extends to the

1. CE 3 November 1995, No. 126513, Sec., Larcher; RJF 12/95 No 1332.
2. 49 *Bulletin for International Fiscal Documentation* 3 (1995) at 107.
3. Art. 4 A of the Code General de Impôrts (CGI).
4. Prior to 1983, the criteria of Art. 4 B applied at the level of the pater familias, the head of the family. Ever since Law No. 82-1126 of 29 December 1982, which put both spouses on an equal footing, the tax residence is to be determined separately for each spouse.

worldwide income of the resident spouse and the French source income of the non-resident. The foreign income of the non-resident spouse is only taken into account for the purposes of computing the effective tax rate.

B. The administrative and traditional case law perspective

The traditional and administrative approach to French residence distinguishes four alternative residence tests: two personal tests, one professional test and one economic test.

1. Personal criteria

(a) *The home (foyer)*

As a general rule, the term "home" refers to the place where people normally live: the place of their habitual residence. Such residence remains the taxpayer's home even if he has to spend some time abroad, either temporarily or through the main part of the year, provided his family continues to live there and it remains the family home and meeting place.[5]

Under this rule, employees who are temporarily seconded outside of France are generally considered to retain their French tax resident status if their family remains in France.[6] Although taxable in France on their worldwide income as French residents, the remuneration for their foreign activity may be taxable in the country where the activity takes place, in which case it is generally exempt in France when the activity is performed in a treaty country.

The following individuals have been considered French resident under the home criterion:

- an engineer seconded to Iraq for a long mission, who kept his apartment in France, where his daughter who was under the age of 25 lived permanently, and whose wife spent more time in France than in Iraq;[7]
- a person who worked in Polynesia[8], since his wife and children lived and worked in a French overseas department, i.e. in France for tax purposes, in a house owned jointly;[9]
- a person who, during the course of a tax year, had an apartment at his disposal in France, owned a car registered locally and held a bank account with a Parisian bank.[10]

The unique nature of the "home" sometimes raises interesting issues, for example in the case of polygamous marriages. The Appellate Court of Nancy for example held that a taxpayer who used to live in Libya with his second wife and two children was nevertheless, in the absence of any tax treaty between France and Libya, a resident of France under Article 4 B CGI because his first wife and two children lived in France where he was first married and used to live prior to moving to Libya.[11] In this case, the *Commissaire du Gouvernement* considered that, irrespective of his polygamous marriage, a taxpayer could only have one home under French domestic law and that in the present circumstances the home should therefore be in Libya, where he now resided for personal and family reasons. The court, however, did not follow this reasoning and considered that the fact that the taxpayer had one home in Libya was not sufficient to override his French residence. The rationale of this decision is not clear, and may be based on the fact that polygamous marriages are not valid in France.[12]

(b) *The main abode (séjour principal)*

This criterion is met when, in a given tax year, the taxpayer spends the major part of his time in France. In contrast to the first test, the main abode criterion applies irrespective of the place where the family lives. Furthermore the place where the person lives in France is also irrelevant i.e. it may be a hotel, free accommodation or any other place of dwelling.

As a general rule, an individual is deemed to have his main abode in France when his stays in France represent more than six months during the relevant year.[13]

Under this criterion, people have been considered to be French resident in the following instances:

- a person who spent from 10 May 1933, to 7 February 1934, in a hotel in France was considered a French resident for the year 1933;[14]
- a person who spent 302 days in a hotel room in France during one year;[15]
- a foreigner who over a number of years stayed frequently in France for periods of at least six months each year;[16]
- a person who during the relevant years stayed in Paris at two different addresses consecutively with little foreign travel;[17]
- a US citizen who was an employee of a US firm which he represented in European countries other than France and in the Middle East. He had an apartment in Paris at his disposal where his family used to live on a permanent basis and where he also lived when he was not travelling for his profession. His travels abroad were generally brief and he did not claim he was a resident of any of the other countries he visited;[18]
- a foreign student who stayed permanently in Paris from October 1968 to October 1972;[19]
- the main shareholder of a French company was considered to be a French resident, notwithstanding the fact that

5. CE 23 April 1958, No. 37792., 8th. s.s.; Dupont 1958 at 298. RO at 112.
6. Inst. 26 July 1977, 5 B-24-77, No. 3; D. Adm. 5 B-1121, No. 5, 15 March 1993.
7. CE 9 December 1988, No. 62909, 9th and 7th s.s.; RJF 2/89, No. 134.
8. Polynesia is not considered to be part of France for tax purposes (even though it is a French territory).
9. CE 30 March 1992, No. 72824, 8th and 9th s.s.; Berger RJF 5/92, No. 585.
10. CAA Lyon 3 March 1994, No. 92940, 4th Ch., de Pedri.
11. CAA Nancy 30 January 1992, No. 113, 2nd Ch., Zitoni ; RJF 7/92, No. 927.
12. This may have led the court to disregard a second marriage when the taxpayer was first married in France where his first family was living.
13. Inst. 26 July 1977; 5 B-24-77, No. 4; D Adm. 5 B-1121, No. 6, 15 March 1993.
14. CE 17 June 1946, No. 59353.
15. CE 5 July 1961, No. 37182, 8th. s.s.; Dupont 1961, at 36.
16. CE 20 February 1961, No. 50475; Dupont 1961 at 57.
17. CE 23 February 1966, No. 62460, 8th s.s.; Dupont 1966, at 221.
18. CE 16 July 1976, No. 94488, 8th and 9th s.s.; RJF 10/76, No. 426 ; BO 5 B-31-76.
19. CE 4 July 1984, No. 33800, 9th and 7th s.s.; RJF 10/84, No. 1106.

he did not have accommodation available to him in France. He used to stay regularly and for long periods each year in France, due to his work for the French company. His wife lived in France and, although they were separated, they filed a joint tax return;[20] and
- a taxpayer who travelled a great deal but did not spend any substantial period of time in any of the countries he visited when performing his professional activities was also considered to be a French resident, on the basis that he periodically spent time in France in a property owned by his wife who lived in that property with their children.[21]

The above-mentioned cases were decided on the basis of the applicable definition of residence prior to 1977. However, they remain valid under the current regime since the criterion of the main abode remains unchanged.

More recently the French Supreme Court held that a Sudanese national whose children studied in a school in France and who owned an apartment in France which was used on a regular basis was a French resident under Article 4 B. Although the taxpayer claimed that he was not present in France for most of the year and was subject to income tax in another country, these assertions, which remained unproved, were not sufficient to overcome the conclusion that he was a French resident.[22]

In the following situations the French Supreme Court considered that a person could not be considered as French resident under the main abode criterion:
- a foreigner who only stayed in France in hotels for periods not exceeding sixty-five to seventy days per year;[23]
- the Chief electrical fitter of a French electrical apparatus company, who worked both in France and abroad, who during the relevant years resided, worked and was paid outside of France and who did not have any personal accommodation available to him in France apart from that of his parents.[24]

Although the main abode test generally calls for a period of six months or more during the year, this is however not an absolute test and the French Supreme Court abstains from referring to the six-month period when the surrounding circumstances lead to the conclusion that the person had his main residence in France.[25] Notably the *Conseil d'Etat* held that a person who during the relevant years spent substantially more time in France than in any other country he visited was a French resident.[26]

2. Professional test

People can also be considered French resident when they carry out a professional activity, salaried or not, in France, unless they can demonstrate that such activity is only accessory.

Salaried employees are generally considered to be French resident if their normal and regular activity is in France, irrespective of the location of their legal employer.[27] Specific provisions apply for French employees seconded abroad.[28] However, these provisions only deal with the taxation of the remuneration for the work carried on abroad. In most instances such seconded employees will remain French resident under the home criterion, if their family remain in France. Employees seconded to France from a foreign country may also be considered to be French resident under this test.

For non-salaried professionals, the test is generally whether they have a fixed place of business in France and whether they derive most of their profits from France.[29]

Under this test, a Lebanese national who had been residing in France for a number of years, having rented an apartment there, and who developed his business activity in France through a foreign company, was considered to be resident in France, notwithstanding the fact that he travelled abroad frequently during the relevant year and that he incurred losses.[30]

Also, a foreigner who controlled almost the entire share capital of a French company and represented a number of French resident companies through this company and through agencies and subsidiaries abroad, was considered a French tax resident. The taxpayer had an apartment in France where his family lived and where he used to stay regularly and, while he was claiming to be the delegate of a Middle Eastern country, he was in fact the exclusive agent of several French companies for that part of the world.[31]

In contrast to this, the non-salaried agent of French and foreign fabric companies who exercised his activity exclusively outside of France could not be considered a French resident under this test. The fact that he owned living accommodation in France from where he could receive instructions from his principals and the fact that a number of French companies paid his commissions in France were not considered sufficient to overcome the fact that his representative activity was not carried out in France.[32]

Also, a foreigner representing a foreign company could not be considered a French resident when his stays in France were less than seventy days per year.[33]

When a person has more than one activity in France and abroad, the question will arise as to which of these activities is the main activity. As a general rule, the main activity is that for which a person devotes most of his time, even if it does not produce most of his income. The income test only applies if the time-spent test cannot be used or is not conclusive.[34]

20. CE 19 March 1958, No. 38090; Dupont 1958; at 232; RO at 90.
21. CE 24 March 1972, No. 75492 Sec.; Dupont 1972, at 217; BO 5 B-4-73.
22. CE 10 February 1989, No. 58873, 7th and 8th s.s.; Vaniau; RJF 4/89, No. 392.
23. CE 22 October 1962, No. 36505, 7th s.s.; Dupont 1962; RO at 178.
24. CE 22 February 1965, No. 51722, 7th s.s.; Dupont 1965, at 221; RO at 291.
25. Inst. 26 July 1977, 5 B-24-77, No. 4; D. Adm. 5 B-1121, No. 8, 15 March 1993.
26. CE 19 November 1969, No. 75925, 8th and 9th s.s.; Dupont 970 at 110.
27. Inst. 26 July 1977, 5 B-24-77, No. 5; D. Adm. 5 B-1121, No. 12, 15 March 1993.
28. Arts. 81 A and 197 C CGI.
29. D. Adm. 5 B 1121, No. 13, 15 March 1993.
30. CE 21 January 1963, No. 46547, 7th s.s.; Dupont 1963, at 204.
31. CE 3 May 1968, No. 67951; RJCD 1st part, at 142.
32. CE 11 April 1962, No. 53256; RO at 70.
33. CE 22 October 1962, No. 36505; RO at 178.
34. Inst. 26 July 1977, 5 b-24-77, No. 5; D. Adm. 5 B 1121, No. 16, 15 March 1993.

3. Economic test

Individuals whose economic interests are focused in France are also deemed to be French resident.

The centre of economic interests is the place from which one plans and carries out one's main investments, the place which is the "hub" and from which assets are managed. It may also be the place from where a person manages his or her professional activity and from where he or she derives most of his or her income.

Individuals have been considered French residents based on this criterion in the following circumstances:

- a taxpayer who settled in France with his spouse and his son after having sold most of his assets in Egypt, purchased an apartment in France for himself and his spouse and one for his son, and invested in a number of French businesses most notably in immovable property companies and banks. He also acted as a manager of a French SARL. The fact that the taxpayer kept an apartment and an office in Cairo was not considered sufficient to overcome the French ties;
- a person who owned an apartment in France, received a substantial French source income and held a substantial portfolio of securities in France was considered to have the centre of his economic interests in France, notwithstanding the fact that he was the manager of a Tunisian company and also owned other assets in Tunisia (Tunisian assets being substantially smaller than the French assets);[35]
- a French Court of Appeal also decided that an individual who owned a number of buildings in France and had a large stake in French real estate companies and agricultural groupings should be considered as having the centre of his economic interests in France, although he was the director of various Moroccan companies and owned other assets in Morocco, since the value of such Moroccan assets was not established and therefore could not be weighted against the French assets.[36]

Conversely, the Conseil d'Etat held that a French citizen who derived most of his income from businesses located abroad could not be considered as having the centre of his economic interests in France, irrespective of the scale of his French investments during the relevant year.[37] Likewise a taxpayer who owned several farms amounting to a total of 166 hectares of farm land and who had a large house where he had an office with four employees in France, but who derived most of his income from properties of over 1,400 hectares in Algeria and Morocco was not considered as having the centre of his economic interests in France.[38]

This review of the administrative and court approach shows how broadly the domestic concept of residence is traditionally construed by the tax authorities and the courts in France. The domestic legislation is extensive and by nature its purpose is to extend the French tax jurisdiction as much as possible.

III. TAX RESIDENCE IN A TREATY CONTEXT

The concept of residence is also essential in a treaty context, since treaties only apply to persons who are resident in one or the other of the Contracting States.

Given the potential overlap of the definition of residence under domestic legislation, income tax treaties generally provide for a tie breaker rule, whose purpose is to solve a potential case of double residence between two Contracting States. However, certain tax treaties such as the treaty between Belgium and France do not refer to domestic legislation and directly define residence under the treaty.

Article 4 of the OECD Model treaty gives the following definition of residence:

"1. 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 or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
   a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
   b) If the State in which he has the centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has a habitual abode;
   c) if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
   d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated."

This provision, which is used in most treaties entered into by France, calls for a number of comments.

35. CE 17 March 1993, No. 85894, 8th and 9th s.s., Memmi ; RJF 5/93, No. 612. In this case, the tie breaker rule of the France–Tunisia treaty was applied, and the taxpayer was ultimately considered a Tunisian resident under the citizenship test.
36. CAA Nantes 29 June 1994, No. 92-811, 1st Ch., Lesmaris; RJF 12/94, No. 1294.
37. CE 27 January 1971, No. 74995; RJ III at 18.
38. CE 11 March 1970; RJ III at 59.

(i) The treaty definition first refers to the domestic legislation of each Contracting State and the treaty tie-breaker only applies in case of conflict. This principle of interpretation was recently confirmed by the French Supreme Court.[39] In this case, the Supreme Court reaffirmed the principle under which, if the treaties have a superior force to the law under Article 55 of the 5th French Constitution, such superiority may only apply if the law potentially applies. In the context of residence, this means that the treaty definition may only apply if in the first instance it is established that French law would otherwise apply.

(ii) The treaty criteria operate in a successive manner while the domestic criteria each have equal force. Accordingly, the domestic legislation and treaty law do not further the same goal, whereas domestic legislation aims to extend as much as possible its jurisdiction over individuals in a number of personal, professional or economic circumstances, treaties are designed to solve a potential conflict between two Contracting States.

(iii) The treaty criteria differ from the French domestic criteria. In particular, the treaty's "permanent home available" is not equivalent to the French "home" test. Although both terms imply a high degree of permanence, the "permanent home available" is a material test which refers to any property that the taxpayer has arranged in such a manner that he or she can effectively use it in a permanent way, whereas the home is the place where he or she usually lives, even though he or she may have to live elsewhere on occasions. By definition, a person may have several permanent homes available, although he or she can only have, in most circumstances, one single home.

(iv) The existence of a conflict of residence under domestic law raises a number of questions when the tax system of the other Contracting State differs substantially from the French tax system. For example, the concepts of domicile, ordinary resident and resident which are peculiar to the UK tax system (and other tax regimes derived from the UK system) do not easily combine with the French criteria. The UK remittance basis principle under which non-domiciled residents are only taxable on their foreign source income in the UK if they remit or repatriate such income to the UK raises the issue of whether such people are from a French tax perspective liable to tax in the UK by reason of their residence. Accordingly, although liable to tax on their worldwide income, they are only taxed on UK source income and on repatriated foreign income.

IV. THE *LARCHER* CASE

A. The Supreme Court decision[40]

Mr Larcher and his wife had lived since 1963 in New Caledonia, where Mr Larcher ran an enterprise. Mr Larcher spent 170 days in France during 1977 and 175 days in France during 1978, and Mrs Larcher spent 275 days in France during 1977 and 273 days in France in 1978. These extensive stays were for the purpose of visiting Mrs Larcher's mother who was seriously ill in France. Mr and Mrs Larcher also owned an apartment in Bordeaux.

New Caledonia is a French overseas territory and is not considered part of France for tax purposes. In 1977 and 1978, there was no tax treaty between France and New Caledonia, so domestic legislation applied to the facts without any restriction or limitation.[41]

On the basis of these facts, the tax authorities considered that Mr and Mrs Larcher were French tax resident during these years, under Article 4 B CGI, and the tax reassessment was upheld by the courts in both the first instance and on appeal on the basis that, given the number of days spent in France during those years, the Larchers had their home in France.

The French Supreme Court reversed the appellate court decision and held that the court had violated the law in considering the number of days spent in France to determine the home of Mr and Mrs Larcher. The Supreme Court held that the "home" test is distinct from that of the "main abode" test and that the computation of the number of days only applies for the purpose of the main abode test.

This was however insufficient by itself to save Mr and Mrs Larcher from the claims that they were resident under Article 4 B. Under the Administrative doctrine, they could still be considered as French resident under the main abode test.

However, and more interestingly, the French Supreme Court considered that:

- the home means the place where a taxpayer usually lives and has the centre of his family interest, without taking into account the temporary periods spent elsewhere due to professional obligations or exceptional circumstances.

and held that:

- Mr and Mrs Larcher must be considered as having maintained their home in New Caledonia, where they used to live on a habitual basis. Therefore, the fact that Mr Larcher or his wife had their main abode in France during those years is irrelevant for the purposes of determining their tax residence.

Considering further that Mr Larcher had his professional activity and the centre of his economic interests in New Caledonia, the Conseil d'Etat therefore reversed the lower court's decision and cancelled the reassessments for 1977 and 1978.

B. Critical analysis

It is the first time since 1977 that the French Supreme Court has had to define precisely the home test and the relationship between the home and the main abode criteria under Article 4 B CGI. As shown in our court case review, the Supreme Court decisions have not clearly distinguished between the

39. CE 17 March 1993, No. 85894, 8th and 9th s.s.; Memmi RJF 5/93, at 359.
40. See *supra* note 1.
41. A tax treaty was signed with New Caledonia on 31 March 1983, which entered into force on 27 July 1983.

two personal tests in the past and a number of decisions based on either of these tests would have led to the same result under the other one. This situation certainly reflects that in most instances the place that would be considered as the home is also the main abode and that the need to distinguish between them is not crucial.

This decision is important since it discusses the domestic tests of tax residence in France without the safeguard of treaty protection. In most situations, residence issues are indeed addressed in a treaty context where the focus is more on the treaty tie breaker rules than on the domestic test. Accordingly, had a treaty been applicable in the *Larcher* case, it is very doubtful that it would have reached the Supreme Court since Mr and Mrs Larcher would in any event have been considered tax residents of New Caledonia under the centre of vital interests test.

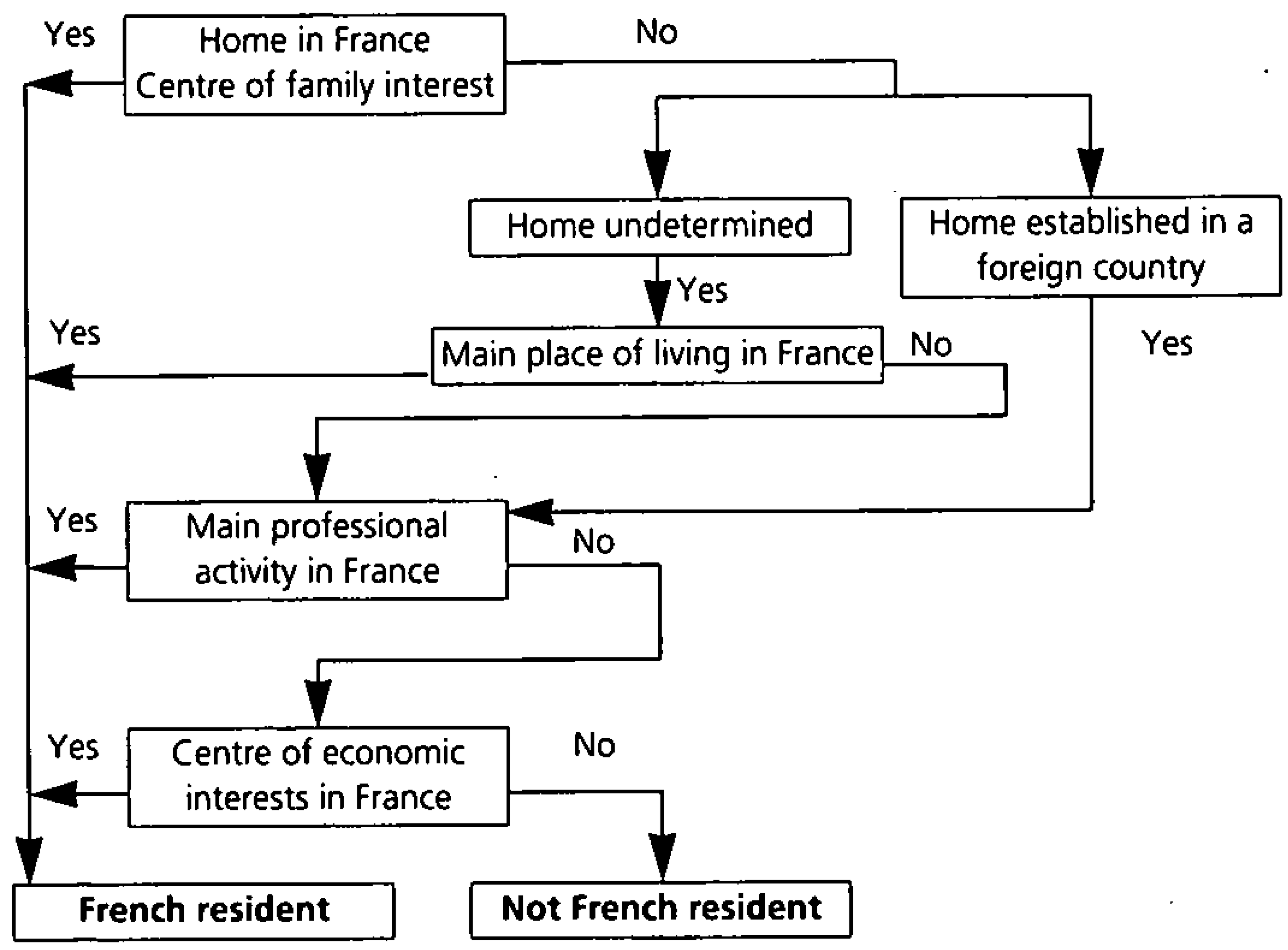
In its judgement, the French Supreme Court followed the proposition of Mr Arrighi de Casanova, the *Commissaire du Gouvernement*, considering that, among the two personal tests of residence, the main abode was contingent and subsidiary to the home test. He indeed proposed to the Supreme Court that in the review of the personal tests, the main abode (i.e. the number of days) be only referred to when and where the home could not be determined with certainty.

The new definition of the home given by the Conseil d'Etat[42] is interesting since it refers to the concept of the "centre of the family interests", a concept which mirrors that of the "centre of economic interests". This is however not particularly new. More revolutionary is the fact that the home test, where characterized, may not be defeated by the main abode test when such test is only fulfilled due to professional obligations or exceptional circumstances.

Further to the *Larcher* case, the four residence tests traditionally considered by the French tax authorities are therefore, broadly speaking, reduced to three, since the first two tests are combined into one, that of the home, the main abode test being only contingent. From now on, following the decision of the Supreme Court, when the home is determined there is no reason to review the facts in the light of the test of the main abode. In other words, a person whose home is clearly established outside of France may only become a resident of France under French domestic tax law if he or she has his or her professional activity or the centre of his or her economic interests in France. The main abode test however remains applicable when the home may not be characterized.

This new analysis may be summarized in the following chart.

Tax residency decision procedure



C. Remaining uncertainties

By introducing the concepts "centre of the family interest" and "exceptional circumstances", the new approach of the residence personal tests raises certain questions that remain to be answered.

1. Centre of family interests

Does the centre of the family interest refer to the immediate family or does it include more than the spouse and the children? In the *Larcher* case, in reaching its decision that Mr and Mrs Larcher's home was in New Caledonia the Supreme Court did not take into account the fact that Mrs Larcher's mother was living in France. More clearly, in the *Memmi* case,[43] the Conseil d'Etat took into account only the immediate family. In that case a Tunisian national had residences both in France and in Tunisia. His wife lived in Tunisia, but his children lived in France and so did most of his extended family (brother, uncles, nephews and nieces). The Court held that Mr Memmi's home remained in Tunisia where his wife used to live, since his children were all of age, and no longer lived with him in France.[44]

Following the *Larcher* case, one hopes that the French tax authorities will provide guidance on what they believe constitutes "the centre of family interests".

2. Home v. tax home

The Conseil d'Etat did not refer to the tax status of Mr and Mrs Larcher in order to reach its decision. Although it can be

42. "The home is the place where a taxpayer usually lives and has the centre of his family interest, without taking into account the temporary periods spent elsewhere due to professional obligations or exceptional circumstances."
43. See *supra* note 39.
44. Although his home was in Tunisia, he was considered to be a resident of France under domestic law following the centre of the economic interests test. Under the treaty, the court had to revert to the citizenship test in order to conclude that he was a Tunisian resident because he was a Tunisian citizen.

assumed that, as residents of New Caledonia, they were liable, during the relevant years, to income tax there, the Conseil d'Etat did not take this element into account and only referred to family ties when characterizing the home.

Nothing in the *Larcher* case suggests that the decision would have been different had Mr and Mrs Larcher lived in a tax haven. However, it remains to be seen whether the tax authorities would accept that *Larcher* applied in cases where the foreign home was a tax haven.

3. Single persons – students

Further, one could wonder whether the centre of the family interest has any impact in determining the home of a single person. It is traditionally considered that the home of a single person is purely where he or she is living on a normal basis and that, as soon as he or she lives more in France than anywhere else, he or she should be considered to be French resident.

The question arises as to whether it is not desirable to introduce some flexibility into this statement, particularly for students. Under French tax law, any child over the age of 18 is in principle taxable separately unless he or she elects to be included in his or her parent's tax return[45]. Such election may be made by any child under the age of 21, or by a child under the age of 25 if he or she is a student.

Under this principle, it should be recognized that a foreign student under the age of 25 studying in France for a limited period of time could escape French income tax by not becoming French resident. However it is unclear as to whether the French tax authorities would accept that such a student, may under certain circumstances be considered not to be a resident of France. An additional question is whether in any event the tax authorities would require that he or she prove that his or her income is taxable in the hands of his or her parents.[46] Under the *Larcher* case, the tax status in the foreign country seems to be irrelevant, but here again, it will be interesting to see whether the tax authorities will follow this approach.

4. Exceptional circumstances

The issue raised by the particular situation of students leads to the additional question raised by the definition of the tax residence given by the Conseil d'Etat. What is meant by exceptional circumstances? In the *Larcher* case, most people would sympathize with Mr and Mrs Larcher and consider their situation exceptional. The scope of the term "exceptional circumstances" however remains to be clarified even though it is by nature not an easy term to define. Could foreign studies be considered as exceptional? Could long term medical treatment also be considered as an exceptional circumstance?

Suppose a wealthy French national, Mr X, decided in his thirties to leave France to settle in Tax Paradise. From that point on he has no further relations with France. When he is sixty he becomes affected by a long term illness. His doctor recommends that he receive treatment in France at a special clinic where a renowned specialist works. He spends one year at the clinic, and then a further year in a hotel room so that he may attend the day clinic, but unfortunately the treatment is ineffective and he dies in France whilst still undergoing treatment.

The determination of Mr X's residence is of paramount importance since it bears not only on income tax but also on wealth tax and estate duties.

Following the *Larcher* case, one could certainly argue that Mr X's home remained in Tax Paradise and that his presence in France was due only to exceptional circumstances. However, one must wonder what would have been the Supreme Court's decision, had the presence in France not been caused by Mrs Larcher's mother's illness, but rather by the illness of one of the spouses. Would the Supreme Court still consider that the presence in France was due to exceptional circumstances?

If the situation of Mr X also calls for sympathy, we nonetheless believe that the exceptional circumstances should be kept to a minimum. In particular we believe such situations are confined to those external to the taxpayer and that affirmative steps toward France for immediate personal reasons could trigger a change of tax residence. In the above example we do not see why Mr X could not be considered as having moved his residence to France when he himself decided to use the French medical system.

US Treasury regulations on the presence test provide interesting comments on medical conditions and the computation of the number of days to be taken into account for the purpose of determining whether an individual is domiciled in the United States for federal income tax purposes. As a general rule, individuals are considered not present on any day that the individual intends to leave and is unable to leave the United States because of a medical condition or medical problem that arose while the individual was present in the United States. Individuals coming to the United States for medical reasons which arose earlier may only claim exemption if they establish that they have closer connections to a foreign country. According to such regulations, this notably requires that the individual be able to prove that he maintains a tax home in such foreign country and that he is subject to taxation as a resident there.

The above outlines some of the uncertainties that remain concerning the definition of residence for tax purposes following the *Larcher* case. Such questions will have to be addressed in the first instance by the tax authorities and in cases of dispute by the courts.

45. French income tax is in principle due on the global income of both spouses.
46. For example, would a wealthy 21-year old foreign student who settles in Paris for three years where he rents an expensive apartment, and has a car registered in France be considered as having kept his home in Tax Paradise and therefore not be taxable in France in respect of the substantial income he derives from assets he owns in Tax Paradise where his family lives?

D. Conclusion

In conclusion, the *Larcher* case is not only important in a strict domestic context, where no tax treaty applies. It is also of importance in a treaty context, since the treaty definition of residence generally refers first to the domestic legislation of both contracting States. By reducing the scope of French domestic tax residence, the French Supreme Court has also necessarily reduced the number of situations where a conflict over residence arises, it has also clarified the position of mixed resident couples, where one spouse is resident and the other is not.

NETHERLANDS

BASE EROSION

Harry Doornbosch and Irma van Scheijndel

I. INTRODUCTION

The erosion of the taxable base in the Netherlands via the deduction of interest on intra-group loans has been the subject of several Hoge Raad (Netherlands Supreme Court) cases. The Netherlands tax authorities tried to combat base erosion on the grounds that it was an abuse of law. In this article we discuss the abuse of law doctrine, the Hoge Raad's decisions on base erosion and their impact on tax planning and finally the recently published plans of the Netherlands Government to combat base erosion.

II. ANTI-AVOIDANCE

A transaction, such as an internal reorganization, which leads to a reduction of Dutch tax can be attacked by the tax authorities in two different ways. The first method is by the "interpretation of the facts" doctrine and the second is to rely on the concept of "abuse of law".

An example of the application of the interpretation of the facts doctrine is the Hoge Raad's decision *BNB 1988/217*.[1] In this case the Hoge Raad ruled that when an instrument is considered to be a loan for civil law purposes, it will also be considered to be a loan for tax purposes unless:

(1) the parties involved really did not intend to grant a loan, but a capital contribution, despite the fact that the transaction was referred to as a loan (i.e. the "loan" was a mere sham); or
(2) the loan has been granted under such conditions that the creditor has, in fact, a participation in the company of the debtor. Based on the particular characteristics of the instrument (no maturity date, interest free, subordinated to other debtors), the instrument while formally called a loan, can be recharacterized as equity; or
(3) a shareholder grants a loan to its subsidiary in such circumstances that it is immediately clear that the debtor will never be in a position to repay it (loss-financing).

If a loan falls into any of the above categories, the debt instrument may be re-characterized by the Hoge Raad as equity. Consequently, interest deductions will be denied and the interest payments treated as dividend distributions.

When a Dutch company is financed by debt, the Hoge Raad may, when the loan does not fall into the above-mentioned categories also deny the corresponding interest deduction on the basis of "abuse of law". The Hoge Raad developed the following two conditions, which must both be met before a transaction can be disregarded:

(1) the motive test: the taxpayer's sole or decisive motive for entering into certain transactions is the reduction of tax, and the transaction does not have any real or practical purpose apart from the reduction of taxes[2]; and
(2) the object test: the relevant transactions violate the object and purpose of the Tax Code.

If both conditions have been met, the Hoge Raad may disregard the transactions together with their fiscal consequences.

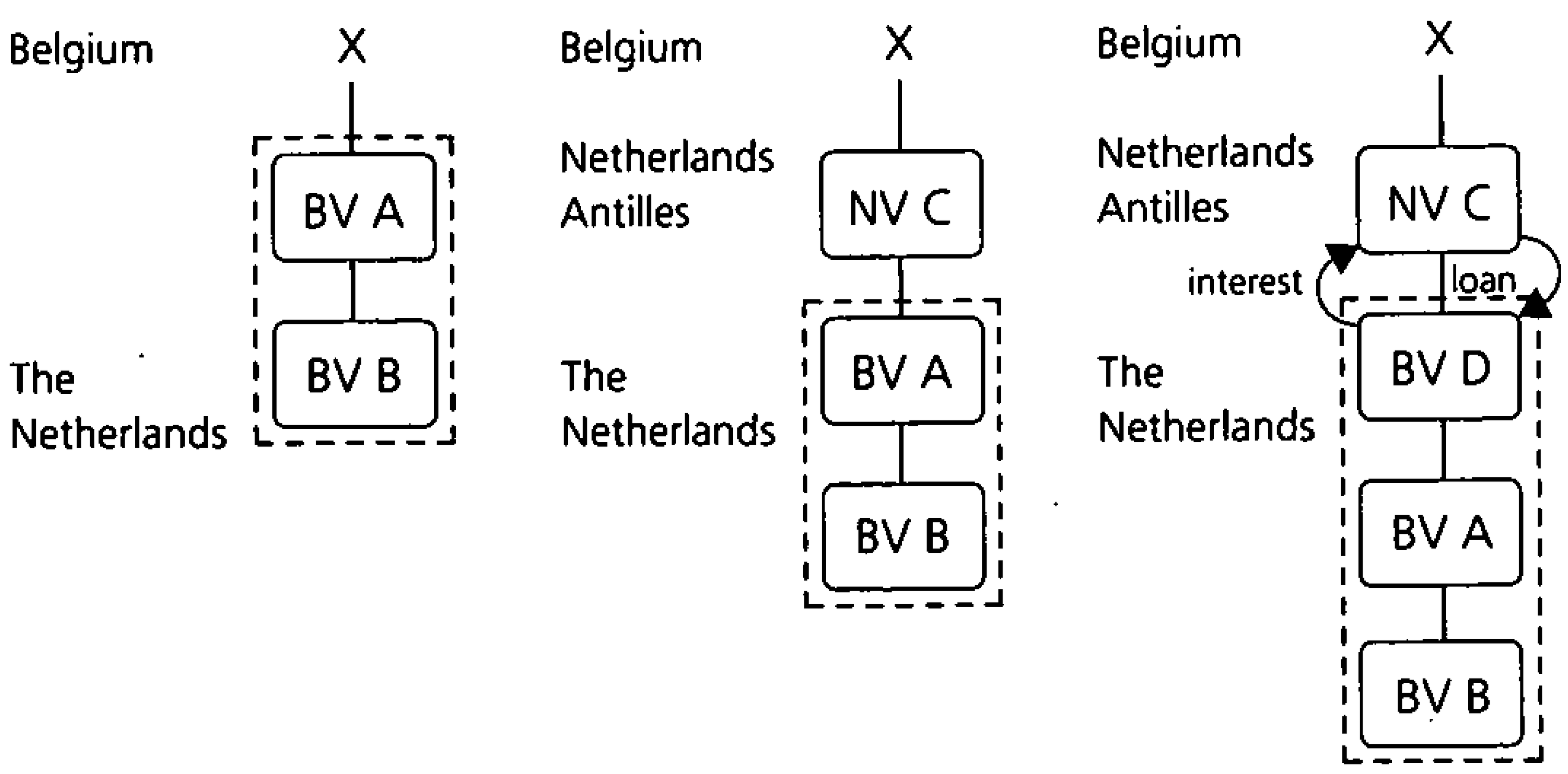
III. IMPORTANT CASES ON INTEREST DEDUCTIONS

BNB 1989/217[3]

X, an individual shareholder residing in Belgium, held all the shares in BV A directly, and in BV B, indirectly. Both companies were resident in the Netherlands. BV A formed a fiscal unity[4] with its subsidiary BV B. The following transactions took place. X contributed his shares in BV A to NV C, resident in the Netherlands Antilles and wholly owned by X. NV C contributed its shares in BV A to a newly incorporated Dutch subsidiary, BV D. BV D financed the acquisition, largely through a debt to NV C. BV D and BV A, including BV B, joined in a fiscal unity. Therefore, the interest payments by BV D could be offset against the profits of the fiscal unity, while the corresponding income was taxed at a very reduced rate in the Netherlands Antilles.

1. Hoge Raad, 27 January 1988, *BNB 1988/217*.
2. Some authors consider this a separate test, but in our view it is more an explanation of the first mentioned test. See Vakstudie, note 31 to Art. 31 AWR. It should be mentioned that since *BNB 1990/293* the Hoge Raad caused confusion on this point. In that case the Hoge Raad decided that although a restructuring has a practical meaning, this does not mean that the chosen structure may nevertheless lead to the conclusion that reduction of tax was the main motive.
3. Hoge Raad, 26 April 1989, *BNB 1989/217*.
4. Fiscal unity implies that the companies have been consolidated for the purposes of Dutch corporate tax.

Diagram 1
BNB 1989/217



The Hoge Raad ruled that the transactions were an abuse of law and the loan, together with the interest deduction, was denied. The Hoge Raad ruled on the following grounds that the decisive motive for the transaction was the reduction of tax: firstly the actual relations between the Antilles company and BV A had not changed (the Antilles company still controlled BV A, albeit indirectly) and secondly there appeared to be no other important business reasons for the transaction beyond the reduction of Dutch taxation.

Furthermore the Hoge Raad ruled that the transactions affected neither the financial position of BV A nor its interest or control by the Antilles company. As a result, it could be concluded that the loan was not meant to contribute to the financing of the operating company and that the interest thereon was not related to the business of the operating company. If the transactions were accepted, corporate income tax could be reduced at any time and more or less without any limit. According to the Hoge Raad, such an arbitrary result would violate the object and purpose of the Dutch Corporate Income Tax Code.

From this case, it can be concluded that:
The motive test will be fulfilled if:
- the actual relations within a group have not changed; and
- there are no important business reasons for the transactions; and
- Dutch taxation is reduced.

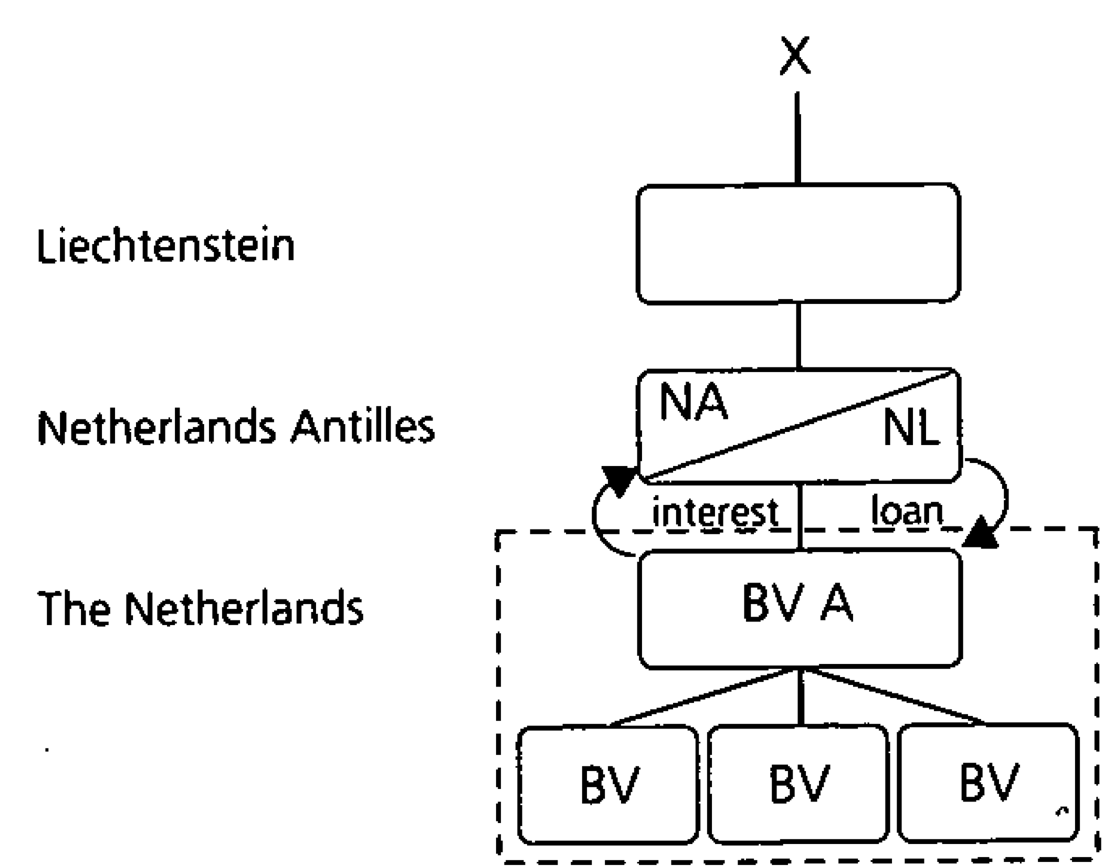
The object test will be fulfilled if:
- the loan cannot be said to contribute to the financing of the business; and
- corporate income tax can be reduced at any time, more or less without any limit.

BNB 1993/194[5]

The Hoge Raad in three cases decided in March 1993, further elaborated on the object test, and the circumstances in which a transaction could be held to be in violation of the object and purpose of Dutch tax law. In *BNB 1993/194* the facts were as follows.

Over a number of years BV A being a part of a fiscal unity distributed dividends to its Netherlands Antilles parent. The Netherlands Antilles parent effectively lent back part of the dividends via interest bearing loans advanced to the subsidiary. As a result, the interest payments of the fiscal unity could be offset against its profits. The loans were extended continuously. In an earlier procedure the Hoge Raad had decided that the Netherlands Antilles parent was managed and controlled in the Netherlands and therefore subject to Dutch corporate income tax on its worldwide income.

Diagram 2
BNB 1993/194



The Lower Court decided that a dividend distribution followed by a loan back of part of the dividend constituted a considerable change in the financing of the company. Equity had been replaced by debt. Moreover, it was undisputed that the loans contributed to the financing of the business of the BV A. As a result, the court concluded that the object test was not met. The transactions could therefore not be considered to violate the object and purpose of the Tax Code.

The Hoge Raad came to the same result, but on different grounds. The Hoge Raad decided that the structure was not an abuse of law, since the interest on the loans was subject to corporate income tax in the Netherlands at the level of the recipient. The transactions could therefore not be considered in violation of the object and purpose of the Tax Code. In other words, when interest deductions by one group company result in interest income in the hands of another group company and both companies are subject to Dutch corporate income tax, there is no abuse of law.

BNB 1993/196[6]

The two other cases dealt with restructurings where there was an interest deduction in one group company, while the interest income was taxable in another group company. However, effectively, no corporate income tax was payable at the level of the recipient due to large losses. The facts of *BNB 1993/196* can be summarized as follows.

BV A and BV B, each owning 50 per cent of the shares in BV C, incorporated BV D. The capital of BV D was paid in by contributing the shares in BV C. The contributors were credited with the excess value. The amount left outstanding was interest-bearing. BV D and BV C joined in a fiscal unity. BV D could offset the interest payments against the profits of BV C. BV A and BV B utilized losses to cover the interest income. Therefore, the interest income was effectively not taxed.

5. Hoge Raad, 10 March 1993, *BNB 1993/194*.
6. Hoge Raad, 10 March 1993, *BNB 1993/196*.

Diagram 3
BNB 1993/196

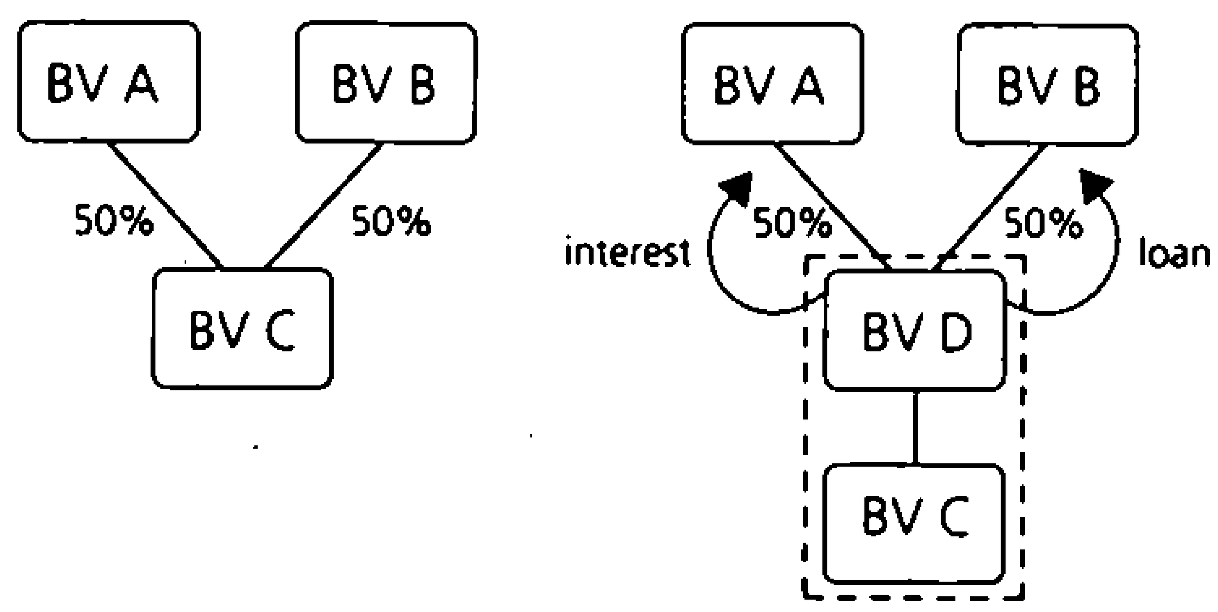
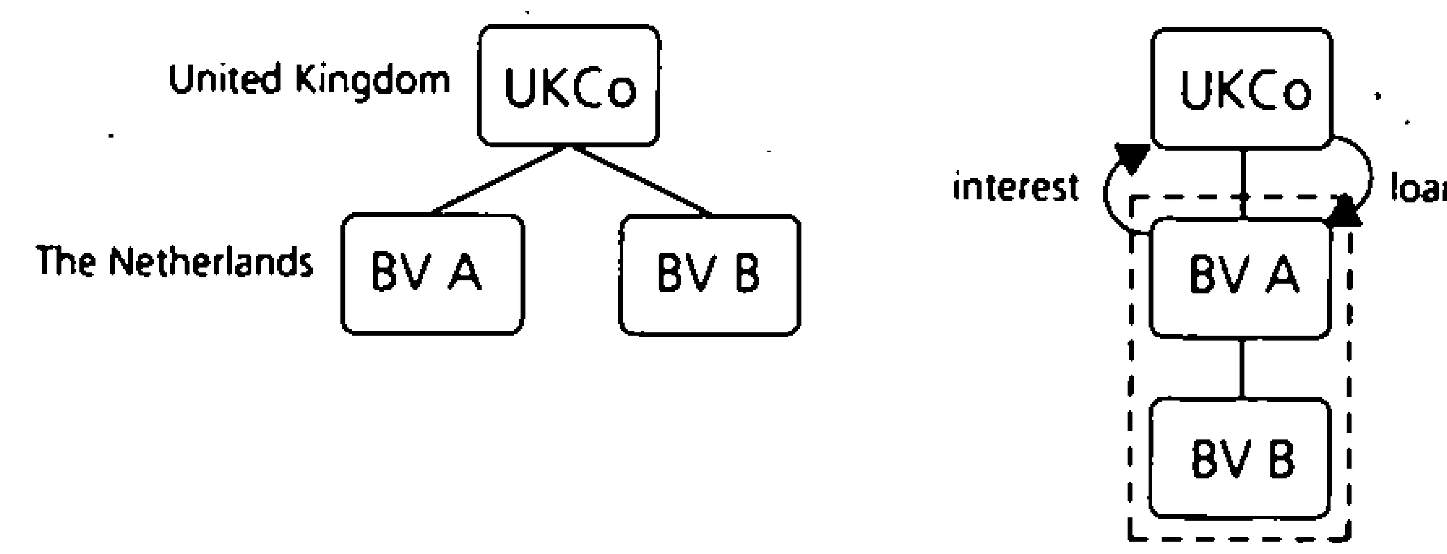


Diagram 4
BNB 1996/5



The Lower Court ruled that the interest payments were not triggered by the business of the operating company. However, as the interest income was taxable in the two holding companies, the transactions could not be considered to be in breach of the object and purpose of the Tax Code. The existence of losses, which covered the interest income, was not relevant in this respect. The Hoge Raad confirmed this point of view. It further explained that if, as a result of an internal reorganization, interest is deducted by one company, but taxable in another group company, such a deduction is not in breach of the object and purpose of the Tax Code. This rule remains valid even if the interest income is reduced by losses from the same, previous, or later years, since those losses only reduce the tax actually payable and have no impact on the fact that the interest constitutes part of the Dutch taxable income. The Hoge Raad indicated, however, that it would have reached a different conclusion if the shareholders in the "loss" company had not been the same persons who were shareholders at the time when the losses were incurred. That was the reason given for denying the interest deduction in *BNB 1993/197*[7].

In summary, it can be concluded that it is possible to reorganize a group structure solely for tax reasons, thereby creating an interest deduction in one Dutch group company and taxable interest income in another Dutch group company. Taxation may effectively be avoided by the use of the recipient's losses. This will not be the case if the losses were incurred prior to the acquisition of that company by the group. In that case and in cases where no corresponding income flow is established in the Netherlands, the interest deduction may be refused if the requirements of the motive and object tests are met.

BNB 1996/5[8]

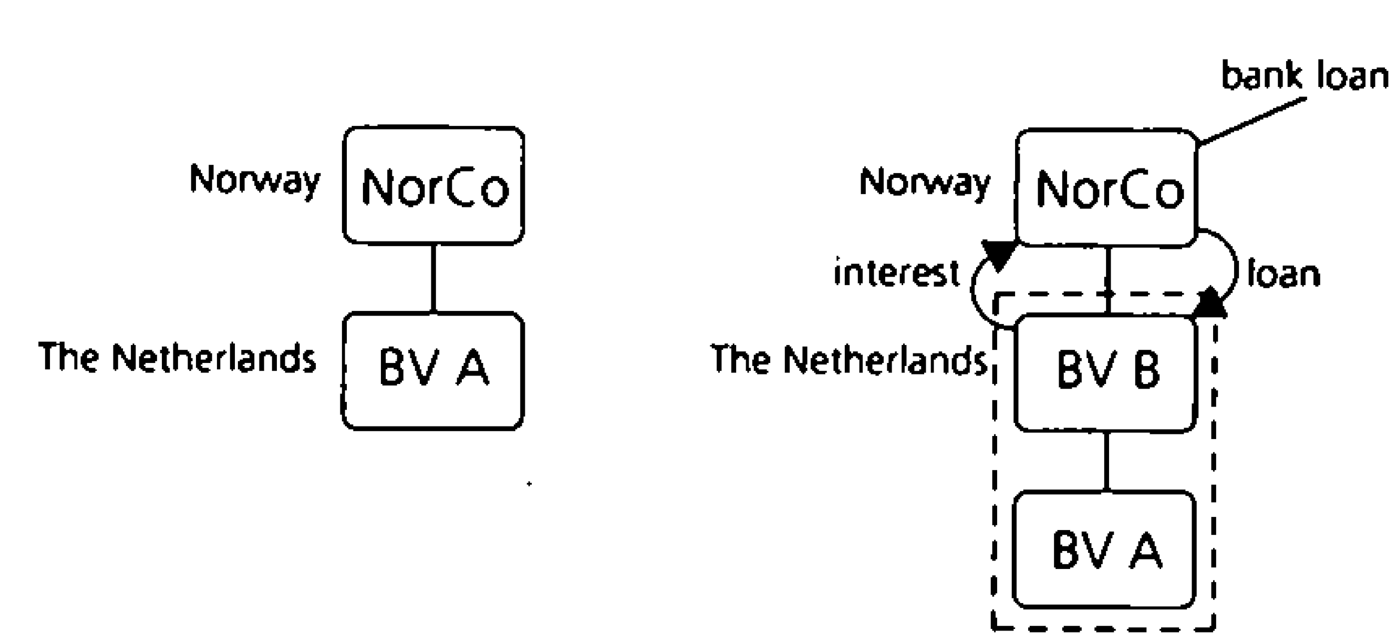
A UK company had two Dutch subsidiaries, BV A and BV B. After a number of years BV A bought all the shares in BV B and the acquisition was entirely financed by a loan granted by the UK company. A fiscal unity was created between BV A and BV B, so that the interest could be offset against the profits of BV B. The UK company did not actually pay tax in the UK because of credits for foreign income and ACT.

The Hoge Raad ruled that when a Dutch company obtains a loan from a foreign company, and the interest is taxable in that foreign country, the interest deduction in the Netherlands cannot be denied on the grounds of abuse of law. The Hoge Raad only requires the level of taxation in that foreign country to be reasonable according to Dutch standards. Interestingly, Hoge Raad considered here that the question of whether the avoidance of taxation was the decisive motive for the transaction was irrelevant.

BNB 1996/6[9]

A Norwegian company, NorCo, financed the acquisition of BV A, a Dutch target company, by means of a bank loan. Three years later a restructuring took place, whereby NorCo interposed BV B, a Dutch holding company, which was financed by a loan from NorCo. BV A and BV B then joined in a fiscal unity. Thus the profits of the fiscal unity were effectively reduced by the interest costs of BV B.

Diagram 5
BNB 1996/6



Both the Lower Court and the Hoge Raad were very brief in their judgments. The Lower Court decided that there was no abuse of law, it stated that a reorganization, which could also have taken place at the time when the Dutch target was acquired[10], cannot be considered as an abuse of law.

However, the Hoge Raad rejected the tax authorities' appeal on other grounds. It was indifferent to the fact that, effectively, no tax was levied on the Norwegian parent company because the interest income was assumed to be offset against the interest expenses of the bank loan. The Hoge Raad considered that the bank loan in Norway had not been taken out in order to avoid Norwegian tax on the profits of the Norwe-

7. Hoge Raad, 10 March 1993, *BNB 1993/197*.
8. Hoge Raad, 20 September 1995, *BNB 1996/5*.
9. Hoge Raad, 27 September 1995, *BNB 1996/6*.
10. BV B could initially have financed the acquisition of BV A by debt.

gian parent company. Therefore, the interest deduction at the Dutch level could not be regarded as violating the object and purpose of the Tax Code.

Both cases add a very important international element to the question as to whether certain transactions can be disregarded by the tax authorities by virtue of the abuse of law doctrine. If a certain deduction in the Netherlands results in the corresponding income becoming taxable abroad, the deduction cannot be refused, even when the foreign taxable income is offset against other business deductions, or credited against other taxes, unless the level of taxation in that foreign country is not reasonable according to Dutch standards.

IV. COMMENT

The decision concerning the Norwegian recipient company (*BNB 1996/6*) leaves some questions unanswered. The Lower Court's decision implied that an acquisition of a Dutch target through a Dutch intermediate holding company may be funded without any limit by loans from the foreign parent company. It is not clear whether or not it was important to the Lower Court's decision that the Norwegian parent company financed the acquisition by a bank loan.

The issue of corresponding taxation in Norway was not seen as a major issue in the Hoge Raad's decision. The Hoge Raad regarded the interest received in Norway as having been used to pay the interest charged on the Norwegian bank loan. Furthermore it was of the opinion that the Norwegian parent did not take out the bank loan to avoid Norwegian tax on its profits and that therefore, the interest deduction in the Netherlands was not in violation of the object and purpose of the Tax Code. The conclusion which we draw from this case is that in debt-push downs, the question of the parent's original loan is highly relevant, it seems that at this level the Dutch courts should apply the abuse of law doctrine.

In the UK case, the court ruled that if the interest income is subject to a profits tax or a tax on income which is reasonable by Dutch standards, the interest deduction in the Netherlands cannot be denied as an abuse of law. The question then arises as to what is a reasonable level of taxation. In our view, both the taxable basis and the tax rate should be taken into account. Is a profits tax of 1 per cent or 2 per cent enough (as with the participation exemption for foreign subsidiaries) or should it be comparable with the Dutch statutory rate of 35 per cent? Most authors believe that the answer lies somewhere in between, at, for example, 15 per cent. This view is based on the contents of a bill dated 16 July 1993, which was never enacted. The bill proposed, amongst other things, to exclude the participation exemption on subsidiaries which were not subject to a profits tax of at least 15 per cent. Support for the 15 per cent rate can also be found in recent proposals made by the Netherlands Government.[11] One of the proposals being made is to improve the fiscal infrastructure by facilitating Dutch based intra-group financing companies. These companies will be effectively taxed at a rate of between 7 and 15 per cent.

V. IMPACT ON TAX PLANNING

A. Restructurings

In our view, it is now possible for international groups of companies to structure their operations in such a way that interest deductions may be taken in the Netherlands. The only requirement is that the income should be subject to a tax on profits (or income) which is reasonable by Dutch standards. The group's effective overall tax rate can be reduced if the recipient company has other business expenses or other credits available to reduce the interest received. The question as to whether the setting off of interest income against the losses of the foreign recipient is acceptable has not yet been addressed by the Hoge Raad. However, the above-mentioned jurisprudence leads us to conclude that an appeal by the Netherlands tax authorities on the grounds of the abuse of law doctrine is likely to fail. Of course, the recipient's losses must have been incurred within the same group. The Hoge Raad decided in *BNB 1996/3*[12] that taxation in the hands of an individual is also acceptable as a compensating taxation.

It should be noted that the above assumes that the decisive motive for the transaction was to reduce tax, and that there were no other sound business reasons for the restructuring. If sound business reasons did exist,[13] the reorganization would not be vulnerable to an attack on the grounds of abuse of law.

B. Third party acquisitions

All of the above-mentioned Hoge Raad cases dealt with internal reorganizations, where the intention was to minimize the group's overall tax burden by shifting income/profits to another group company and thereby reduce the effective Dutch tax rate. The Hoge Raad has not yet decided on the situation whereby a third party acquisition is financed by a loan from a tax haven company, such as a Swiss, Netherlands Antilles or Jersey financing company, or a company with an attractive regime for interest income, such as an Irish IFSC or a Belgian coordination centre. The interest is deducted from the profits of the operating company and is effectively not taxed (or is taxed at very reduced rates) in the tax haven company. A tax deduction of 35 per cent in respect of the interest is thus created. Can the Netherlands tax authorities successfully attack this structure as an abuse of law? In the light of the above-mentioned jurisprudence, we do not believe that any such attack would be successful.

Typically, the acquisition of a Dutch target company by a foreign group is structured through an intermediate Dutch holding company. The Dutch holding company is financed with debt from the group financing company, preferably subject to

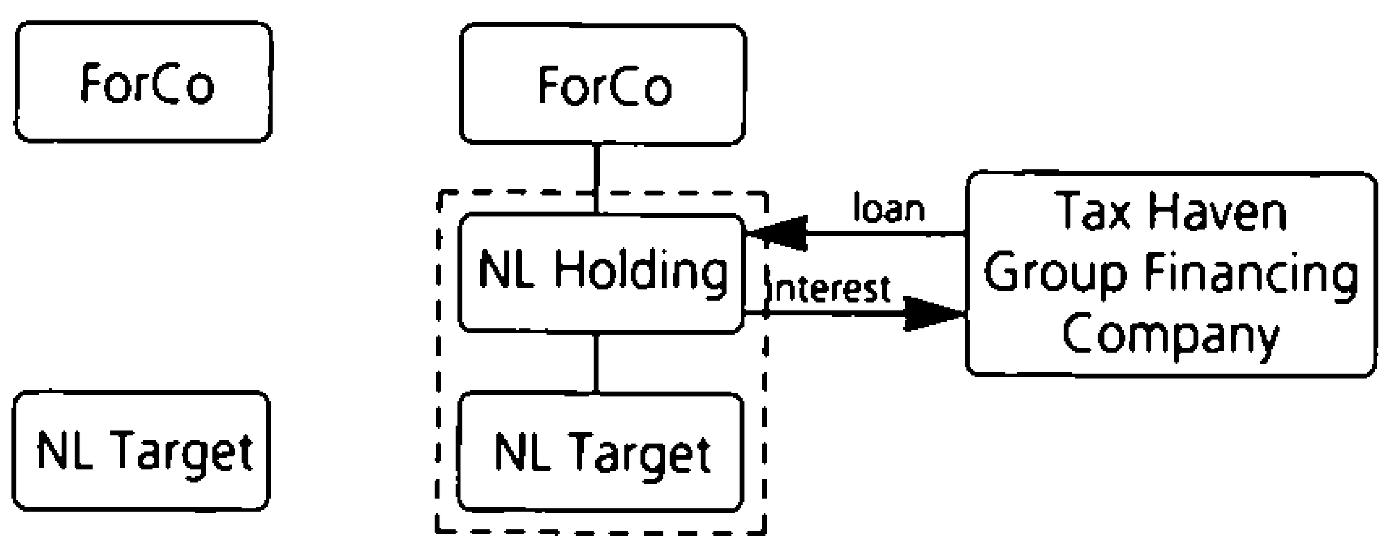
11. Proposed legislation against base erosion and to improve the fiscal infrastructure. Press release Ministry of Finance, 26 January 1996.

12. Hoge Raad, 23 August 1995, *BNB 1996/3*.

13. Care is needed here since if various alternative structures were available and the chosen structure was motivated solely or mainly by tax avoidance then it could not be said that the reason for choosing that particular structure was predominately a business one.

an attractive tax regime. Through a tax consolidation between the holding company and the target company, the Dutch taxable base is reduced considerably.

Diagram 6



In our view in the above situation, the requirements of neither abuse of law test will be met. The requirements of the motive test are not met, as the ultimate shareholders of the target change. The holding company performs a genuine financing function, namely, the acquisition of the target. With regard to the object test, we agree that the loan to the Dutch holding company is not meant to contribute to the financing of the business of the target, even so it cannot be concluded that, as a result of the acquisition and the way in which it is financed, corporate tax can be reduced at any time and more or less without limits. The acquisition of a target is typically a single event, which cannot be repeated constantly. As a result, it can be concluded that the structuring of the acquisition does not violate the object and purpose of the Tax Code. The general principle that every taxpayer is entitled to arrange his affairs in the most tax-efficient way now takes precedence[14].

C. The loan back of the dividends

If we apply the same abuse of law tests to the situation whereby a Dutch company distributes a dividend to its parent company and then subsequently borrows back the same amount via an interest bearing loan, we again conclude that the tests will not be met and that the tax authorities will not succeed. The motive test will probably be met, since the interest of the parent company in its subsidiary will not be changed. Moreover, Dutch corporate income tax will be reduced. The object test will not however be met, since the funds borrowed back will probably be used in the subsidiaries business. Moreover, it is not a transaction which at any time and more or less without limit can be used to reduce Dutch corporate income tax. A company has to earn profits first. Finally we would argue that on certain occasions it is commercially more appropriate to use debt as opposed to equity.

VI. THE GOVERNMENT'S COUNTER ATTACK

Very recently the Netherlands Government announced plans to combat base erosion occurring as a result of "artificial transactions" and certain group loans.[15] The proposals are obviously based on the Hoge Raad's decisions on this subject. If the proposals become law, deduction of interest payments on intra-group loans will be restricted.

According to the press release intra-group payments of interest will be completely disallowed; if the debt is a result of a dividend that has been declared but not actually paid; if the debt arises from a repayment of capital which has not actually been paid; or if the debt is incurred in the subscription to an issue of new shares. It is not clear from the press release whether the deduction of interest paid on such debts will be allowed in cases where the debts can be justified on the basis of sound business reasons.

Apart from the above "artificial transactions", interest payments relating to a number of other transactions will be disallowed where the debts of the Dutch company on a consolidated basis are not part of the group's debts. In these cases however, the interest payments may nevertheless be deducted if the taxpayer gives credible evidence that the underlying transactions were entered into for sound business reasons, or proves that the company receiving the interest payment is subject to a tax on income which is reasonably comparable with Dutch corporate income tax. In addition, the taxpayer must give credible evidence that the payment is not effectively tax-free in the hands of the recipient as a result of losses or other comparable claims relating to years preceding the year in which the loan was entered into. The requirement that the interest received will be effectively subject to tax, will also apply to a Dutch group company if it is the recipient of the interest. In addition, deduction of interest in a fiscal unity will be restricted in the case of third party acquisitions if the group on a consolidated basis has not raised loans from third parties to the same extent as the interposed Dutch holding company.

VII. COMMENT

If the press release is worded correctly, the deduction of interest on loans which form part of the specified "artificial transactions" will be refused without allowing the taxpayer an opportunity to prove that the transactions, including the loan, can be justified on the basis of sound business reasons. In our view such a harsh approach would severely infringe the right of the freedom of entrepreneurship. There are many situations where the so-called artificial transactions are not artificial at all, but are entered into for real and sound business reasons. Therefore in general, we wonder whether it would have been better to introduce thin capitalization rules with fixed debt/equity ratios plus an escape provision allowing a full deduction of interest costs if the taxpayer proves that an independent party would also have granted the relevant loan. If this test were used, a lot of time, energy and money could be saved on proving, as is the case in so many situations, that the decisive or main motive for the transactions were sound business reasons, particularly since the case law on sound business reasons is far from consistent.[16]

14. This principle is written down in the Tax Statute, Art. 4(3).
15. *Supra* note 11.
16. An additional advantage is that no intra-group loan will be excluded from interest deduction in advance.

Refusing the deduction of interest in cases where the interest income is not effectively taxed as a result of losses or other similar reliefs, cannot be justified in the situation where the losses and other burdens have been incurred directly or indirectly by the same shareholders as those who receive the interest. This proposal seems to violate the principle of loss relief and the general principle that each taxpayer is authorized to arrange his affairs in the most tax-efficient way.

VIII. SUMMARY

From case law, we can deduce that the deduction of interest paid on intra-group loans used to finance reorganizations is allowed when interest income is subject to Dutch corporate income tax, Dutch individual income tax, foreign profits tax or to other income tax comparable with Dutch levels. It is irrelevant that the interest income is not effectively taxed due to losses, etc, as long as these losses or other burdens have been suffered by the same direct or indirect shareholders, as those who benefit from the interest income. There is no case law on the implications of foreign loss relief. Interest payments are also deductible when the transactions of which the intra-group loan forms a part, were entered into for sound business reasons and the structure was not chosen primarily to benefit from tax deductions.

This leads to tax-planning opportunities. We have discussed restructurings involving the offsetting of the interest income against foreign losses, third party acquisitions and the loan back of dividends. The plans of the Netherlands Government to attack base erosion may reduce these tax-planning opportunities. It however remains to be seen what legislative form the proposals contained in the press release will take, the road from press release to effective law is long and rocky!

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

APRIL 1996

International tax planning techniques, Amsterdam, 11-12 April 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MAY 1996

Tax Planning for Expatriates resident in the UK, Royal Lancaster Hotel, London, 13 May 1996 (English):

Juliet Neckar, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

US International Taxation & Transfer Pricing APAs, Amsterdam, the Netherlands, 13-14 May 1996 (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.

JUNE 1996

International Taxation of Permanent Establishments, Amsterdam, 10-11 June 1996 (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.

AUGUST 1996

Summer Course on Principles of International Taxation, Amsterdam, the Netherlands, 19-30 August 1996 (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.

Indonesian Tax and Foreign Investment Seminar, Singapore, 23 August 1996 (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.

OCTOBER 1996

13th Asia-Pacific Tax Conference, Kuala Lumpur, 10-11 October 1996 (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.

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

CROATIA

THE NEW CROATIAN TAX SYSTEM[1]

Peter Schmidt Harald Wissel Manfred Stöckler

The authors are Ph. D. candidates at the Eberhard-Karls-Universität of Tübingen, Faculty of Economics, in the field of business taxation and auditing at the chair of Prof. Dr Franz W. Wagner. For several years they have contributed to the Croatian tax reform project.

Peter Schmidt works in the design of the Croatian VAT law and the VAT administrative directive. **Harald Wissel** and **Manfred Stöckler** work in the field of the Croatian profits tax. They have co-authored educational material for the Croatian treasury and trained treasury personnel.

I. CONCEPT OF THE TAX SYSTEM

A. Underlying theory

The move of the young Republic of Croatia towards a market economy has provided a rare opportunity to establish a new tax system without the usual impediments that accompany tax reform. The new Croatian tax system is unique, as its tax acts are designed according to an explicit theoretical ideal, the taxation of consumption.[2] The purpose of this article is to present the transformation of tax theory into an actual tax system. A basic understanding of the theory is necessary to appreciate the creation of consumption oriented tax regulations on personal income, business profits, and value added.[3]

A goal of the tax reform project was to create a tax system which is neutral with respect to economic decision making. This requirement is based on the concept that the welfare optimum of a market economy is achieved through resource allocation determined by market forces. In this allocation process, non-neutral taxation causes inefficient resource allocation.

In tax theory, neutral taxation can be achieved by taxing only the consumed portions of the taxpayer's current income thereby not discriminating against savings and investment. This requirement for neutrality between present and future periods is especially important for economies in transition[4] that suffer from a lack of capital. Thus, the traditional concept of comprehensively taxing income, which does not satisfy this requirement and heavily burdens capital formation, is unsuitable.

The most natural way of taxing consumption is through a value added tax as a general consumption tax. It is impracticable to set a VAT tax rate high enough to rely solely on VAT revenue for the budget. Such a tax rate would encourage dishonesty. A superior way of raising revenue is through a mix of indirect and direct taxes, thus keeping the VAT tax rate at an acceptable level to prevent business transactions from going underground into the black economy. A consumption tax can also be designed as a direct tax, as in the form of a cash-flow tax. This tax would be linked to the annual income of a taxpayer. The tax base would be reduced by those portions of income that go into savings, and increased by withdrawals from savings for consumption. Unfortunately, the monitoring problems in a savings-adjusted income tax are substantial.[5]

Another method of achieving the same economic effect without the technical difficulties of supervising cash flows to and from savings accounts is the taxation of interest-adjusted personal income and interest-adjusted business profits.[6]

An interest-adjusted income tax exempts that portion of income covering the normal (standard) interest cost of capital. Thus, only the actual net present value of an investment is taxed. Even though the interest-adjusted income tax does not achieve year-by-year equivalence to the savings-adjusted income tax, which always taxes the annual personal consumption, it does achieve equivalence to the taxation of personal lifetime consumption.

An interest-adjusted tax leads to a prepayment of tax on future consumption, thus eliminating the discrimination against savings of the traditional income tax. Furthermore, the interest adjustment guarantees that the deductible expens-

1. The authors would like to thank John Methven, CPA, Toronto, for helpful comments on this article.

2. As the design of the new Croatian Tax Acts is based on theoretical ideals, they have attracted considerable attention among tax scholars and tax experts. Indeed they have recently influenced Germany's tax reform discussion.

3. The Croatian tax acts have been elaborated in Croatia on the basis of the recommendations of a group of German tax experts under the direction of the professors Manfred Rose (University of Heidelberg), Ekkehard Wenger (University of Würzburg), and Franz W. Wagner (University of Tübingen). The reform project was commissioned by the German Ministry of Economic Cooperation and funded by the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).

4. Countries of the former socialist bloc of Eastern Europe and the former Soviet Union.

5. Yet maybe not insoluble, cf. the savings-adjusted income tax reform proposal of Joachim Lang: *Entwurf eines Steuergesetzbuchs*, Bonn 1993.

6. Following a proposal of Ekkehard Wenger: Gleichmäßigkeit der Besteuerung von Arbeits- und Vermögenseinkünften, in: *Finanzarchiv*, N.F., vol. 41 (1983), at 207-252 and Robin Boadway and Neil Bruce: A General Proposition on the Design of a Neutral Business Tax, in: *Journal of Public Economics*, vol. 24 (1984), at 231-239.
In respect to the Croatian reform project cf. especially Manfred Rose and Rolf Wiswesser: Changing the entire tax system towards decision neutrality and efficiency. Paper presented at the 51st Congress of the International Institute of Public Finance, held on 21-24 August 1995, in Lisbon, Portugal, unpublished manuscript, at 4.

es of capital correspond in present value terms to the amount of investment expenditure. Consequently, investment decisions are made independently of depreciation allowances or tax regulations.

The profits tax base is the income of the firm, independent of its legal form of organization[7], and allows for a deduction of interest not only on debt, but also on equity.[8] Due to the principle of taxing all income once and only once, the income for businesses is computed and taxed in the firm. There is no connection between the personal income tax and the profits tax. Nor does a tax imputation or tax credit system exist to account for one firm's ownership of another if both are taxable under the profits tax.

While interest-adjustment is a major feature of the profits tax, the income tax as a tax on income from employment and other non-business sources follows a "pay-as-you-earn" concept and leaves income from private investment outside the tax base.

B. Development of the new tax system

On 29 November 1993, both an Income Tax Act and a Profits Tax Act were published in *Narodne novine* No. 109/93 to launch a comprehensive tax reform starting on 1 January 1994.[9] This new system of taxing personal income and business profits replaced the Direct Taxes Act and its antiquated schedular system of income tax.

The third component of the Croatian tax reform is the Value Added Tax Act, published in *Narodne novine* No. 47/95 on 12 July 1995. When it goes into effect on 1 January 1997, it will conclude the tax reform process by replacing the current turnover taxes on goods and services. This transition period is necessary to issue the administrative directive and to thoroughly educate businesses and the tax administration thus facilitating the smooth introduction of the tax.

In addition to the three major taxes, there are a number of small taxes, such as excise taxes and special turnover taxes, that are levied in Croatia. Although these taxes are partly influenced by the reform process, they are beyond the scope of this article.

II. INCOME TAX

A. Taxable persons

Income tax is payable on the sum of all taxable income earned in Croatia and abroad by any natural person permanently or temporarily residing in Croatia. The liability for taxation of non-residents is limited to income from domestic sources.

B. Types of income

The following types of income are taxed:
- income from employment;
- income from self-employment; and
- income from property and proprietary rights.

1. Income from employment

Income from employment consists of wages and salaries paid to employees in cash or in kind, and also pension payments. The only deductible item is the legal minimum contribution to social security. Tax on this income is called a wage tax and is paid directly to the treasury through a wage tax deduction scheme (pay-as-you-earn) by the employer or pension fund when it is earned. It is calculated monthly, and is based on the tax rate and personal allowances of the employee. This information is obtained from the employee's wage tax card.

If the employee earns income from one source only, the annual total wage tax equals the sum of the monthly wage tax deductions. The employee has the option to submit a tax declaration, which may result in a tax refund if monthly payments vary between two tax brackets, or if special payments above the tax free allowances have occurred.

2. Income from self-employment

Income from self-employment is earned from a trade (or by any other continuous profit-oriented activity) carried on by commercial and industrial companies and self-employed individuals. Taxing these activities under the Income Tax Act (ITA) rather than under the profits tax is a simplification. If business activity exceeds certain limits or if the taxable person must keep accounting records for reasons other than tax law, he is taxable under the profits tax. It is also possible to opt for taxation under the profits tax instead of under the income tax.[10]

Income from self-employment is computed on a cash basis. Contributions or withdrawals reduce or increase the tax base respectively. Credit payments or debt repayments are ignored. Information on property and plant and equipment above a defined value is kept in a fixed asset register. The only deductions allowed are for depreciation and the "protective costs" of the capital tied up in those assets. These protective costs consist of the book value of fixed assets at the beginning of the fiscal year multiplied by the ITA's "protective interest rate". Protective costs for fixed assets purchased or sold during the fiscal year are computed proportionately.

7. That is corporations, partnerships and sole traders are subject to the same taxation treatment.
8. Manfred Stöckler and Harald Wissel: Die Gewinnbesteuerung in der Republik Kroatien, in: *Internationale Wirtschafts-Briefe*, Fach 5, Kroatien, Gruppe 2, at 1-10, as well as Section III of the present article.
9. Further modifications published in *Narodne novine* No. 95/94, 7/95 and 25/95.
10. Income from agriculture and forestry is also taxed under the second income type. In this particular sector, however, income is computed as "assumed income" based on physical criteria, it thus deviates from the principle of interest adjustment.

In the case of debt financing the actual interest rate on debt may be higher than the standardized rate, thus distorting investment decisions. In this case, it may be preferable for the taxpayer to elect for taxation under the profits tax instead.

3. Changes in business ownership

When transferring all or part of a business, two cases are possible. If the buyer takes over the accounting books, including all items of the fixed asset register unchanged in kind, quantity, and value, the ownership transferral has no tax consequences[11]

If the purchase price compensates for reserves, or if all or part of the business is liquidated, the seller pays tax on the profit and the buyer records the assets at the seller's book values. If the purchase price exceeds the total book value, the difference is recorded in a special depreciable account ("goodwill") in the fixed asset register.[12]

In either case the consumption potential of the business' investment programme is taxed only once.

4. Income from property and proprietary rights

Income from property is generated by renting property whilst income from proprietary rights consists of income from the licensing of royalties, patents and industrial proprietary rights etc. In some cases there may be monthly prepayments, e.g. in the case of rent payable monthly in advance by the tenant.

A flat deduction of 30 per cent is allowed against rent, royalties or similar income, so that only 70 per cent of the income is taxed. No further deductions are allowed.

Profits from the sale of property are only taxable if they occur within a three-year period after acquisition. If taxable, they are calculated as the proceeds of the sale minus the compounded[13] acquisition costs. There is no deduction for depreciation. A loss from the sale of property can only be set off against profits from the sale of a similar property made in the same year.

C. Tax base

The income tax base is computed according to the following formula:

Income from employment
plus
income from self-employment
plus
income from property and proprietary rights
= total income
minus
loss carry forward[14]
= total income net of loss carry forwards
minus
deductions for voluntary payments for health insurance and the taxpayer's personal allowance[15]
= total taxable income[16]

Generally, losses of one income type can be offset against profits of the same or of another income type in the same fiscal year. Exceptions are losses from real estate transactions and proprietary rights, which can only be offset against profits of the same kind. For example the set off of losses from real estate transactions with profits from the sale of author's rights, or vice versa, is not permitted.[17] Since income from employment is rarely negative this reduces the availability of loss set offs to income from self-employment.[18]

The carry forward of unutilized losses is limited to losses from self-employment. These can be carried forward for five fiscal years and are compounded with the protective interest rate.[19]

The taxable person has personal deductions according to Section 35 ITA and Section 50 ADI, which vary according to the number of dependent persons in the "immediate family". The immediate family for tax purposes includes the married couple, their parents, their children, and any adopted or foster children. The deductible allowances are intended to ensure that the minimum basic cost of living expenses are not subject to tax.

The allowances are not lump sums, but vary according to a legally defined basic personal allowance. If M is the basic personal allowance and f is the allowance factor per person, then all factors for the taxpayer's immediate family are added up and result in a deductible allowance of A = f . M. The allowance is deducted from total income after the loss carry forward. Allowance factors depend on the status of the family member. The basic personal allowance for 1995 is Croatian Kuna (HRK) 700 monthly, while retired persons are entitled to a monthly allowance of HRK 1,750 (Section 35 ITA).

Person	f
taxable person	1.0
spouse	0.3
1st child	0.3
2nd child	0.4
3rd child	0.5
...	...
others	0.3
disabled	+0.2

11. Secs. 32(2) and (3) Administrative Directive Income Tax (ADI).
12. Sec. 33 ADI.
13. The compounded acquisition costs represent the acquisition costs adjusted upwards by the protective interest rate factor. The protective interest rate factor is calculated for the period from the date of acquisition to the date of disposal.
14. Sec. 36 ITA.
15. Sec. 35 ITA.
16. Sec. 5 ITA.
17. Sec. 30(4) ITA and Sec. 9(4) ADI.
18. Current income from property is never negative due to the flat percentage deduction.
19. Sec. 36 ITA and Sec. 47 ADI.

D. Tax rate

The income tax uses a two-step progressive tax rate. The marginal rates for the two brackets are 25 per cent and 35 per cent and are applied to total income after deducting loss carry forwards and personal allowances.

There are three steps in calculating the income tax rate:

Tax free bracket	The amount of allowance factor(s) times basic personal allowance, A = f . M , is tax free.
First tax bracket	Additional income up to three times the basic personal allowance is taxed at 25 per cent.
Second tax bracket	Any income beyond three times the basic personal allowance is taxed at 35 per cent.

E. Allocation of tax revenue

70 per cent of the income tax revenue goes to the federal budget. Municipalities receive 25 per cent, and counties (or *županijas*) receive 5 per cent. As an exception, Zagreb receives 45 per cent of the income tax revenue of its citizens and 50 per cent goes to the federal budget.

Municipalities have the right to set a levy rate within certain limits, which alters the tax rate for the municipal portion, but does not affect the revenue for the federal budget portion or the *županija* portion. Cities with more than 40,000 inhabitants can modify the tax rate in the second tax bracket within a range of 32.375 per cent and 37.625 per cent.

Zagreb has an enlarged range of 30.275 per cent to 44.45 per cent. Its 1995 levy rate is 50 per cent, resulting in a marginal tax rate in the second bracket of 35% x 150% x 0.45 + (35% x 0.55) = 42.875% for every additional Kuna.

While increasing income tax rates via municipal levy rates increases the tax revenue from employees, taxable persons with income from property, proprietary rights or self-employment have an incentive to opt for the lower profit tax, thus decreasing the municipalities' income tax revenue.

III. PROFITS TAX

A. Taxable persons

For the purposes of the Profit Tax Act (PTA), taxable persons are defined as individuals, partnerships or legal entities that independently and continuously engage in profit-oriented business activities. Accounting records must be maintained in all cases.[20] Thus, the Croatian PTA does not distinguish between the different legal forms of doing business.

All business entities resident in Croatia are fully taxable. This includes legal entities controlled by management resident in Croatia, as well as the businesses of individuals controlled by management in Croatia.

Businesses that are neither resident in Croatia nor controlled by management resident in Croatia are taxable on profits earned in Croatia if they maintain a permanent establishment, or appoint a permanent representative for their business activities in Croatia.[21]

Legal entities become subject to taxation upon inscription in the trade register. If business activities start before incorporation, the firm is for tax purposes treated like a partnership.

Individuals and partnerships are generally subject to income tax. They must keep accounting records from 1 January of the first year in which they exceed one of the following limits and receive a corresponding notice:[22]

- sales exceed HRK 2,000,000;
- income exceeds HRK 300,000;
- value of property, plant and equipment exceeds HRK 2,000,000; or
- an annual average of more than 30 employees.

If several individuals engage in business activities together, they become taxable as a partnership as soon as the partnership's overall business activity exceeds one of the above limits.[23]

Individuals liable to the income tax may voluntarily keep accounts and thus become taxable under the profits tax instead.[24] Due to the difference between the income and profits tax rates, this option should prove attractive.

Institutions and non-profit organizations are not subject to the profits tax if they have not been founded with the purpose of earning a profit. However, if they also engage in profit-making activities, they are taxable on the profits earned.

B. Tax base

The tax base of the profits tax is the profit of the fiscal year minus a deduction for imputed interest on equity ("protective interest"); minus any losses carried forward from the previous year, compounded by the "protective interest rate" (see below). The basic procedure of determining taxable profits follows the widely accepted method of net worth comparison, slightly modified by reason of the interest adjustment.

1. Calculation of the interest-adjusted profit and the profit tax base

According to Sections 3-9 PTA, the profit net of protective interest and the tax base are calculated as follows:

20. Sec. 2(2) PTA.
21. Sec. 2(3) PTA.
22. Sec. 2(6) PTA.
23. Sec. 2(7) PTA.
24. Sec. 2(5) PTA.

Book value of equity at the end of the assessment period
minus
book value of equity at the beginning of the assessment period
plus:
- open transfers and withdrawals[25], e.g. dividend payments or reductions of capital;
- covert transfers and withdrawals[26], e.g. covert distribution of profits;
- payments of profit tax;[27]
- income received from shares in businesses taxable under the income tax (i.e. not liable to profits tax);
- losses from investments in other firms taxable under the profits tax, e.g. a loss resulting from the sale or depreciation of such an investment in another firm;
- negative differences in respect of transactions falling within Section 12 PTA, e.g. liquidation loss;
- depreciation exceeding the depreciation limits of the profits tax;[28]
- interest paid, but not deductible for tax purposes;[29] and
- other expenses not deductible for tax purposes.[30]

minus:
- open capital payments[31], e.g. increase of capital;
- covert capital payments;[32]
- repayments of profits tax;[33]
- losses from shares in businesses liable to income tax;
- income from investments in other firms taxable under the profits tax, e.g. income from sale, appreciation of interest in another firm, or dividends received;
- positive differences from legal transactions falling within Section 12 PTA, e.g. liquidation surplus;
- depreciation previously rejected on grounds of Section 6 (1) PTA, but now deductible; and
- imputed interest on equity ("protective interest" according to Sections 7-9 PTA).

= interest-adjusted profit or loss
minus
- compounded loss carried forward from the previous assessment period[34]

= tax base of the profits tax.

To understand the computation it is necessary to understand the meaning of certain key terms.

2. Equity concept

Equity, for the purposes of the PTA, is broadly defined. It includes all accounts on the right hand side of the balance sheet for:
- common or preferred stock;
- certificates of participation;
- profit participating loans;

and all other financial commitments remunerable depending on profit. The following accounts are particularly important:
- retained earnings;
- profits resulting from the revaluation of assets required by accounting legislation;
- all kinds of reserves.

Capital decreases arising due to losses which are not deducted from capital accounts[35] but instead are included as a separate capital deficit account, must be deducted in calculating equity. Equity for profits tax purposes is calculated either in a separate tax balance sheet or in a modified general balance sheet that includes the changes required by the PTA.

3. Standard interest costs on equity

In the tax base calculation for the profits tax, the standard interest cost ("protective interest") is deducted. This amount is the product of the "protective interest rate" applied against the equity base during the assessment period (fiscal year). Changes in equity within the fiscal year result in reductions or increases of the initial amount of protective interest. The applicable equity base for the purposes of Section 8 PTA is computed as follows:
- book value of equity at the beginning of the assessment period
minus
- book value of shares held in other firms subject to the profits tax
plus or minus
- valuation corrections for tax purposes at the beginning of the assessment period

= equity base for the calculation of protective interest

The Ministry of Finance sets a protective interest rate p for the fiscal year by increasing the rate of inflation on industrial products (i) by three percentage points, this protective interest rate is itself multiplied by 1+i/100 (the inflation factor). This ensures that equity is protected from erosion caused by inflation, and that real interest on equity remains tax free. Thus, the goal of neutrality of consumption is achieved (Section 9 PTA):

$$p = i + 3 \times \left(1 + \frac{i}{100}\right)$$

Protective interest rates are fixed monthly.

These monthly rates are used to compute corrections to the initial protective interest due to changes in the equity base during the fiscal year. Increases or decreases of equity must be summarized each month, then multiplied by the corresponding protective interest rate, then deducted from or added to the initial amount of annual protective interest. This information is included as a separate schedule attached to the annual profits tax declaration.

The two key features of the profits tax are:
1. The principle of single taxation at source, which is visible both in the treatment of investments made in other firms and in the treatment of Section 12 PTA transactions (liquidation, sale, merger, etc.).

25. Sec. 5 PTA.
26. Secs. 5(2) and (3), Secs. 6(3) and (4) PTA)
27. Payment of tax must not influence the tax base. Sec. 3 (5) PTA.
28. Sec. 6(1) No.1 PTA.
29. Sec. 6(1) No.1 PTA.
30. Secs. 6(1) Nos.3-7 and (2) PTA.
31. Sec. 5 PTA.
32. Sec. 5(4) PTA.
33. Sec. 3(5) PTA.
34. Sec. 10 PTA.
35. E.g.: capital subscribed, capital surplus or earned surplus.

2. The deduction of protective interest, which is not merely a means of compensating for inflation, but an actual tax shield on a portion of the real return on equity.[36]

4. Treatment of investments in other firms taxable under the profits tax

Ownership interests between firms that are taxable under the PTA create direct and indirect influences on the tax base when shares are bought, sold or transferred.

If a firm buys the shares of another firm also taxable under the profits tax, there are direct and indirect influences on the tax base. Direct influences result from acquiring, holding (e.g. dividends), or selling (e.g. profit or loss) investments in other firms (subsidiaries). These transactions have no influence on the income statement or tax base of the investing firm (parent).

Changes in the value of an investment may be recorded as a profit decrease (depreciation) or profit increase (appreciation) of the investment account in the parent's balance sheet, this increase or decrease must be excluded when calculating the parent's profits tax base.

Under the profits tax, profits or losses arising in respect of investments made in other firms independently taxable under the profits tax are deemed to occur only in the original firm and thus all those transactions are taxed there and only there. For profits tax purposes, the firm holding an investment is not affected by the subsidiary's business decisions. The economic outcome of the subsidiaries decisions is taxed solely in the subsidiary.

The indirect influence of investments in other firms on the tax base of the investing firm results from the influence of these investments on the calculation of the protective interest. The amount of protective interest deductible is computed through compounding the book value of equity at the beginning of the assessment period with the protective interest rate.

To remove the effects of this indirect influence the book value of investments in other firms must be eliminated from the equity used for the interest computation.[37] This regulation prevents the double deduction of interest on an equity portion equal to the investment's book value: as the subsidiary computes its profits tax base according to the same procedure in deducting protective interest from its profits, twice the protective interest would be deducted if the parent was allowed to deduct protective interest computed on its full equity. For the purposes of the computation the parent must reduce its equity by the book value of its investment in the other firm.[38]

If the subsidiary pays out dividends, there is no direct influence on the tax base of the parent. Yet the payments change the equity position in both firms' balance sheets and thus they are indirect influences on the tax base. The equity of the subsidiary paying out dividends diminishes, the equity of the parent receiving those dividends increases. Both firms thus need to correct their protective interest deduction computations for the period from the dividend payment to the end of the fiscal year. The subsidiary needs to reduce its protective interest deduction by the interest attributable to the portion of the equity reduced by the dividend payment for the period from payment to the end of the year. On the other side, the parent may add this amount to its deductible protective interest.[39] The reduction and increase are not exactly equivalent, however, as the equity decrease is deemed to occur at the beginning of the month, and the equity increase at the end of the month.[40]

Similarly, the acquisition of another company's shares leads to a reduction of deductible protective interest from the beginning of the month of the acquisition. On the other hand, the sale of shares requires the firm to increase its standard interest cost deduction by the interest on the investment book value to the end of the assessment period.

While a profit on the sale of an investment results in an increase of equity and thus to an increase of protective interest, a loss diminishes equity and requires a reduction of protective interest.

5. Section 12 PTA transactions

Such transactions are:
- liquidation (sale of all assets and repayment of all debts);
- sale (sale of the firm as a going concern);
- merger (takeover);
- changes in the legal form of business organization; and
- demergers.

In the case of a liquidation, the disclosure of reserves in the liquidating firm results in profits that are measured and taxed according to the same principles as operating profits. Following the principle of single taxation at source, the total profit net of protective interest is taxed in the firm being liquidated. Pay-outs to shareholders have, as usual, no further tax consequences.

Where a firm is sold as a going concern, two options are available. If the buyer retains the firms pre-sale book value the transaction is disregarded for profits tax purposes. This implies that the buyer has no depreciation tax shield resulting from any excess of the price paid over the book value of the firm. Alternatively, the sale can be treated like a liquidation, disclosing reserves as taxable profits on the seller's side and creating depreciable assets on the buyer's side.

A takeover of one firm by another firm, both taxable under the profits tax, requires that the book values be retained. Any difference between the equity of the firm taken over and the book value of those shares in the acquiring firm's balance sheet is a change in the equity position of the acquiring firm, and is otherwise irrelevant for tax purposes.

In the case of a change in the legal form of organization, if book values are kept, no profits tax consequences arise. If

36. This is demonstrated by the fact that protective interest can also be deducted in the case of zero inflation.
37. Sec. 8(1) PTA.
38. This book value represents capital of the subsidiary and as mentioned above is taken into account in the subsidiaries own profit tax calculation.
39. Sec. 7(4) PTA.
40. Sec. 7(5) PTA.

book values are not kept, the resulting difference in equity in the tax balance sheets is treated as a profit in the current assessment period.

Firms that are created through the demerger of a firm which was previously subject to the profits tax, may retain the book values of assets and debts they received from the original firm. If book values are changed, this may cause a tax liability within the original firm. All firms involved are jointly liable to pay this tax.

6. Deduction of losses

A loss after the deduction of protective interest may be compounded with the protective interest rate and deducted when computing the following year's tax base. Losses may only be carried forward five years.[41]

C. Tax rate

As a result of political considerations, the tax rate for the profits tax is set at 25 per cent[42], this rate is considerably lower than the income tax rate. For example, in Zagreb the income tax rate is approximately 42.9 per cent, due to the municipal levy rate.

D. Tax assessment and payment

The assessment period of the tax is usually the calendar year.[43] For each assessment period the firm is required to submit a tax declaration, which specifies the amount of tax payable. To reduce administrative work, the tax authorities will only issue tax assessment notices in case of corrections.

At the end of each month tax prepayments are due depending on the tax liability declaration of the previous assessment period and on the general price trend.[44] At the end of the fiscal year any differences between the sum of the monthly prepayments and the tax balance due according to the tax declaration will be paid out or credited against the following year's tax liability.

IV. VALUE ADDED TAX

The Croatian Value Added Tax Act (VATA) codifies a VAT system, modelled after the EEC 6th Directive. It follows the destination principle, i.e. export sales are zero rated and imports are taxed.

A. Taxable persons

For VAT purposes a taxable person is any natural person or legal entity that independently and repeatedly engages in a taxable business activity.[45] Profits are not a prerequisite for taxability under the VAT.

Bodies of state or local government, political parties, unions and other professional associations are not taxable persons while engaging in activities discharging their public duty. However, if they engage in business, they must be treated as taxable persons with respect to that business activity.[46] This avoids any unfair competitive advantage that would result from their non-taxable status.

Every person, must pay VAT on the importation of goods. Anyone unlawfully charging VAT on an invoice is liable for the amount charged.

B. Taxable supplies

The following transactions are taxable:[47]

– the supply of goods and services for consideration by a taxable person to others within Croatia.

  These are typically sales of goods or services. Also taxable are supplies of goods or services ordered by a governmental body.

  In addition to the above, supplies by a taxable person to his employees or to members of his employees families on grounds of the employment relationship are taxable, even if the employee does not pay a cash consideration for the supplies.[48]

– the self-supply of goods and services by a taxable person in Croatia.

  Typically three types of self-supplies fall within this category: consumption of goods, consumption of services, and consumptive expenses[49].

  In each case, the taxable person benefits from input tax credit upon acquisition of the inputs, yet those supplies are deemed to be of a consumptive nature. Thus, taxability offsets the input tax credit.

  Such self-supplies are taxable regardless of the legal form of the taxable person's business. Legal entities can also self supply goods and services ("shareholders' consumption").

– the importation of goods into Croatia.
  This is a necessary consequence of the destination principle. Any importation into Croatia is taxable, whether by a business or by private persons, as the imported goods may be consumed there. If they are used for business purposes, the VAT on importation is deductible like any other input tax.

41. Sec. 10 PTA.
42. Sec. 13 PTA.
43. Secs. 15 and 18 PTA.
44. Secs. 16 and 19 PTA.
45. Secs. 2 and 6 VATA.
46. Sec. 3 VATA.
47. Sec. 2 VATA.
48. Such supplies may represent employees' consumption on which the employer benefited from input tax deduction. Thus, in a true consumption tax such supplies must be taxable to offset the input tax credit.
49. Consumptive expenses are expenses that to a significant degree replace private consumption, e.g. expenses for entertainment or gifts. Such expenses are generally non-deductible in the income and profits tax.

C. Tax liability and tax base

The tax liability originates at the time of the supply, or at the time of a down payment before supply, and becomes due at the end of the current payment period. Payment periods run from the first to the 15th and from the 16th to the last day of every month.[50] This rule applies to all businesses paying profits tax.[51]

D. Exemptions

VAT exemptions do not necessarily result in a lower tax burden. As the VAT exemption of a sale is always linked to the loss of input tax credit, the economic result of a VAT exemption depends on factors such as the economic situation of the taxable person and the VAT status of his customers.

As is often stated, the transparent nature of a VAT is lost when there are a large number of exemptions. Following the principle to equally tax all consumption, the Croatian tax contains remarkably few exemptions, this not only reduces the administrative costs but also minimizes any undesired effects on economic decisions.

The main exemptions[52] include the usual technical exemptions, such as banking, finance, and insurance and exemptions for health, housing rent, education, and some 'cultural' activities.

The full list of exemptions is as follows:
- renting of private dwellings;
- services of banks, savings and loan institutions, insurance and reinsurance companies;
- supplies of gold by the National Bank of Croatia;
- supplies of domestic or foreign legal tender, securities or ownership stakes in companies;
- services of medical doctors and dentists, nurses and physiotherapists, engaged in private practice;
- services of medical care performed in health care institutions;
- services and supplies by welfare institutions;
- services and supplies by institutions of child and adolescent care;
- services and supplies by nursery, primary and secondary schools, universities and by student catering and boarding institutions;
- services and supplies by religious communities and institutions; and
- services and supplies by public institutions in the field of culture (museums, archives, libraries, theatres, orchestras, institutions for conservation and protection of monuments).

Most of these exemptions are defined institutionally and not by the type of transaction. This simplifies tax administration, as it avoids splitting the input tax into deductible and non-deductible components.

Furthermore institutionally defined tax exemptions are easier to check. In the VATA, the exemptions are granted only if the exempted body meets set standards.

As the catalogue of exemptions is brief, providing the option to waive an exemption was considered unnecessary. Although some taxable persons will be denied the opportunity to fit into the VAT chain, the law remains easier to administer, which was deemed the greater advantage.

E. Tax rate

In order to create a simple consumption tax Croatia has decided on a single rate of 22 per cent. Only export sales qualify for the zero rate.

F. Input tax deduction

The input tax deduction is tied to taxable sales.[53] Input tax must be documented on invoices meeting the VATA requirements.[54]

Due to the short list of exemptions and their institutional definition, situations requiring the splitting of input tax into deductible and non-deductible portions are kept to a minimum.[55] If necessary, the non-deductible portion may be estimated by reference to an appropriate method. If input supplies are first used for taxable sales and at a later time for exempt sales, a correction of the initial input tax deduction becomes necessary.[56] For general moveable supplies, a change in the use of input supplies requires correction if it occurs within five years of first use. In the case of real estate, the period is ten years.

The repayment of input tax to businesses not resident in Croatia (e.g. participants in trade shows) will be regulated by administrative order.[57] Businesses without an establishment in Croatia that have delivered taxable services do not collect VAT from their customers. Instead, the domestic customer is required to remunerate only the net price to the foreign business, paying the VAT directly to the treasury.[58]

G. Tax collection

The regular payment schedule consists of two prepayment periods per month (1st to 15th and 16th to last day). The taxable person calculates his tax liability as the difference between the VAT invoiced and the input tax deductible. If there is more input tax than VAT invoiced, a refund is issued. Businesses with quarterly sales of up to HRK 50,000 inclu-

50. Sec. 16(2) VATA.
51. Due to the tax rate gap between income and profits tax together with the option for profit tax in lieu of income tax, the vast majority of Croatian businesses originally taxable under the income tax are likely to elect for taxability under the profits tax.
52. Sec. 11 VATA.
53. Sec. 20(3) VATA.
54. Sec. 20 and Sec. 10 (15) VATA.
55. Sec. 20(6) VATA.
56. Sec. 20(5) VATA.
57. Sec. 21(2) VATA.
58. Sec. 19(2) VATA.

sive of VAT have a quarterly prepayment period.[59] If they prefer, they may submit their repayment claims twice a month, according to the regular schedule.

The VAT is an annual tax. Taxable persons must submit their prior year's final annual tax declaration and settle any outstanding liability by 30 April. Businesses terminating their taxable activities are required to submit a final declaration within three months of ceasing business.

Non-resident purchasers who are private tourists are entitled to a VAT refund when they take goods purchased in Croatia abroad. The amount of each invoice must exceed HRK 500 to qualify.

H. Small businesses

Taxable persons with annual sales of less than HRK 50,000 fall under the small business regulation of the VATA.[60] They are not permitted to charge VAT on their sales, nor can they reclaim any input tax paid. For VAT purposes, they are outside the system.

As this regulation may be detrimental to small businesses, e.g. where sales are made exclusively to a taxable person, it may be waived and treatment as a fully taxable person will then be granted. Once made the waiver is irrevocable for a five year period.

V. CONCLUSION

The main feature of the new Croatian tax system is its strict focus on taxing consumption. This consumption orientation is achieved through a mixed system of direct and indirect taxes on interest-adjusted personal income or interest-adjusted business profits, and on value added.

For the vast majority of taxpayers, consumption taxation through a personal income tax is easily achieved by the pay-as-you-earn tax on income from employment together with a tax exemption for income from private investment.

A more complex treatment is required for the consumption-oriented taxation of income from self-employment, i.e. from small businesses, professional work, farming and forestry. In these cases, taxation of interest-adjusted income would require exhaustive bookkeeping to calculate the standard interest costs on equity. In the design of this system, however, simplicity has prevailed over neutrality. Minor deviations are tolerated as the taxpayer is free to voluntarily request the profits tax instead.

Transparency and simplicity rule the strict limitation in the deduction of expenses. The deduction of personal allowances ensures that basic living costs are not directly taxed. At the same time, the restriction of deductions to the indispensable minimum ensures a tax base still large enough to make Croatia's moderate tax rates possible, even though income from private savings and investment is not part of the income tax base.

The incomes of larger businesses are subject to the profits tax. The profit tax achieves a consumption orientation through the standard interest cost deduction on equity without the simplifications employed in the income tax. It accomplishes neutrality with respect to legal forms of organization, the choice between equity and debt financing, and depreciation methods.

The most remarkable feature of the value added tax is its simplicity. With the single rate and the short catalogue of exemptions, it avoids the mistakes made by other European systems.

In conclusion, the recently completed tax reform project in the Republic of Croatia has created a tax system that may serve as a source of inspiration for tax reform efforts around the world.

59. Secs. 16(2) and (3) VATA.
60. Sec. 22 VATA.

Erratum

In the July/August 1995 issue at page 371 under "J. Tax rates" the higher Croatian tax rate should have read 35% (not 45%).

AUSTRALIA

THE NEED FOR FURTHER REFORM OF AUSTRALIA'S INTERNATIONAL TAXATION RULES IN VIEW OF THE SPOTLESS SERVICES CASE

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I. INTRODUCTION

The purpose of this article is to highlight some international tax planning techniques that have eroded Australia's income tax base in relation to foreign source income (in particular, interest income) derived by Australian residents. These avoidance techniques have given the Australian Taxation Office ("ATO") major problems in enforcing and administering Australia's fiscal jurisdiction as contained in the *Income Tax Assessment Act 1936* (the "Act"). The benefit of this approach is that by examining such techniques it will become apparent that explicit source rules are needed to reduce the uncertainties surrounding the case by case approach currently adopted by the courts and highlighted in the *Spotless Services* case.[1]

To give a practical focus to the discussion, source of interest income rules will be examined since such rules have been the most easily manipulated and avoided given the passive and highly mobile nature of such income. Moreover, it was the source of interest income which the Full Federal Court[2] in *Spotless Services* was concerned to determine.

The impetus for writing this article partially derived from my doctoral thesis examining the policy rationale for introducing a controlled foreign company (CFC) regime in Australia. However, the recent Full Federal Court decision in *Spotless Services* has demonstrated clearly that Australia stands to lose a substantial amount of revenue if its fundamental taxing rules (i.e. source and residence) are not substantially overhauled.[3]

In the *Spotless Services* case, it was held by majority, that a scheme entered into by an Australian resident company to invest surplus funds in the Cook Islands (a tax haven) and which incidentally gave rise to a tax benefit to the taxpayer in Australia did not constitute a tax avoidance scheme for the purposes of the general anti-avoidance provisions in Part IVA of the Act. However, the point which arose from this case and which is of more interest as far as this article is concerned is the Court's unanimous finding that the source of the interest income was the Cook Islands.[4] In reaching this conclusion the Court appears to have applied a form over substance approach in favour of the substance over form approach adopted by the Court in previous cases.[5]

The *Spotless Services* decision lends further support for the argument that explicit statutory source rules are required to alleviate the uncertainties associated with courts at various levels applying the one principle emanating from Isaacs J's dicta in *Nathan v. FCT* where his Honour held that the ascertainment of the real source of income is a "practical, hard matter of fact".[6]

There has always been a perceived need to reform Australia's source regime. The Asprey Committee[7] (which recommended wholesale changes to Australia's income tax system as well as its international tax rules), as early as 1975 recommended and the Treasurer in 1985 promised[8] implementation of explicit source rules in order to alleviate some of the shortcomings with applying existing source rules which depend to a large extent on judge-made law for their operation. However, as yet there have been no developments on that front.

By contrast, the New Zealand Government has been very active on the international tax reform front. The government recently introduced new transfer pricing and thin capitalization regimes. These reforms were originally foreshadowed by the New Zealand Government in its discussion document

* I wish to thank Ms Joanna Wheeler, Principal Research Associate, IBFD, for her helpful comments on the first draft of this article.

1. *FCT v. Spotless Services Pty. Ltd.* 95 ATC 4775.
2. The Full Federal Court, is empowered to hear appeals from Single Federal Court judges or Administration of Appeals Tribunal decisions. The decision of the Full Federal Court is reviewable by the High Court, which is the ultimate court of appeal in Australia.
3. The Australian Government's concerns over the loss of revenue caused through international activities and the introduction of measures to counter such activities, was first announced in *Reform of the Australian Tax System* (AGPS, Canberra, 1985) (the "Draft White Paper") at pp 230-233. For an account of the measures that were introduced subsequently, see Azzi J., "Historical development of Australia's International Taxation Rules" (1994) 19 *Melbourne University Law Review* 793 at pp 806-811.
4. In this case Cooper J (with whom Northrop J agreed) held that the general source of income or form of activity was the investment of the capital sum of $ 40 m to generate interest for the taxpayer: 95 ATC 4775 at 4808-4809.
5. See for example *Cliffs International Inc. v. FCT* 85 ATC 4374 and *Thorpe Nominees Pty. Ltd. v. FCT* 88 ATC 4886.
6. (1918) 25 CLR 183 at 189-190.
7. *Taxation Review Committee: Full Report* 31 January 1975 (KW Asprey Chairman, AGPS: Canberra) (the "Asprey Committee Report") at 255.
8. *The Treasurer's Economic Statement of 19 September 1985* (AGPS: Canberra, 1985) at 66.

on international tax.[9] Moreover, the government has expressed its intention to address the problem of insufficient statutory detail of where income is sourced in the course of the rewrite of the *Income Tax Act 1994*.[10] Therefore, it is intended in this article to set out the policy considerations that Australia (a net capital importer) should consider in formulating statutory source rules.

In view of the fact that a task force – the Tax Law Improvement Project, is currently in the middle of rewriting the Act, the call for the introduction of explicit statutory source rules becomes stronger. It is noted that the rewriting of the Act does not involve considerations of policy reforms, merely the rewriting of the Act into plain English. Nevertheless, it would be a waste of resources not to examine this issue given that the Committee responsible for rewriting the Act has to rewrite for example, Sections 6C and 6CA which contain explicit statutory source rules.[11]

However in addition to the need to reform the statutory source rules, it will become apparent from the discussion on tax planning techniques that another regime, the CFC regime is required to overcome the shortcomings with applying the residence rule in view of the deferral problem. The CFC rules are capable of largely alleviating the deferral problem which arises where an Australian resident company accumulates income in a foreign subsidiary so as to avoid being subjected to Australian tax.[12] The advantage with adopting a CFC regime is that it enables the Australian revenue authorities to effectively tax the foreign source profits of a non-resident company without breaching international rules, since it is the controlling resident company which is taxed currently under the CFC regime on its pro rata share of the profits of the non-resident company.

The problem of deferral arises predominantly because under Australia's domestic tax laws a company is treated as a separate legal entity from its shareholders.[13] Therefore, the avoidance of any exposure to the Australian taxation system simply involves the interposition of a foreign company (which is normally resident in a low tax country) between the source of the income and the ultimate beneficial recipient of that income, an Australian resident. As a result, the timing of the Australian resident's liability on the foreign income depends on the distribution policy of the foreign company. Where the foreign company retains the income rather than distributes it to its shareholders, *deferral* of shareholder (residence country) taxation occurs.

Given that Australia's (and most other nations'[14]) CFC rules contain an active (i.e. non-passive) income exemption, Australian companies with "direct foreign investments"[15] that derive active income can still utilize the deferral advantage in relation to active income.[16] It is not intended to consider the policy rationale for excluding active income from the CFC rules nor the source rules pertaining to active income in this article.

II. THE SOURCE RULE IN GENERAL

Australia asserts jurisdiction to tax the domestic and the foreign source income derived by its residents.[17] This is more commonly referred to as the residence principle of taxation. In addition, fiscal jurisdiction is claimed by Australia over income derived by non-residents but which has an Australian source.[18] This is referred to as the source principle of taxation. Taxation on this basis, requires some rules for determining source in light of the foreign tax credit system ("FTCS")

9. *International Taxation: A Discussion Document* ("ITDD") (a consultative document released by the New Zealand Government on 28 February 1995 outlining policy reforms to New Zealand's international taxation rules).
10. See Sawyer AJ, "International Taxation: A Complete Approach at Last" 49 *Bulletin for International Fiscal Documentation* 10 (1995), at 472 at p 478.
11. Sec. 6C supplements the case law rules for determining the source of royalties where those royalties are paid to a non-resident. It gives a deemed Australian source in circumstances where there might otherwise be a non-Australian source. Sec. 6CA operates in conjunction with Division 3B of Part VI of the Act to ensure that income of non-residents from natural resources in Australia will be treated as having a source in Australia.
12. Pursuant to Sec. 23(r) of the Act, a non-resident is exempt from Australian tax in relation to foreign source income.
13. See the corporate veil doctrine expounded by the House of Lords in *Salomon v. Salomon & Co Ltd.* [1897] AC 22. This doctrine was applied in a tax context by the High Court in *Gorton v. FCT* (1965) 113 CLR 604 at 627.
14. There are some 15 countries that have introduced CFC rules since 1962 when the United States first introduced its CFC rules in Subpart F of the *Internal Revenue Code 1954* (The "Code"). The CFC measures introduced by the 15 countries (viz., United States, United Kingdom, Germany, France, Japan, Canada, New Zealand, Australia, Sweden, Denmark, Finland, Indonesia, Portugal, Spain and Norway) to combat the use of CFCs share a common feature in that the target of such measures is not CFCs generally, rather it is primarily CFCs based in tax havens: see Arnold B J *Taxation of Controlled Foreign Corporations: An International Comparison* (1986, Canadian Tax Papers, No. 78) at 72; Sandler D *Pushing The Boundaries: The Interaction Between Tax Treaties and Controlled Foreign Company Legislation* (The Institute of Taxation, London, 1994); the FSIIP *op cit.*, at Chapter 1; Mangin E & Rautalahti E "Finland's New Controlled Foreign Corporations Legislation" 49 *Bulletin for International Fiscal Documentation* 3 (1995), at 118; and Amat P & Monasterio P "Controlled Foreign Corporation Legislation" 49 *Bulletin for International Fiscal Documentation* 6 (1995), at 289. Most recently, Korea announced that it will introduce CFC rules into its *Corporation Tax Law*.
For a discussion of the historical developments leading up to the introduction of CFC rules in Australia see Azzi J "Historical Developments of Australia's International Taxation Rules" [1994] *Melbourne University Law Review* at 801-811.
15. A direct foreign investment is an investment where a resident person owns 10% or more of the voting rights and capital of a foreign company.
16. Exempting active income from the CFC rules can be rationalized on the basis that it is in Australia's interest to encourage active investments abroad, if for no other reason than the fact that a distribution and marketing network is created for the Australian company in a foreign country: see also Azzi J "Policy Considerations in the Taxation of Foreign-Source Income" 47 *Bulletin for International Fiscal Documentation* 10 (1993), at 557-564. See also Vogel K "Worldwide vs. Source taxation of income – A review and re-evaluation of arguments (1988) 11 *Intertax* at 393 where the author argues in favour of territorial taxation. For example at 402 Professor Vogel observes that to the extent that sales income is derived through the seller's own manufacturing or marketing and distribution network, it may be taxed by the state in which it arose.
17. Sec. 25(1)(a) of the Act provides:
"The assessable income of a taxpayer shall include - (a) where the taxpayer is a resident ... the gross income derived directly or indirectly from all sources whether in or out of Australia and ...which is not exempt income ...."
18. Pursuant to Sec. 25(1)(b) of the Act the assessable income of a non-resident taxpayer shall include: "... the gross income derived directly or indirectly from all sources in Australia, which is not exempt income ...."

which was introduced in 1987 to alleviate international double taxation.[19]

There are only a few judicial pronouncements on the determination of source of income, the most famous and often cited decision being the Isaacs J's dictum in *Nathan's* case (see above). Understandably, this dictum has not proved very helpful. Much reliance must therefore be placed upon principles developed in case law in deciding what the real source of an income item is.[20] In determining the source of income, courts have concentrated on the type of income derived and the form rather than the substance of the transaction. However, as a general statement, it is true to say that despite the lack of real guidance offered by Isaacs J's dictum in *Nathan's* case, courts in recent years have tended to place a greater emphasis on substance over form in the determination of the source of income.[21] Unfortunately, as noted above this trend was recently reversed by the Full Federal Court in the *Spotless Services* case, since in that case the court seemed to place an emphasis on the situs where the loan contract was made as an important factor in deciding the source issue rather than on the circumstances existing prior to the loan contract being made.[22]

The analysis of source of interest rules to follow immediately below will proceed by firstly examining the explicit statutory provisions contained in the Act. The discussion will then analyse explicit rules contained in Australia's tax treaties (in particular, the United States–Australia treaty). The final part of the discussion will examine the judicial decisions dealing with source of interest income.

A. Source of interest

As a matter of policy, interest income which is the product of economic activity in Australia should have an Australian source. The justification for this line of reasoning is based on the "benefit" principle.[23] The non-resident would not have been able to generate the interest income if the resident taxpayer had not been able to generate the original funds in the first place which it then invests with the non-resident company.

Unfortunately, the Full Federal Court in *Spotless Services* appeared to pay no credence to the benefit principle in holding that interest derived by an Australian resident taxpayer from Australian generated funds invested in a Cook Islands bank was sourced in the Cook Islands. Interestingly, the court was divided on the question as to whether the investment scheme was a scheme the dominant purpose of which was to obtain a tax benefit and therefore in breach of Part IVA of the Act. In holding that the scheme was not caught by Part IVA, the majority (Cooper and Northrop JJ), were of the view that the dominant purpose of the taxpayer in investing the funds offshore was to maximize its after-tax returns and not to gain a tax advantage in the sense of avoiding the payment of Australian tax on the interest derived from the investment.[24]

Beaumont J in dissent, held that the dominant purpose for investing funds with a Cook Islands bank as opposed to an Australian bank, was to avoid the Australian tax net by rely-

19. The interaction of the residence rule (which states that residents are taxed on their worldwide income) with the source rule of a foreign country which adopts similar international tax rules as Australia, could lead to an overlap of fiscal claims over the same income. This could occur where income is derived by an Australian resident from sources in the foreign country. Unilateral relief from such international juridical double taxation (to be referred to throughout the paper as "international double taxation") is provided by Australia in the form of a credit for the source country (i.e. foreign) taxes paid where the Australian resident (who is deemed to be personally liable and to have paid the foreign tax) is subjected to both source country and residence country taxation on the same amount of income. However, it is beyond the scope of this article to pursue this point.
20. A more comprehensive discussion of source rules pertaining to other types of income may be found in Magney T "Source of Income", *Tenth Taxation Convention of the New South Wales Division of the Taxation Institute of Australia* (May, 1978), 1.
21. See for example *Cliffs International Inc. v. FCT* 85 ATC 4374; *Thorpe Nominees Pty. Ltd. v. FCT* 88 ATC 4886.
22. For a discussion of the circumstances surrounding the derivation of interest income by Spotless Services Pty. Ltd., see the quote of Beaumont J reproduced at footnote 24 below.
23. The Asprey Committee which was set up to examine and recommend reforms to, *inter alia*, Australia's international tax regime, explained the rationale for adopting the benefit principle on the basis that income which is generated by economic activity conducted under the protection of a particular country and relying on facilities provided there, at least in part at public expense should be taxed by that country: see *Taxation Review Committee: Full Report* 31 January, 1975 (Canberra, AGPS, 1975) (the "Asprey Committee Report") at 263-265. See also Azzi J "Policy Considerations in the Taxation of Foreign-Source Income" 47 *Bulletin for International Fiscal Documentation* 10 (1993), at 548-550. Secs. 6C and 6CA of the Act, which were briefly examined in the introduction, broadly adopt the benefit principle by deeming the source of royalty income and natural resource income, respectively, to be Australian source where the place of economic activity generating such income is Australia. The Commissioner of taxation also has power to allocate income and deductions between a resident company and a related non-resident company for the purposes of making a transfer pricing determination under Division 13. Accordingly, the Commissioner is able to determine the source of income and deductions for the purposes of Division 13 (see Sec. 136AE(1) of the Act). However, it should be noted that the definition of "foreign income" in the Act is such that any statutory provisions which give a source *in Australia* to the particular income (such as Secs. 6C and 6CA) are irrelevant since foreign income is not defined in the Act as the converse of Australian source income: see Sec. 6AB(1) of the Act which provides that "A reference in this Act to foreign income is a reference to income derived from sources in a foreign country or foreign countries."
24. 95 ATC 4775, at 4811. The only comment I would make in reference to the anti-avoidance part of the decision of the majority in the *Spotless Services* case is that by treating tax as if it were a cost of business, their Honours (Cooper and Northrop JJ), with respect, have failed to properly identify the role and function of an income tax. To treat taxes as another cost of business would logically imply that in a simple (i.e. purely domestic) investment/income model, the less income you earn the less tax you pay. The amount of tax payable (under a progressive system) is commensurate with the amount of income derived by a taxpayer. Income in this case becomes a measure of the benefit that a taxpayer derives through the process of wealth generation that is facilitated by the infrastructure and political stability provided by the state in which the taxpayer conducts its business. However, it should not be extrapolated from such an argument that less income derived by the taxpayer means less benefit accrued to that taxpayer. If that was the case then why bother with a general anti-avoidance provision in the first place? Also, why did the Federal Government abolish the Sec. 23(q) exemption if it did not perceive an inequality in the tax system?

Complications arise when international factors are introduced into the model. It becomes necessary to identify the geographical source of income to determine the place where the benefit accrued and thus the state which has the primary taxing rights over such income. Given this basic premise, it is difficult to support the majority's decision in *Spotless Services* where it was held that the taxpayer did not breach Part IVA because its dominant purpose in investing the surplus funds in a tax haven was to maximize its after-tax returns (i.e. a commercial purpose). The reason why the majority decision is difficult to support is because Spotless Services Pty. Ltd. would not have had the opportunity to derive the interest income if it were not for the favourable conditions existing in Australia which enabled the surplus funds to be generated so that they could be invested with a Cook Islands Bank. The court applied a form over substance approach. In that regard I respectfully agree with Beaumont J's findings where his Honour said (at 4798) that:

> "The interest rate [offered by the Cook Islands bank] was unattractive, being substantially less than the domestic rate. Moreover, there appeared to be a security risk in dealing with an offshore, Cook Islands bank ... Further, the Cook Islands dealings were far more complicated, time-consuming (in executive travel time) and expensive in their application than a similar domestic transaction. Why did the respondents choose to adopt such an "uncommercial" course with so many disadvantages? The reason could only be that given by the Information Memorandum. The "nature of the investment" ... was not its commercial attraction, but its taxation benefits. Its dominant purpose was to offer a tax advantage by combining a nominal tax regime located offshore with the operation of Section 23(q)."

ing on the now repealed Section 23(q) of the Act which exempted foreign source income derived by an Australian resident from Australian taxation where such income was subject to tax in the foreign country. Therefore, instead of the taxpayer being subjected to full taxation in Australia, it was able to claim an exemption from Australian taxation by virtue of the funds being subject to a 5 per cent withholding tax rate in the Cook Islands upon remittance of the funds to Australia. The decision in *Spotless Services* has given many commentators, and the ATO, cause for concern.[25]

B. Explicit statutory source rules for interest income

The first explicit statutory provision dealing with source of interest income is subsection 25(2) of the Act.[26] Pursuant to this subsection, interest paid upon money secured by the mortgage of any property in Australia is deemed to have an Australian source, except where the interest is paid to a non-resident in respect of company debentures which are issued outside Australia and the interest payment also occurs abroad.[27] The source rule contained in subsection 25(2) is one-sided to the extent that it only deals with Australian source and does not have any effect on the operation of the FTCS since "foreign income" is not defined in the Act as income which does *not* have an Australian source.

Another statutory source rule which is of limited application in terms of protecting Australia's claims over the foreign source income of its residents is the interest withholding tax rule. This rule which is contained in Section 128B(2) of the Act, is of limited use since it only applies to the payment of interest by an Australian resident to a non-resident. If the withholding tax regime applies, the person receiving the interest is not subject to further tax by assessment.[28] Where Section 128B applies then the Australian resident payer is obliged to deduct, on behalf of the non-resident recipient, withholding tax where the payee has a foreign address or has authorized payment of the interest at a place outside Australia.[29]

By making reference to the carrying on of a business at or through a permanent establishment in Australia, Section 128B infers that the interest income must have been generated by economic activity in Australia and therefore, the person who derives the interest income is liable to pay income tax upon that income.[30] To that extent, Section 128B is a quasi-source rule since it provides that interest income for withholding tax purposes will have an Australian source if it was generated by economic activity in Australia. However, like Section 25(2), it is not applicable for the purposes of the FTCS, since it only applies to determine whether interest income is Australian source and as mentioned earlier, foreign source income is not defined in the Act as non-Australian source income.

Another explicit interest source rule is contained in Australia's tax treaties. Article 11(7) of the Australia–United States treaty (this provision which is to be found in all tax treaties negotiated by Australia) is based on Article 11(5) of the OECD Model Tax Convention (Model).[31] The source rule contained in Article 11(7) will normally be invoked for foreign tax credit purposes where generally a payment of interest occurs between an Australian resident person and a US resident or vice versa. Article 27(1)(a) of the Australia–United States tax treaty further provides that income derived by a resident of the United States which may be taxed by Australia (e.g. because of the source rule contained in Article 11(7)), shall for the purposes of the Convention and the income tax law of Australia be deemed to be from sources in Australia.

25. See Passant J., "Spotless: A Not So Clean Australian Tax Avoidance Decision" 1 *Asia-Pacific Tax Bulletin* 3 (1996), at 88. See also *Butterworths Weekly Tax Bulletin* No. 55, 5 December 1995 at para. [1108] where the decision in *Spotless* is criticized for treating the cost of taxation as if it were a cost of production. In a brief note on the *Spotless Services* case, Mr Michael D'Ascenzo, Chief Tax Counsel, ATO, stated that the Commissioner is seeking leave to appeal the Full Federal Court decision to the High Court: (1996) 1 *Weekly Tax Bulletin* [1].

26. The subsection provides:
"Interest (except interest paid outside Australia to a non-resident on debentures issued outside Australia by a company) upon money secured by mortgage over any property in Australia shall be deemed to be derived from a source in Australia."
It is clear from decided cases on subsection 25(2) that it is not necessary that repayment of the principal be secured by mortgage of property wholly situated in Australia. A majority of the High Court (Latham CJ, Starke, Dixon, Evatt and McTiernan JJ, with Rich J dissenting) in *Broken Hill South Limited (Public Officer) v. Commissioner of Taxation for New South Wales* (1937) 56 CLR 337, held that the words "interest upon money secured upon mortgage of any property in [New South Wales]" in Sec. 4 of the Income Tax Management Act must be given their natural meaning and were not limited to cases where the only security was a mortgage of property in New South Wales.

27. The Asprey Committee was unsure as to whether this exception meant that such interest income is deemed to have a foreign source or whether other general rules relating to source would apply: see the Asprey Committee Report *op cit.*, at para. 17.A24.

28. See Sec. 128D of the Act.

29. See Sec. 221YL(2A) of the Act.

30. Sec. 128B(2)(b) could be easily avoided, for example, by simply arranging for the non-resident lender to pay the funds to an overseas permanent establishment of an Australian resident company which then on-lends the funds to the ultimate Australian resident borrower. The interest paid by the Australian resident would be paid to another resident and therefore outside the scope of Sec. 128B. To alleviate the avoidance opportunities that could arise, Parliament passed Sec. 128B(2A). To be caught by Sec. 128B(2A) the interest (i) must not be an outgoing wholly incurred by the resident payer in a business carried on outside Australia at or through a permanent establishment there; or (ii) paid by a non-resident and is an outgoing wholly or partly incurred by the non-resident payer in carrying on business in Australia through a permanent establishment in Australia.

31. Art. 11(7) of the Australia–United States tax treaty provides that:
"[i]nterest shall be treated as income from sources in a Contracting State when the payer is that State itself or a political subdivision or local authority of that State or a person who is a resident of that State for the purposes of its tax. Where, however, the person paying the interest, whether he is a resident of one of the Contracting States or not, has in one of the Contracting States or outside both Contracting States a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to have its source in the State in which the permanent establishment or fixed base is situated."

Effectively, Article 27(1)(a) incorporates the source rule contained in Article 11(7) into Australia's domestic tax laws, where the conditions set out in that Article are satisfied (i.e. the parties to the transaction giving rise to the derivation of interest income are residents of Australia and the United States). Outside that context, it is necessary to resort to principles derived from case law.

The residence-based interest source rule contained in Article 11(7) provides that the source of interest income is determined by the residence status of the payer company. Where, on the other hand, the payer incurs a debt in respect of a permanent establishment which either exists in one of the Contracting States or outside both of the Contracting States, and the interest is borne by such permanent establishment then such interest is deemed to have a source where the permanent establishment is situated. This reflects the economic nexus rule. However, as with the explicit statutory interest income source rule in Section 128B, the source rule in Article 11(7) can be easily manipulated as it effectively reproduces the same economic nexus rule.

The manipulation can take two main forms. Where the lending is between related parties, e.g. within a group of companies, the residence of the parties can be easily controlled by the parent company such as by incorporating the lender or borrower in a tax haven. Secondly, in a non-related party case, the manipulation is achieved by simple investment choice. Funds can be deposited in an Australian resident bank or a tax haven bank, as was the case in *Spotless Services*. That is, the mobility of loan capital in the absence of exchange controls leaves it up to the investor/lender to choose where interest is sourced.

Apart from the explicit statutory and treaty rules above, the dominant factor in determining the source of interest income under principles established by case law, is the "originating cause" of the obligation to pay the interest. According to Watermeyer CJ in *Commissioner for IR v. Lever Bros and Unilever Ltd.*[32], the originating cause is the "provision of credit". That is, the "service which the lender performs for the borrower in return for which the borrower pays him interest".[33] This rule was applied by the New Zealand Court of Appeal in *Commissioner of IR v. N.V. Philips Gloeilampenfabrieken*[34] where it was held that the source of the interest income was the actual giving of the credit which was made under an agreement entered into in the Netherlands. The High Court of Australia had held, some 33 years before that the source of interest income was the country in which the agreement was made: *Studebaker Corporation of Australasia Limited v. Commissioner of Taxation for New South Wales*.[35]

Clearly, these rules are also easily manipulated by simply drafting and concluding the relevant agreement in a foreign jurisdiction. Again, the decision in *Spotless Services* confirms such an interpretation. Given the ease with which judge-made source rules can be manipulated and the uncertainty in applying such rules in various circumstances, the Asprey Committee recommended the adoption of a source of interest income rule based on the residence of the debtor but with more emphasis on the economic activity which produced funds to pay the interest.[36] The rationale for implementing such a source rule will be examined below.

However, the conclusion that can be drawn from the above discussion is that a major flaw exists with rules for determining the source of interest income – viz. uncertainty. The explicit statutory rules which exist are easily circumvented with clever planning. Moreover, the problem with judge-made rules is the fact that each case must be considered on its facts. This is a highly impractical and costly method of enforcing a fundamental principle of taxation which impacts upon a great number of transactions and concurrently on Australia's ability to assert fiscal jurisdiction over such transactions. Hence, the need for the Government to provide real guidance by formulating appropriate statutory source rules.

III. POLICY CONSIDERATIONS IN FORMULATING STATUTORY SOURCE RULES

The implementation of statutory source rules should add certainty and improve the effectiveness of the existing policy options for dealing with international transactions that minimize residence country taxation by manipulating existing source rules. In theory, any statutory source rule should provide adequate guidance for taxpayers and tax administrators to enable the determination of the source of income. It should also allow for income from each income tax base to be measured accurately and the application of relatively uniform rates of tax on each base.[37]

In designing explicit source rules for Australia it is instructive to examine the US approach since the United States is one of the few countries with comprehensive explicit statutory source rules. In general, the United States sets out rules for determining US source income depending on the type of income being derived (see Section 861 of the Code) and income which does not fall within that definition is deemed foreign source income (see Section 862 of the Code). The source of income rules contained in Sections 861-865 of the Code cover substantially all items of income, and those not expressly mentioned have their source determined by finding the closest analogy to items expressly dealt with by the Code, considering the nature of the item, the nature of the economic activity that generates it and the location of the property to which it is related.

32. (1946) SAfPC 1.
33. Ibid., at 4.
34. (1954) 5 AITR 158 (especially the decision of Gresson P at 163). In the same case, North J (with Hay J agreeing) held that the place where the credit is provided is the place of contracting (i.e. the loan agreement).
35. (1921) 29 CLR 225 at 233. See also the Full Federal Court's unanimous finding that the interest income was sourced in the Cook Islands in the *Spotless Services* case.
36. See the Asprey Committee Report *op cit.*, at para. 17.A25.
37. See *International Taxation: A Discussion Document* ("ITDD") (a consultative document released by the New Zealand Government on 28 February 1995 outlining policy reforms to New Zealand's international taxation rules) at 31.

The statutory source rule for interest income set out in Section 861(a)(1) of the Code provides for a residence based source rule for interest income. That is, an interest payment generally has its source in the country where the person obligated to make the payment resides. However, there are exceptions to this general rule which *inter alia* incorporate an economic nexus rule of the type that the Asprey Committee had recommended for Australia. The principal exceptions treat as foreign source income any interest received from:

(1) foreign branches of domestic banks and savings and loan associations which are engaged in the commercial banking business (see Section 861(a)(1)(B)); and
(2) domestic persons who derived at least 80 per cent of their gross income during the preceding three years from the "active conduct of a trade or business" outside the United States (see Section 861(a)(1)(A), (c)(1)).

The 80 per cent test is applied to the three-year period as an aggregate, rather than year by year. Also, where the recipient is a "related person"[38] to the payer, only the actual foreign percentage of the interest is treated as foreign source income.[39]

The Asprey Committee noted the operation of US statutory source rules and recommended that statutory source rules for Australia should operate to tax income generated by economic activity within the country which, if not taxed on the basis of source, would be excluded from the total base of income tax. This would put pressure on the foreign base to compensate for the loss of revenue that would arise. The Committee noted that the justification for imposing tax on the basis of source rests on the benefit principle. However, it is extremely difficult to apply such a rule in practice. This is because it is difficult to determine what economic connections with a country are sufficient to justify taxation in that country. Some answers to this puzzling question may be gleaned from the information disclosed by Australian companies with international operations in Schedule 25A.[40]

On a more general level, some guidance on this question may be obtained from Professor McIntyre's work in this area. He observes that in a model income tax system the limitations on tax jurisdiction provided by the source rules should be designed to achieve three goals – (i) the elimination of double taxation; (ii) the elimination of "under-taxation"; and (iii) the distribution of tax jurisdiction over income among sovereign governments in some mutually agreeable fashion.[41] He suggests that there are an indeterminate number of ways that these three goals could be achieved and that the economic nexus test is only one means of achieving the three goals. But whichever test is preferred, he argues that the following guidelines designed to facilitate the achievement of the three goals should always be borne in mind. These are:[42]

(i) The source rules should be as simple for the tax authorities to apply as possible. In particular, source rules applicable to foreign taxpayers should not depend for their application on detailed factual inquiries or on refined accounting judgments.[43] The need for simplicity stems from the fact that many source rules in the United States are tantamount to withholding rules as they apply to foreign taxpayers.
(ii) A government should not unilaterally adopt a source rule that it would find objectionable if adopted by another sovereign government, as this would be incompatible with the goal of a mutually agreeable sharing of tax jurisdiction. Where a sovereign state has "look-through" rules to take away the incentive available to its domestic taxpayers for shifting investment income to a foreign jurisdiction or increasing foreign tax credits, then there is no reason to impose complex rules on foreigners. Accordingly neutrality in this context does not require that foreign taxpayers and domestic taxpayers be subject to identical source rules.

In Australia source of income rules for non-residents do not necessarily correspond with source rules for FTCS purposes.[44] For FTCS purposes "foreign income" is defined in Section 6AB(1) as, *inter alia*, "income derived from foreign sources in a foreign country or foreign countries...." The effect of this provision is that explicit statutory source rules which give particular income a source in Australia (e.g. Sections 6C and 6CA) are deemed irrelevant since foreign income (unlike the definition of "non-resident" set out in Section 6(1) of the Act) is *not* defined in the Act as the converse of Australian source income.

Therefore, in ascertaining whether income has been derived from foreign sources it is necessary to resort to Australian judge-made source rules to determine whether the income is characterized as having an Australian source. Thus, it is possible for the same income to be treated as having an Australian source for one purpose and to be foreign source for the purposes of the FTCS, and vice versa.[45]

38. A "related person" includes any person owning, "directly or indirectly" at least 10% of the stock of the payer: Secs. 861(c)(2)(B) and 954(d)(3).
39. See Sec. 861(c)(2)(A) of the Code.
40. The substantially revised "Sch. 25A" which is the supplementary foreign income questionnaire that companies with international transaction must fill in and lodge with their tax returns. The new schedule requires companies to provide details of business activities in comparable tax jurisdictions. Companies are also required to disclose information on taxpayers' interests in foreign trusts or companies and international property and insurance dealings. In addition, companies are required to disclose particulars of international revenue and expenses related to 13 separate headings ranging from derivative financial transactions to royalties.
41. McIntyre M J *The International Income Tax Rules of the United States* (Butterworths Legal Publishers, 1989) (Looseleaf) at 3-65.
42. This part of the analysis is based on the analysis in McIntyre, Ibid., at 3-66 to 3-70.
43. Cf. Professor Vann's ideal multilateral approach to achieving uniformity of tax systems and thus minimizing international double taxation, where he advocates reliance on advanced accounting theory for dealing with corporate groups and consolidation of group accounts: "A Model Treaty for the Asian-Pacific Region?" (1990) 8 *Asia-Pacific Tax and Investment Bulletin* 392 at p 411.
44. Cf. US source of interest rule which deems those amounts that are not US source interest income under Sec. 861(a)(1), to be foreign source interest income.
45. The tax treaties which Australia has negotiated, could play a major role in this regard, since they contain explicit source rules which take precedence over Australia's own source rules. However, as Australia has only negotiated some 38 tax treaties, the possibility of double economic taxation or double domestic taxation would have to be addressed unilaterally.
Recently the Commissioner of Taxation issued a draft taxation ruling outlining the steps the ATO will take to alleviate international double taxation and economic double taxation that result from another country's tax administration adjusting the profits of a multinational enterprise group. For a discussion of this ruling and a comparison with the approach taken by the Internal Revenue Service in the US, see Azzi J, "Correlative Adjustments to Relieve Double Taxation Arising from an Adjustment by a Foreign Tax Administration" in 1 *Asia-Pacific Tax Bulletin* 4 (1996), at 119.

(iii) As was recommended by the Asprey Committee some 14 years earlier, McIntyre notes that to the extent possible, income should be sourced in a country where it has some economic nexus. He goes on to deal with the situation where income may not have a clear economic nexus with any country. In such a case he suggests, statutory provisions assigning the source of such income to the country of residence of the persons carrying on the income producing activities would not violate the economic nexus guideline.

It appears that the US Tax Court has recently applied a wide concept of the economic nexus test by extending the US equivalent of Australia's active income test (in particular the tainted sales income provisions[46]) to assembly operations. In *Bausch & Lomb Inc., et al. v. CIR*[47], Judge Carolyn P. Chiechi agreed with the taxpayer in concluding that income generated from the assembly operations of two related CFCs was not foreign base company sales income and therefore, excluded from the US parent company's gross income under subpart F which contains the US CFC rules. The test applied by the Court was the "substantial transformation" of property test found in Reg. Section 1.954-3(a)(4)(ii) of the Internal Revenue Code 1954 (the Code). Under this test, if the purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation.

The test applied by Judge Chiechi requires the operations to be present in the particular jurisdiction and that substantial transformation of the goods occurred in that jurisdiction. However, in applying the Section 954(b) exclusion from Subpart F, the Judge gave a broad interpretation to the word "manufacture" by finding that the assembly of parts into a finished product constituted substantial transformation of the product.

The relevance of the above case to Australian policy makers is the fact that any government wishing to embark on a course of reform of its source of income rules needs also to incorporate statutory rules which define the type of income that is generated before applying any new source rules to such income. This would also require detailed rules for allocating deductions to the particular income generated and providing adequate guidance as to whether apportionment rules apply to gross or net income.[48] The definitions found in Australia's CFC rules of passive income, tainted sales and tainted services income could be a good start for reform proposals.

(iv) McIntyre suggests that, to the extent feasible, income with an economic nexus with more than one country should be sourced in a country that is inclined to subject the income to taxation. This would reduce the risk of under-taxation, thereby promoting fairness and economic efficiency.[49] It would also make possible a generally lower rate of taxation on other sources of income. Under this guideline, interest income should be sourced in the country of the recipient rather than in the country of the obligor. If this approach were to be adopted in Australia, there would also need to be changes made to the FTCS to ensure that the problem of international double taxation is addressed properly.

Introducing clear guidelines for identifying the type of income derived (which includes identifying the person who has derived such income) and incorporating simple rules for determining when income is deemed to be derived in Australia, would add certainty and thus efficiency into the Act. The rules need not be overly complex. The US approach of drawing analogies could be useful in this regard. But what is important is that any reforms to the source rule should be accompanied by reforms to the residence rule to ensure that manipulation of one rule does not avoid the operation of the other rule.[50] Residence based source rules which correlate residency of the taxpayer with the source of income fall squarely into this category.[51]

46. The Australian equivalent to the foreign base company sales income regime is contained in Sec. 447 of the Act.

47. (US Tax Court) (T.C. Memo. 1996-57, Tax Ct. Dkt. No. 13983-91) at para. [113].

In rejecting the IRS's argument that the assembly operations of the two CFCs "were not substantial in nature when compared to the fabrication of the parts used in those operations", Judge Chiechi was of the view that such an interpretation misses the mark since both companies "performed [a] full range of activities necessary to assemble sun-glasses parts into finished, quality sun-glasses". The court was able to reach such a conclusion based on the fact that both CFCs purchased eyeglass parts from B&L including front and temple pieces, lenses, screws, and even packaging materials. The operators received parts to be assembled together with a manufacturing order. Following assembly, each pair was inspected and further adjustments could be made to the frames, including buffing out imperfections on the lenses. The sunglasses were then cleaned and packed.

48. See ITDD *op cit.*, at p 32 and at p 33 where it is concluded: "The current statutory rules applying to cross-border income can be improved. This would involve clearer and more detailed rules for determining New Zealand-sourced and foreign-sourced income and apportionment rules for income that has more than one source (where apportionment is allowed) and expenditures incurred in producing both New Zealand-sourced and foreign-sourced income. Such rules should include approved methodologies for determining transfer pricing."

49. McIntyre also suggests that the application of source rules should be under the control of sovereign governments and not taxpayers, except to the extent that they have a choice of where to conduct their economic activities giving rise to income. Without this control, he notes, the actual or deemed agreement among sovereign governments over the sharing of possible tax revenues will not be implemented, as taxpayers having control over source rules, would be able to manipulate source rules so as to minimize their exposure to any particular country's tax rules: McIntyre *op cit.*, at p 3-69.

50. The place of incorporation or seat of management tests fail to respond to modern economic realities. The place of incorporation of a company and the location of its head office and seat of management and control are all largely within the control and subject to the manipulation of the taxpayer. Moreover, the residency of the controlling shareholders test is very easily manipulated. The ease with which the residence rule is manipulated greatly affects the integrity of explicit statutory source rules which attribute the source of income to the state of residency of the payer.

51. It is interesting to note that on 11 February 1996, the then Treasurer Mr Ralph Willis announced the Government's intentions to *inter alia*, reform the corporate residence rules to make it harder for non-resident companies to derive benefits that would apply solely to an Australian resident corporation: *The Treasurer's Press Release* (11/2/96). One such benefit is the preservation of pre-capital gains tax status of non-taxable Australian assets owned by a foreign company which subsequently becomes a CFC in relation to an Australian resident company: see Azzi J "Proposed Amendments to Controlled Foreign Corporation Rules" 1 *Asia-Pacific Tax Bulletin* 11 (1995), at 315.

IV. THE RESIDENCE RULE

One of the most important provisions on defining the income tax base in relation to foreign source income is Section 25(1) of the Act.[52] It states that residents are taxed on their worldwide income. As was noted briefly above, the corporate veil doctrine, *inter alia*, has enabled Australian resident companies to set up subsidiaries in tax havens for the purpose of avoiding Australian tax by accumulating funds in those subsidiaries. How this process works in practice will be discussed below.

A resident of Australia in relation to a company is defined in Section 6(1) of the Act, as follows:

> "(b) A company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia."

From the above definition, it is clear that there are three tests to determine the residency of a company. The first limb – incorporation in Australia is decisive in determining a company's residence. However, the "incorporation" test is but one test of residency for companies.[53] The underlying policy for the incorporation test is that a company which owes its existence to the law of a country should be subject to that country's tax system on the worldwide income it derives.

Where a company is not incorporated in Australia, then the question arises as to whether the company which carries on business in Australia has its "central management and control"[54] in Australia or whether its voting power is controlled by shareholders who are resident in Australia.

The rationale for the "central management and control" test is that if the manifestations of the company's existence in ultimate decision making take place under the protection of the law of a country, then the income which it derives from its worldwide activities should also be subject to that country's tax regime.[55] Support for the requirement that the company whose central management and control is in Australia must also be carrying on business in Australia before it is deemed to be resident in Australia is drawn from the economic nexus rule.

The rationale for the third limb of the residency test derives support from the provisions of Subpart F of the Code and the suggestion of the Asprey Committee that the central management and control test should have a wider scope where the company is incorporated in a tax haven. It has been suggested that Australian residents "should not be able to shed their subjection to tax on their world-wide incomes by operating through a corporate entity."[56]

A. The residence rule in practice

Despite the policy justifications for incorporating the three tests of residency, in practice such rules have proved to be ineffective in countering tax haven and transfer pricing activities. A company will be treated as carrying on business in a country by reason of the fact that its central management and control is there.[57] In *Malayan Shipping Co. Ltd. v. FCT*[58] it was held that all that must be shown to establish that a company (which is not incorporated in Australia) is resident in Australia is that the central management and control of the company is situated in Australia. The central management and control of a company will be in Australia if there is some part of the superior or directing authority (or mind) of the company in Australia by means of which the affairs of the company are controlled and the centre of its trading is in Australia.[59]

The Asprey Committee was anxious not to extend the meaning of the "central management and control" concept beyond the formal proceedings of the boardroom. Such an extension would increase the likelihood of a company being resident in both Australia and a foreign country beyond what may be regarded as the internationally acceptable norm. However, the Committee suggested that such an extension would be appropriate where the company is incorporated in a tax haven. For this purpose, the Committee observed that it will be necessary to identify tax haven countries either in the Act or, preferably, in regulations.[60]

Subsequent to the decision in the *Malayan Shipping* case, the High Court arguably took a different approach in the *Esquire Nominees* case.[61] One of the questions raised was whether the taxpayer company whose directors were residents of Norfolk Island and who held all the meetings of the company there, was resident in Australia. The Commissioner contended that as the taxpayer habitually responded to advice from Australian accountants, it should be characterized as resident in Australia. In rejecting the Commissioner's contention, Gibbs J did not regard the fact that the Board of Directors habitually responded to instructions formulated in Australia as suffi-

52. See Parson R W *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company Limited, Sydney, 1985) at 4.

53. Under US residency rules a company will be characterized as a US company where it is simply a corporation which is "created or organized in the United States or under the law of the United States or of any State": Sec. 7701(a)(4) of the Code. Where it is not so created or organized then it is deemed to be a foreign corporation. Under Sec. 11 of the Code tax is imposed on the taxable income of every domestic US corporation for each taxable year.
The US incorporation test is said to maintain neutrality of taxation between foreign investors: see E A Owens, *International Aspects of U.S. Income Taxation: Cases and Materials* (International Tax Program, Harvard Law School, Cambridge, Mass., 1980), at II/43.

54. For a discussion on the distinction between "management" and "control", and the various definitions of control see the judgment of the majority (Stephen, Mason and Wilson JJ) in *FCT v. Commonwealth Aluminium Corporation Limited* (1980) 143 CLR 646, at 658-661.

55. Vann & Parsons, "The Foreign Tax Credit and Reform of International Taxation", (1986) 3 *Australian Tax Forum* 131, at 148.

56. Ibid.

57. *De Beers Consolidated Mines Ltd. v. Howe* [1906] AC 455.

58. (1946) 71 CLR 156. In this case, Williams J held that a Singapore company set up by an Australian resident (who was really in charge) had an Australian residence, on the basis that the company's central management and control was situated in Australia. This is despite the fact that two Singaporean persons were appointed as directors and met outside Australia.

59. *Koitaki Para Rubber Estates Ltd. v. FCT* (1940) 64 CLR 15, at 19; per Dixon J. See also *De Beers Consolidated Mines Ltd. v. Howe* [1906] AC 455.

60. Asprey Committee Report *op cit.*, at 255.

61. (1973) 129 CLR 177. The taxpayer appealed from the decision of Gibbs J to the Full Court of the High Court, which reversed Gibbs J's judgment but approved his findings in relation to residence, reported at (1974) 4 ATR 75.

cient evidence that the taxpayer was resident in Australia.[62] In reaching this conclusion, his Honour stated that he believed that if the directors had been instructed to do something improper or inadvisable they would not have done it. Gibbs J was of the view that although the Australian accountants had "power to exert influence, and perhaps strong influence" on the company, they nonetheless did not "control" the company. Accordingly, actual management and control of the company and thus its residence was in Norfolk Island.[63] Gibbs J's judgment on this point was upheld by the Full Court of the High Court.[64]

B. Management and control

The precise meaning of the phrase "management and control" of a company is uncertain since there has been no specific judicial consideration of this phrase in the Australian courts. The majority judges in *FCT v. Commonwealth Aluminium Corporation Ltd.*[65] in concluding that the term "controlled" as it appeared in the now repealed Section 136(a) of the Act referred to de facto control[66] of the business of the company, noted that control and management are not synonymous terms. Each may be in different hands. Their Honours went on to explain that such a distinction did not necessarily lead to the conclusion that directors of the company are to be treated as managers and the shareholders as controllers of the company in all cases.[67] These terms are traditionally treated as a single concept, and hence it is possible to infer that control in the context of Section 6(1) also refers to de facto control of the business of the company rather than actual control of the company itself.

There have been numerous judicial decisions that have examined such concepts as "control of a company" and "controlling interest" – such as *Mendes v. Commr. of Probate Duties (Vic)*;[68] *Kolotex Hosiery (Australia) Pty. Ltd. v. FCT*;[69] *W P Keighery Pty. Ltd. v. FCT*;[70] *British American Tobacco Company Ltd. v. I R Commrs*;[71] and *Barclays Bank Ltd. v. I R Commrs*.[72] However, the majority of the judges in the *Commonwealth Aluminium* case noted that most of these cases were of little assistance since they reflect, in varying degrees, the different notion of capacity to control which is not an element that is prevalent for the purposes of Section 136(a). Their Honours remarked that control of a company for the purposes of Section 136(a) may be inferred from the existence of a power to control its business.[73]

The reasoning of the majority judges in the *Commonwealth Aluminium* case, it has been suggested, represents a softening of approach from the *Esquire Nominees* case to the extent that the reasoning can be applied to determine the degree of control required to be shown in each case.[74] Nevertheless, the concept of de facto control as applied in the *Commonwealth Aluminium* case would not arguably extend to overcome the reservation that Gibbs J expressed in the *Esquire Nominees* case about the actual directors' ultimate power of veto. Such power of veto could be exercised in refusing to do something improper or inadvisable on the basis of instructions by the de facto controllers. After all, the duty of directors under Australian company law is to the company itself.

The uncertainty surrounding the precise scope of the central management and control concept has given rise to tax planning activities along the same lines as the taxpayer in the *Esquire Nominees* case. Effectively, this has allowed offshore subsidiaries to argue that they are not necessarily resident in the country of their holding company. Consequently, it is not difficult to understand why the *Esquire Nominees* decision has been attributed with inspiring many corporations to set up offshore subsidiaries to engage in business in low tax countries which do not repatriate a significant part of their profits to Australia. The extent of international planning activities based on *Esquire Nominees* has led one commentator to suggest that the CFC regime was introduced to counter deferral of Australian tax arising from that decision.[75]

C. Control of voting power

The third test of residency set out in Section 6(1)(b) treats a company as being a "resident of Australia" where it has "its voting power controlled by shareholders who are residents of Australia". Unfortunately, this test suffers from the same fate as the test in the second limb of the definition. Not only is the precise meaning of the phrase "control of voting power" uncertain, but also this test is easily avoided.[76] In order to avoid control being attributed to Australian resident shareholders, such shareholders could either simply refrain from voting or give a non-resident person a proxy to vote. The High Court in the *Commonwealth Aluminium* case was at pains to point out that it is not very helpful to suggest that it is the shareholders who ordinarily control the business and the business activities of the company.[77] This is confirmed by the definition of a resident company in Section 6(1) which refers to voting power being controlled by shareholders as opposed to shareholders controlling the company itself. In

62. Ibid., at 185- 186.
63. Ibid., at 186.
64. Per Barwick CJ and Menzies J (1974) 4 ATR 75 at 77, and 85.
65. (1980) 143 CLR 646.
66. Cf. the definition of "control" for the purposes of the Canadian Income Tax Act where it is stated that "control" means *de jure* rather than *de facto* control: *Krishna v. Canadian International Taxation* (Carswell Publishing, Ontario, 1995) (Looseleaf) at 7-43.
67. Ibid., at 659 (per Stephen, Mason and Wilson JJ), where it was stated that the word "controlled" when used passively, in its ordinary meaning refers to de facto control rather than capacity to control. Their Honours said (at 661): "[Section] 136(a) in speaking of de facto control is ... aimed, though not exclusively, at a situation in which the business is controlled by a non-resident, not being the person who carries on the business, with the consequence that the person who carries on the business becomes liable to pay income tax under the Section."
68. (1967) 122 CLR 152.
69. (1975) 132 CLR 535.
70. (1957) 100 CLR 66.
71. [1943] AC 335.
72. (1961) AC 509.
73. (1980) 143 CLR 646 at 659. See also *British American Tobacco Company Ltd. v. I R Commrs* [1943] AC 335, at 339.
74. See Waincymer *op cit.*, at 350.
75. Ibid.
76. See Vann "The Background & Policy of the Australian International Accruals Regime", *The Taxation Institute of Australia – Intensive Seminar Papers* (New South Wales Division, 9-11 November, 1989) 1 at 10.
77. (1980) 143 CLR 646 at 659.

this regard, the decision of the High Court in the *Mendes* case may be of relevance.

It has been held that control of voting power (in a different context to the third test of residency set out in Section 6(1)) refers to "direct" control (or "de facto" control) of the voting power and not indirect or practical control.[78] Moreover, "voting power" means voting power in a general meeting of the company and includes the whole of the voting power exercisable by members of the company, not just that attached to shares.[79]

Moreover, the decision in *Patcorp Investments Ltd. & Ors v. FCT*[80] has enabled tax planning in the form of manipulation of the residency of shareholders registered as shareholders of the company. This is because beneficial owners of a company can nominate non-resident nominees to exercise voting power on their behalf. Such a scheme will be effective in altering the residency status of a company since the third limb (as with the second limb) of the residency test set out in Section 6(1) does not look through to the residence status of the ultimate owners (or ultimate managers) of the company.

Other problems arise when determining the residency status of individual shareholders. For this purpose it is necessary to resort to the statutory rules expounded in Section 6(1) to determine the residency of individual persons and companies. It will not serve our purpose to discuss the residency tests for individuals set out in Section 6(1)(a) of the Act. Suffice to note that the complex rules contained in Section 6(1)(a) may be circumvented relatively easily. For instance, it has been held that an individual does not have to be permanently resident in a foreign country before he or she will be regarded as a non-resident of Australia.[81]

D. How the CFC regime looks through the corporate veil

Manipulation of the residency rule, as shown above, is primarily achieved by reason of the corporate veil doctrine. This has enabled Australian resident taxpayers to successfully incorporate a foreign company and effectively control it from Australia. By interposing the controlled foreign company between the source of the income and the ultimate beneficial owners, Australian taxpayers avoid or defer exposure to Australian tax.

As far as upholding the integrity of the second and third limbs of the residence rule, the CFC rules achieve this by incorporating comprehensive direct and indirect control tracing rules which look-through the corporate veil to the ultimate beneficial owners and therefore, the controllers of the CFC. The definition of a CFC set out in Section 340 incorporates two broad concepts of control (i) control in the strict sense (which looks at the aggregate interests held by a *group*, [defined in such wide terms as to cover a single entity acting alone], of resident shareholders to see whether it has at least 50 per cent of the foreign company's capital or voting power); (ii) control in the economic sense (which looks at interests of a single resident shareholder or a group of resident shareholders which, prima facie, own less than 50 per cent of the foreign company and thus would not have satisfied the strict control test).

The concept of "control" in Section 340 is not defined in the Act and nor has it been judicially considered in Australia. In fact, of all the common law countries that have introduced CFC rules (i.e. the United States, Canada, the United Kingdom and New Zealand) only the United States has had cause to judicially consider such a concept in the context of its Subpart F rules. A major reason for this is that the United States introduced Subpart F into the Code in 1962 whereas Canada introduced its foreign accrual property income (FAPI) rules in 1976[82], the UK in 1984[83] New Zealand in 1988 and Australia in July 1990. Therefore, it is necessary to turn to the US cases which have examined when a company is to be deemed a CFC for the purposes of Subpart F in the hope of identifying the types of issues that Australian taxpayers and the Commissioner of Taxation may have to confront in relation to Australia's CFC rules.[84] As far as Australian courts are concerned, it is not beyond reason that they will consider the US cases in this area as persuasive as they do UK or Canadian cases, especially where there is no Australian authority on the point.

The US "control" threshold which is contained in Section 957 of the Code defines a CFC to mean any foreign corpora-

78. See *Mendes v. Commissioner of Probate Duties (Vic)* (1967) 122 CLR 152, where Kitto J said (at 162): "... a Company A, which by virtue of its voting power in a general meeting of Company B controls that company, has a controlling interest in Company C if Company B holds the majority of votes in the general meeting of Company C."

79. *Kolotex Hosiery (Australia) Pty. Ltd. v. FCT* (1975) 132 CLR 535. Gibbs J commented at 571: "... 'the voting power in the company' is the voting power exercisable by members of the company ... I am unable to agree that the words are restricted in their meaning to voting power attached to or carried by shares. The words are quite general, and in their natural meaning would include all voting power that may be exercised in the company, however conferred."

80. (1976) 140 CLR 247. It was held that a person who was not entered on the register of shareholders but was the beneficial owner of shares could not be described as a "shareholder".

81. See *FCT v. Applegate* 79 ATC 4307, at 4314, per Northrop J, where the taxpayer was away for two years. See also *FCT v. Jenkins* 82 ATC 4098; where the Queensland Supreme Court held that the taxpayer who had been away for only 18 months had a "permanent place of abode outside Australia".

82. Harris E C., *Canadian Income Taxation* (4th ed) (Butterworths, Canada, 1986) at 654 where it was noted that originally the FAPI rules were to be introduced in 1973 but they were delayed until 1976 primarily to allow sufficient time to review and improve the proposed rules. It should be noted that in Sec. 256 (5.1) of the Canadian Income Tax Act, the term "controlled" is defined generally for the purposes of the Tax Act and not specifically for the purposes of Canada's FAPI rules.

83. After a lengthy consultation process in which several drafts of the proposed CFC rules were produced, the final provisions were included in the Finance Act 1984 and are now to be found in Secs. 747 to 756 of and Schs. 24 to 26 to the Taxes Act 1988: Bramwell R., Hardwick M., James A., and Oratore V., *Taxation of Companies and Company Reconstructions* (Sweet & Maxwell, London, 1991) at 351. There have been no UK cases to date which have considered the concept of control in the context of the CFC rules.

84. It should be noted that as much as Australian policy makers examined the US approach under Subpart F before drafting the CFC rules, there are distinct differences in approach between the two regimes. The approach adopted in Australia's CFC rules operates around the concept of "listed" and "unlisted" countries (i.e. "designated comparable-tax jurisdictions" approach), whereas, the approach in Subpart F focuses on the particular transaction (the "transactional approach"). Under the Australian approach, income which is sourced in those countries which have a comparable tax system to that of Australia will generally be exempt from the CFC measures. Under the US approach, Subpart F income which has been taxed at a high rate (i.e. 90% of the US corporate tax rate) is generally exempt from Subpart F.

tion of which *more than 50 per cent* of the total combined voting power of all classes of stock entitled to vote, or the total value of stock of such corporation, is owned directly or indirectly,[85] or owned constructively,[86] by a US shareholder ("USS"[87]) on any day during the taxable year of such foreign corporation.[88]

E. De facto control in the US Subpart F rules

The crux of the US approach is that substance over form is the preferred approach in applying the control provisions of Sections 957 and 958.[89] The courts have similarly expounded such views. The US Court of Appeals in *Garlock Inc v. Commissioner*[90] held that "it is real voting power and not the mere mechanical number of votes which Congress was concerned with [in enacting Subpart F]". The same court in *Kraus v. Commissioner*[91] held that in determining whether "real" voting power was surrendered by means of the creation and splitting of preferred stock, the "actualities" stressed in Treasury Regulation Section 1-957-1(b)(2) must be looked at. The court emphasized the need to "look behind the facade" to determine whether a real transfer of voting power to the preferred stockholders took place, or whether the purpose of the arrangement was simply to avoid the appearance of the foreign corporation as a "CFC".[92]

Whether the approach of the US Tax Courts in *Garlock* and *Kraus* would overcome the *Esquire Nominees* point in relation to the exercise of the power of veto is yet to be tested in the Australian courts.[93] Ironically, the substance over form approach could be relied upon to argue that the foreign company is ultimately controlled by those directors who have a power of veto over decisions made by the de facto directors. That is, the directors of a foreign company, depending on the circumstances of the case, could in substance be regarded as the ultimate controllers of the company if there was scope for arguing that they would not implement directives (issued by the Australian de facto controllers) which are improper or inadvisable for the purposes of the company. It is not clear what kind of evidence a court of law would consider persuasive in upholding this type of argument. An insight of the type of evidence that a court may find persuasive in resolving this issue can be gained from the US decisions in *CCA Inc.* and *Koehring*.

The taxpayers in *CCA Inc v. Commissioner*[94] (who were also USSs) were successful in their attempt to decontrol a foreign corporation. CCA Inc. (the "taxpayer"), a US corporation established a wholly owned Swiss corporation. The taxpayer became concerned about the possible adverse effects of the newly introduced Subpart F on its ability to defer income with respect to its European operations. Accordingly, CCA Inc. sought to decontrol its Swiss corporation by transferring all its shares to a wholly owned Netherlands Antilles company, and had the Swiss company issue a new preferred stock with 50 per cent of the voting power going to unrelated parties who were not USSs. Thereafter, the shareholders of the Swiss company comprised non-related persons holding 800 cumulative preference shares and a Netherlands Antilles subsidiary of CCA holding 800 ordinary shares. Each share had the same par value and carried with it the right to vote.

The Articles of Incorporation of the Swiss company were amended to provide for a ten-member board of administrators, one half of whom were to be nominated by the ordinary shareholders and the other half to be nominated by the preference shareholders. The chairman did not have a casting vote. The preference shares carried a 6 per cent cumulative preferential dividend.

After a comprehensive analysis of the evidence, Wiles J, in the US Tax Court held that the taxpayers had divested themselves of meaningful voting power in the wholly owned Swiss subsidiary. He found no evidence of any agreements, whether oral or written, between the parties with respect to the manner in which the preference shareholders would vote their stock.[95] He distinguished the facts of the present case from those in the *Kraus*' case in that the preferred sharehold-

85. See Sec. 958(a) of the Code.
86. See Sec. 958(b) of the Code.
87. A USS is defined in Sec. 951(b) of the Code as a *"United States person"* who owns directly, indirectly, or constructively 10% or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. A "United States person" is, in turn, defined to mean a citizen or resident of the United States, a domestic partnership, a domestic corporation and any estate or trust (other than a foreign estate or trust). (See Sec. 957(c) and Sec. 7701(a)(30)).
88. Sec. 957 also contains special rules in respect of foreign companies deriving income from the insurance of US risks: Secs. 953, 957(b) and Reg Sec. 1.951-2. However, given the scope of the discussion, this aspect of determining what constitutes a CFC (see also Sec. 957(c) and (d), and Regs. Sec. 1.957-3 and 1.957-4) will not be discussed.
89. See Reg. Sec. 1.957-(1)(b)(2) which states that mere ownership of shares does not of itself dictate where control of the foreign corporation rests. It provides that:
"[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock had the voting power of such stock for the purposes of Section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having no more than 50 per cent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement."
90. 489 F 2d 197 (1973) at 201-202. The court there referred to the example provided in Reg. Sec. 1.957-1(2)(b) (cited in footnote 39 above). See also *Kolotex Hosiery (Australia) Pty. Ltd. v. FCT* (1975) 132 CLR 535 at 571, where Gibbs J said that voting power in the company is not restricted to voting power attached to or carried by shares and includes all voting power exercised in the company however, conferred.
91. 490 F 2d 898, at 900-901.
92. Ibid at 901. Mulligan J in concluding that the taxpayers (who were USSs) never surrendered any real voting power said (at 902): "... it defies credulity that the taxpayers who owned 100% of [the foreign corporation], a corporation which at the end of the fiscal year 1962 had a net worth in excess of $250,000, and was then making annual profits in excess of $225,000, would surrender 50% of the control of their corporation to new shareholders who were making a capital contribution of CHF 100,000, less than $25,000."
93. See Gibss J's reservations expressed in *Esquire Nominees Limited v. FCT* (1973) 129 CLR 177 at 185-186 where his Honour did not regard as persuasive the fact that the taxpayer habitually responded to instructions formulated in Australia.
94. 64 TC 137.
95. Cf. the findings of the Court in the *Kraus*' case, where Mulligan J said that all "the new preferred stockholders were carefully selected, moreover, so that no rocking of the corporate boat could be anticipated" (at 902-903).

ers in the latter case had no "real opportunity to alter the course of events".[96]

On 28 June 1982, the US Internal Revenue Service announced that it no longer acquiesces in the decision of the Tax Court in *CCA Inc. v. Commissioner*.[97] The need for such a drastic action is questionable in the light of the important decision of the US Court of Appeals in *Koehring Company v. US*,[98] which purported to confine the scope of the *CCA Inc.* case.

The facts in *Koehring's* case are somewhat involved; however, for present purposes it is sufficient to merely convey the essential facts of the case. In 1959 Koehring acquired a wholly owned Panamanian subsidiary, KOS. In 1963, concerned about the adverse effects of Subpart F, Koehring entered into an arrangement with an English corporation, NC, under which voting control of KOS was transferred to NC. Subsequently, NC acquired 44,000 shares of 8 per cent cumulative voting preferred stock with a par value of $10 per share. This represented 55 per cent of the outstanding KOS stock entitled to a vote. Koehring retained 36,000 voting shares of $10 par value common stock, representing the remaining 45 per cent of the voting shares.

At the time of the sale, NC and Koehring enjoyed a long standing relationship. Further, after NC acquired majority control of KOS there were remarkably few changes in KOS operations. NC did not attempt to replace existing management, which was closely identified with Koehring, with executives more loyal to NC. KOS continued to sell only Koehring products until 1967, when it began selling a few NC products on a trial basis at the suggestion of Koehring's president. No NC directors were authorized to draw cheques on behalf of KOS. Moreover, NC referred to its control over KOS as being "nominal" in the minutes of the Board of Directors meeting held on 11 September 1963.

Upon reviewing the above facts and other facts such as the existence of a reciprocal arrangement whereby Koehring provided funds indirectly to NC to enable NC to take up its investment in KOS, Harlington Wood Jr, J., found the existence of an implied agreement between Koehring and NC which evidenced an intention on the part of Koehring not to divest itself of operating control of KOS.[99] The Judge was not persuaded by submissions on behalf of Koehring stating that there were genuine commercial reasons for entering into the arrangement with NC. He said (at footnote 5):

> "Koehring's concern with the tax consequences of Subpart F was manifest even before that Section was enacted. Moreover, the record is replete with evidence which demonstrates that, even if there were some business reasons for [NC] to make an investment in KOS, the transaction was timed and structured the way that it was largely because of Koehring's desire to avoid the tax consequences of Subpart F."

It appears that the result of the above decisions and the withdrawing by the IRS of its acquiescence to the *CCA Inc.* decision has created serious concern as to what exactly a USS would have to do to decontrol a foreign subsidiary without giving up complete financial interest in the company as a shareholder. Perhaps the courts' overly broad interpretation of Subpart F could be put down to a desire to ensure that the operation of Subpart F is not circumvented where there are no justifiable commercial reasons for attempting to decontrol a foreign subsidiary apart from avoiding the adverse tax implications of Subpart F.

The effect of the above cases and the examples provided in the FSIIP would appear to make it very difficult for Australian shareholders to effectively divest their interests in a foreign company in the case where control would revest with the Australian shareholder upon the happening of a defaulting event. However, the correctness of the approach adopted in the US cases is not beyond doubt. Professor Kaplan, for instance, argues that the court in *Koehring's* case was too quick to dismiss the fact that Koehring had installed as co-owner an unrelated company, a competitor even. He notes the court's observation where it said that NC was unlikely to exercise its control of KOS antagonistically to Koehring's interests and asks whether "antagonism" is the standard that foreign shareholders must satisfy to be deemed in "control".[100]

F. The applicability of the US approach to Australia

Despite the above analysis of the US courts' interpretation of the concept of de facto control, it is submitted that the decision in *CCA Inc.'s* case may nevertheless prove to be a stumbling block for the ATO, so far as it can be relied upon to support the resident taxpayer's claim that it had effectively divested 50 per cent of its control in the foreign corporation. Harlington Wood Jr, J., was at pains to distinguish the facts in the case before him from those of *CCA Inc.* He found that Koehring's attempt to divest itself of operating control of KOS was done pursuant to an agreement; whereas in *CCA Inc.* no such agreement existed.

The applicability of US cases in Australia would largely depend on whether the Australian courts are prepared to steer away from the approach adopted by the High Court in the *Esquire Nominees* case. This in turn might depend on how Australian cases dealing with the question of control in other contexts are interpreted by a modern day court asked to look at the question for the purposes of the CFC rules. Prima facie,

96. 64 TC 137, at 151. Wiles J concluded (at 153):
"The aggregate effect of the factors considered above indicates that the old CCA did divest itself of dominion and control of AG [the Swiss subsidiary]. There were no substantial restrictions placed upon the preferred stock that were not also placed upon the common stock. Nor were there any provisions made whereby old CCA would reacquire the stock of the preferred shareholders should they desire to sell the stock ... The preferred stock was sold to non-related shareholders whose representatives at the shareholders meetings and the board of the directors took an active part in the consideration of AG's business. Old CCA retained no significant strings which could have been used by it to require the preferred shareholders to vote with it regarding AG's business. This is in sharp contrast to the ... [*Kraus* case]. We recognize that, as in the *Kraus* case, the amount paid by the preferred shareholders for their stock was less than 50 per cent of the net worth of AG. This fact alone, in the light of other factors present in this case, is not sufficient to classify AG as a controlled foreign corporation."
97. 1982-28 IRB 5.
98. 583 F 2d 313. At footnote 13, Harlington Wood Jr, J stated: "We do not mean to imply that we would necessarily agree with the tax court's analysis in CCA Inc if a similar situation were presented to us."
99. Ibid, at 320-321.
100. Kaplan *op cit.* (1988), at 242-243.

the approach of the US courts extends beyond the approach adopted by the Australian courts since the "power of veto" test in *Esquire Nominees* and the requirement expounded by the High Court in *Mendes* that to control a company a shareholder must control the triggering events which may entitle the shareholder to vote, could still prove to be a stumbling block for the Commissioner.

Nevertheless, the broad definition of a CFC contained in Section 340 combined with the equally broad scope of the look-through rules for tracing indirect and constructive control (i.e. tracing control interests set out in Section 353(2)(b) and (c)) and the general anti-avoidance provisions of Part IVA, should ensure that manipulation of the residence rule via the corporate veil doctrine is minimized if not completely eliminated.

By providing look-through rules which ignore the fiction of corporate structures, the control rule will effectively eliminate the deferral problem caused by the use of foreign incorporated companies which intercept income that would otherwise be received and taxed in the hands of the controlling Australian shareholders. When coupled with the attribution rule, contained in Section 456 (which includes in the assessable income of an Australian taxpayer its pro rata share of the non-active income derived by the CFC which has not been taxed at comparable rates to those existing in Australia), the control rule will enable the Commissioner to attribute foreign sourced passive income derived by a non-resident company to the beneficial owners of that income – i.e. the Australian controlling shareholders. Consequently, Australia's domestic tax base is protected in relation to any arrangements or schemes which Australian residents may try to enter into in order to disguise their beneficial ownership of foreign subsidiaries. This is particularly the case where there is no commercial basis for entering into such an arrangement in the first place.

V. CONCLUSION

In summary, there is little doubt that the worldwide basis of taxation is warranted. It can be justified on the basis of equity, neutrality and revenue. This form of taxation maximizes the amount of revenue raised to finance government expenditures.[101] In theory, the residence rule promotes capital export neutrality by subjecting taxpayers to Australian income tax on their worldwide income. However, the interaction of the separate entity approach and the *Esquire Nominees* case has meant that the residence rule is easily manipulated. Combined with the ease with which the interest source rules can be avoided, this has historically created a tax-induced incentive for Australian business to invest in low-tax jurisdictions. Such investment is contrary to the Federal Government's expressed intention in announcing the repeal of the Section 23(q) exemption in 1985, which was to increase efficiency and fairness in the Australian economy.

The means by which Australia's traditional taxation principles may be manipulated were discussed above. In particular subvention of the residence based source rules was shown to seriously undermine Australia's domestic tax base. The recent Full Federal Court decision in *Spotless Services* has somewhat exacerbated the need for reform of the source rules in view of the adoption by the court of the form over substance approach.

The need for a statutory source regime which defines the type of income generated and the geographical source of that income was also highlighted in the above discussion. In this respect the US approach is commendable on the basis that the source rules in the United States define income to be foreign sourced if it does not fall within the definition of US source income. However, even here inefficiencies arise from implementing highly complex technical provisions for international transactions while at the same time allowing deferral of domestic taxes through non-repatriation and/or transfer pricing activities. Thus the need for a statutory regime, so as to counter manipulations of the residence rule.

In Australia the need for CFC legislation was heightened because the corporate veil doctrine had historically enabled Australian companies to defer Australian taxation on income.[102] In this regard, the possibility of tax deferral had provided a significant incentive to source income in low-tax countries, especially tax havens, and a disincentive to remit income to Australia.

By averting the possibility of manipulation of the residence rule, the CFC regime ensures that the integrity of residence based source rules is also upheld and therefore that the domestic tax base in relation to foreign source passive income is protected.[103] Additionally, the introduction of explicit statutory source rules should increase the efficiency of the Australian tax system by removing the uncertainty surrounding the application of judge-made rules to international transactions. In practice, if such a system existed in Australia the Commissioner of Taxation may not have had to resort to Part IVA in the *Spotless Services* case to catch a transaction which arguably would be deemed to be Australian sourced on the basis that the source of the original funds deposited was Australia since the funds were generated there.

101. See McIntyre *op cit.* (1989), at 1-9.

102. Such deferral is not countered in the FTCS since that system does not expose to Australian tax, those profits which are retained in overseas companies. Manipulation of source rules also created tax benefits under the FTCS by allowing inflation or deflation of profits resulting from related party transactions.

103. The CFC regime is invoked in most cases, where a foreign incorporated company is beneficially owned or controlled by Australian resident taxpayers. Once it is determined that a CFC exists in relation to an Australian taxpayer then the income of that CFC may, in certain circumstances, be attributed to the extent that the Australian taxpayer has an interest (direct or indirect) in the CFC.

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US IFA ANNUAL MEETING

This issue features six of the papers presented during the Annual Meeting of the US IFA Branch, which was held on 29 February – 1 March 1996, in Miami, Florida. A very impressive array of experts drawn from practitioners, academics and government officials addressed the meeting, giving a valuable insight into current major developments in international taxation.

Topics examined at the meeting included expatriation, foreign trusts, the flat tax, transfer pricing, tax treaties, cross border financial instruments and doing business in South America.

UNITED STATES

SELECTED HIGHLIGHTS OF THE NEW US–CANADA PROTOCOL AND THE NEW US–FRANCE TREATY

Mary C. Bennett and Charles W. Cope

Mary Bennett is a partner in the Washington, D.C. office of Baker & McKenzie, where she specializes in representing both US and foreign-based multinational corporations on international tax matters. Ms Bennett publishes and speaks frequently on international tax issues. Together with colleagues from the Washington and Amsterdam offices of Baker & McKenzie, she has authored the treatise *A Commentary to the US–Netherlands Income Tax Convention*, published in 1995.

From 1985 to 1990, Ms Bennett served in the US Treasury Department's Office of Tax Policy, including the last three years of that period as the Deputy International Tax Counsel.

From 1979 to 1985, Ms Bennett practised international tax law with firms in Boston and London. She received an AB *cum laude* from Radcliffe College in 1976 and a JD from Columbia Law School as a Harlan Fiske Stone Scholar in 1979. She was also awarded an LL M in Taxation by Boston University in 1985. She is a member of the Bar of Massachusetts, New York and the District of Columbia.

Charles W. Cope holds a BA from Rice University and degrees in economics and law from the University of Chicago. He also has received an LL M in taxation from New York University.

During the 1980s Mr Cope practised international tax law in New York City with the law firm of Chadbourne & Parke, and from 1991 until 1994 he served in the US Treasury Department's Office of Tax Policy. Until recently he was a director in the structured products group of BZW, the investment banking division of Barclays Bank Plc.

I. INTRODUCTION

This paper discusses some of the highlights of two recent US income tax treaties: the new Convention between the United States and the French Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital (the "French Treaty") and the Convention between the United States and Canada with respect to taxes on income and capital (the "Canadian Treaty") as amended by the most recent protocol (the "Canadian Protocol"). The Canadian Protocol is the third such protocol amending the Canadian Treaty, which is more than 15 years old. The paper focuses on the treatment of cross-border financing structures and on selected other aspects of general interest in the Canadian Protocol.

II. TREATMENT OF FINANCING STRUCTURES

A. The Canadian Treaty

1. Lower rate of tax at source on interest

The rate of tax at source on interest is lowered from 15 per cent to 10 per cent.[1] This provision is effective beginning 1 January 1996.[2]

2. Lower rate of tax at source on dividends

The rate of tax on direct investment dividends is lowered from 10 per cent to 5 per cent,[3] which is the preferred US position. This provision takes effect beginning in 1997. A transition rule provides for a rate of 6 per cent from the effective date of the Canadian Protocol, 1 January 1996, until the end of 1996.[4]

3. Dividends paid by a Canadian NRO

In line with other recent US treaties, the dividend article of the Canadian Treaty is amended to provide that dividends paid by a Regulated Investment Company ("RIC") are always subject to US tax at a 15 per cent rate (even if the Canadian corporate investor is a 10 per cent shareholder).[5] The Protocol also provides that dividends paid to a 10 per cent or greater US corporate shareholder of a Canadian non-resident investment corporation ("NRO") remain taxable at a 10 per cent rate.[6]

A Canadian company qualifies as an NRO if it (1) is owned by non-residents, (2) meets certain income and business activity tests, and (3) elects to be treated as such.[7] An NRO pays a 25 per cent tax on its income that is refunded if it pays out that income as a taxable dividend.

In the past, US companies established NROs to fund their Canadian subsidiaries. Since prior to the Protocol interest was taxed at 15 per cent at source, use of an NRO reduced the Canadian tax on repatriated income by 5 percentage points. In light of the changes made by the Canadian Protocol to the

1. Canadian Protocol, Art. 6(1).
2. Canadian Protocol, Art. 21(2).
3. Canadian Protocol, Art. 5(1).
4. Canadian Protocol, Art. 21(2).
5. Canadian Protocol, Art. 5(2).
6. Id.
7. Income Tax Act Sec. 133(8).

interest and dividends articles, NRO structures no longer provide any Canadian withholding tax saving. However, such structures may provide US tax benefits (e.g. interest allocation).

4. REIT capital gains dividends received by Canadian pension funds

The dividends article of the Canadian Treaty also is amended to provide that dividends paid by a Real Estate Investment Trust ("REIT") are subject to US tax at a 30 per cent rate unless the Canadian investor is an individual owning less than 10 per cent of the REIT.[8]

The treatment of REIT capital gains dividends paid to a Canadian pension fund is unclear. On its face, Article XXI (Exempt organizations) of the Canadian Treaty as amended by Article 10 of the Canadian Protocol exempts all "dividends" from tax at source. The Canadian Treaty's definition of dividends would appear to include REIT capital gains dividends.[9]

The US–Netherlands income tax treaty ("Dutch Treaty") has a similar provision that exempts US dividends paid to Dutch pension funds,[10] but that exemption is negated explicitly for REIT capital gains dividends by Article 6 of the protocol to that treaty.[11] The Technical Explanation to the Dutch Treaty states that the protocol language is unnecessary, however, because capital gains dividends paid by a REIT are not "dividends" for the purposes of the treaty, but are gains taxable under the gains article[12] because of their characterization under Section 897(h).[13]

The Technical Explanation to the Canadian Treaty does not draw this distinction; it states only that REIT dividends are taxed at 30 per cent when paid to a beneficial owner other than a small individual investor. Note that the Canadian Government has issued a press release indicating its agreement with the Technical Explanation.

The Treasury's approach to the taxation of REIT capital gains dividends raises the issue of whether domestic law's definition of a term that conflicts with a treaty's specific definition of a term can control under the treaty. Assuming it does, this approach may have implications for other "special" dividend definitions in US domestic law. Consider, for example, deemed dividends taxable under Section 304. This approach implies that the United States can demand a treaty-level dividend withholding tax if the item would otherwise be exempt under the gains article. See Rev. Rul. 92-85, 1992-2 C.B. 69, which treats the payment on a cross-chain Section 304 stock purchase by a US corporation from a sister foreign corporation as a "dividend" payment by the US corporation to the foreign corporation, albeit one subject to reduced withholding under the foreign corporation's treaty at the direct investment dividend rate. That ruling, in effect, treats the selling corporation as receiving a "dividend" for treaty purposes from a US corporation in which the selling corporation owns no shares.

Such an approach may also circumscribe the US taxing jurisdiction. A non-resident payee might demand a treaty-level dividend withholding rate if the gain would otherwise be fully taxable under the gains article (e.g. as income from the disposition of shares in a US real property holding corporation). Note that Rev. Rul. 92-85 carefully specifies that the US corporation involved is not a US real property holding corporation.

Consider also deemed dividends in the form of substitute dividend payments on a stock lending transaction. The United States has issued proposed regulations which would treat such substitute payments as withholdable dividends for treaty purposes.[14] Can the United States demand a treaty-level dividend withholding tax if the item would otherwise be exempt under the business profits or other income article? In a Memorandum of understanding accompanying the Dutch Treaty, the United States sought to clarify that it could do exactly that.[15] Note that the Netherlands Finance Ministry's Technical Explanation of this provision suggests that the recipient of the substitute dividend payment, and *not* the "borrower" actually holding the shares at the time the divi-

8. Canadian Protocol, Art. 5(2).
9. See Sec. 857(b)(3)(C) which states that a capital gains dividend is "any dividend ... which is designated by the real estate investment trust as a capital gains dividend ...." Para. 3 of Art. X (Dividends) states that "[t]he term 'dividends' as used in this Article means *income from shares* or other rights, not being debt-claims, participating in profits, as well as income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident [emphasis added]."
10. Dutch Treaty, Art. 35(1).
11. Art. 6 reads:
Paragraph 2 of Article 35 of the Convention shall be amended by adding the following: "The provisions of paragraph 1 shall also not apply with respect to dividends paid by a person resident in the United States that is a Real Estate Investment Trust from gains realized on the disposition of real property situated in the United States."
12. The Technical Explanation states:
Section 897(h) of the Code provides that distributions by Real Estate Investment Trusts to non-resident alien individuals or foreign corporations are treated as gain recognized by such non-resident alien individual or foreign corporation from the sale or exchange of a United States real property interest. Such distributions consequently are not treated as dividends for purposes of the Convention and are subject instead to Article 14 (Capital Gains). Article 6 of the Protocol confirms this result with respect to capital gains dividends received by exempt pension trusts, providing that Article 35 does not apply to such distributions.
13. Code Sec. 897(h) provides:
For purposes of this section: (1) Look-through of distributions. – Any distribution by a REIT to a non-resident alien individual or a foreign corporation shall, to the extent attributable to gain from sales or exchanges by the REIT of United States real property interests, be treated as gain recognized by such non-resident alien individual or foreign corporation from the sale or exchange of a United States real property interest.
14. See Prop. Reg. Sec. 1.894-1(c), which provides:
Relevant law. Where a provision of an income tax convention refers to United States law, the relevant United States law is the section or sections of the Internal Revenue Code and regulations thereunder governing the tax which is the subject of such provision. For example, where a provision of an income tax convention governing the withholding tax on dividends paid to a non-resident of the United States defines the term "dividend" to include payments treated as a dividend under United States law, the relevant sections of United States law are those which define the term "dividend" for purposes of that withholding tax. Accordingly, a substitute dividend payment (as defined in section 1.861-3(a)(6)) is treated as a dividend for purposes of the relevant provisions of the convention. See section 1.871-7(b)(2). See also sections 1.861-2(a)(7), 1.881-2(b)(2), and 1.1441-2(a)(1).
15. See Dutch Treaty, Memorandum of Understanding, Para. VI: [I]t is understood that where a person loans shares ... and receives from the borrower an obligation to pay an amount equivalent to any dividend distribution made with respect to the shares or other rights loaned during the term of such loan, such person shall be treated as the beneficial owner of the dividend paid with respect to such shares ... for purposes of the application of Article 10 (Dividends) to any such equivalent amount.

dend is paid, will be treated as the "beneficial owner" of the dividend for treaty purposes. The Treasury Department's position presumably is that *both* persons (i.e. the stock lender and the record holder) are treated as recipients of "dividends" for treaty purposes.

5. Dual-incorporated companies

It is not possible to have a dual-resident corporation under the Canadian Treaty. Article IV (Residence) of the Canadian Treaty contains a tie-breaker rule that makes a corporation resident in its country of incorporation. For example, a corporation that is created under US law but is managed in Canada is a US resident even if it might qualify as a Canadian resident under Canadian internal law. Section 250(5) of the Income Tax Act makes such a corporation a non-resident of Canada for purposes of the Act. This forecloses opportunities for such a corporation to cherry pick the Income Tax Act and the Canadian Treaty.[16]

It is possible for a company that is incorporated in one state (e.g. the United States) to be locally incorporated ("continued") in another (e.g. Alberta). Section 250(5.1) of the Income Tax Act makes such a dual-incorporated company a resident of the continued jurisdiction for purposes of the Income Tax Act. Under Paragraph 4 of Article IV (Residence), prior to its amendment by the Canadian Protocol, such a company would be a US resident. The Canadian Protocol's amendment to Article IV reverses this rule and treats such a company as a resident of the state in which it is continued. The provision was inserted at Canada's request and forecloses opportunities to cherry pick the Treaty and the Income Tax Act. It is understood that certain financing structures may have taken advantage of this discontinuity to reduce Canadian tax on cross-border interest payments.

6. Partnerships, LLCs and S corporations

The Canadian Treaty and Protocol are silent on partnerships and related entities, as is the Technical Explanation. The omission of any provisions in the Canadian Treaty dealing with partnerships and related entities is being addressed by continued discussions between the IRS and Revenue Canada.

There are interpretive letters (similar to private letter rulings) issued by Revenue Canada which treat an S corporation as a resident of the United States for purposes of the Canadian Treaty.[17] However, Revenue Canada also has stated that a US LLC is not a resident of the United States for treaty purposes.[18]

Canada exempts Canadian corporate shareholders from tax on dividends paid by "foreign affiliates" out of active business income in certain cases.[19] Under proposed regulations, dividends paid by an affiliate that is a resident of a country with which Canada has a comprehensive income tax treaty qualify. The proposed regulations also would deem US LLCs to be residents of the United States, despite the fact that in Canada's view they are not residents of the United States for purposes of the Canadian Treaty.[20] A 1973 Interpretation Bulletin, IT-343R, takes the same position. Financing structures that take advantage of this anomaly to avoid Canadian and US tax have been in vogue for several years.

B. The French Treaty

1. Usufructs

A usufruct is a property right with limited life (less than 30 years) providing the holder with all rights to the underlying property other than the right to dispose of such property.

In recent years financing transactions involving the use of usufructs to claim the benefit of the *avoir fiscal*, and similar imputation credits provided by other European countries, have been heavily marketed.

Under the old, as well as the current, French Treaty, a US parent corporation with at least a 10 per cent interest in a French subsidiary is not allowed to claim a refund of the *avoir fiscal*.[21] In a typical transaction designed to avoid this limitation, a US parent with a French subsidiary would sell a usufruct in shares of the subsidiary to an unrelated French company. The parties would enter into a put and call at an agreed price to allow the transaction to be unwound. The usufruct would be priced to take into account the present value of the expected dividend flow adjusted for the tax benefits received and the sharing of the tax risks.

The purchaser of the usufruct would claim two benefits under French tax law. It would amortize the amount paid for the usufruct over its life, and it would claim the benefit of the *avoir fiscal* for dividends received with respect to the shares. The purchaser of the usufruct need not be a French company. A Dutch company can obtain similar benefits under the Netherlands–France Treaty.

The attractiveness of the usufruct lies in the debt-equity arbitrage that it allows. The US parent would treat the transaction as a financing relying on the put and call arrangement and the authorities on repo transactions. It therefore reported the dividends paid by the subsidiary as its income and claimed the indirect foreign tax credit with respect to the underlying tax paid by its subsidiary. The US parent also claimed an interest deduction with respect to a portion of the dividends paid to the French purchaser of the usufruct.

2. Anti-usufruct provisions

Since December 1993 French domestic tax law has provided that the French tax authorities may disregard usufruct structures as an abuse of law. The French Treaty contains two provisions aimed, at least in part, at reinforcing this aspect of French domestic law. Subparagraph (g) of paragraph 4 of Article 10 (Dividends) allows the French tax authorities to

16. See the discussion of anti-cherry picking language in the Technical Explanation, below.
17. LTR 9416455 (3 April 1995).
18. Id.
19. Income Tax Act Sec. 113.
20. Income Tax Reg. Sec. 5907(11).
21. Small shareholders may, subject to a withholding tax on the amount of the refund. See para. 4 of Art. 10 (Dividends) of the French Treaty.

deny a refund of the *avoir fiscal* if it cannot be shown that the person claiming the refund is the beneficial owner of the underlying shares.[22] Thus, usufruct structures that are designed to allow small US investors to claim a refund of the *avoir fiscal* would be ineffective.

The French Treaty also contains an unusual feature in Article 28 (Assistance in collection). When the United States agrees to such provisions, there ordinarily is a limitation against the assisting (requested) state collecting from its residents, tax that is owed to the requesting state.[23] With regard to transactions that claim a refund of the *avoir fiscal*, the US competent authority may agree to assist the French in collection from US citizens and companies.[24]

III. OTHER PROVISIONS OF INTEREST IN THE CANADIAN PROTOCOL

A. Know-how, trademarks, copyrights

The 10 per cent tax at source is eliminated on amounts paid for the use, or the right to use, patents or information concerning industrial, commercial, or scientific experience. Royalties paid for the use of trademarks and trade names remain taxable at source at a 10 per cent rate. The Canadian Protocol retains the exemption from taxation at source for copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical, or artistic work.

As with any split-rate royalty article, difficult issues can arise in characterizing or allocating payments as between exempt and taxable amounts (e.g. mixed trademark and copyright royalties).

B. Computer software royalties

Amounts paid for the use of, or the right to use, computer software are specifically exempted at source. The Canadian Protocol eliminates the distinction between royalties paid for use and royalties paid "in respect of production or reproduction". In the past, Canada had relied on this distinction to tax royalties paid for "shrink-wrapped" as well as "custom" software licensed solely for use in Canada. The licensing agreement for such software generally does not include the right to reproduce. While the Canadian Protocol was being negotiated, Canada changed its interpretation of domestic law that bears on this issue. Accordingly, the Canadian Protocol is consistent with Canadian domestic law.

The Technical Explanation states that this new provision "is not intended to suggest that the United States views the term "copyright" as excluding software in other US treaties (including the current treaty with Canada)".

C. Source rule change for royalties and the questionable "anti-cherry-picking" principle

Under the Canadian Treaty, the source of royalties had been determined according to the following hierarchy: (1) place of use, (2) place of permanent establishment bearing the royalties, and (3) place of residence of the payer. The Canadian Protocol changes that hierarchy to: (1) place of permanent establishment bearing the royalties, (2) place of residence of the payer, and (3) place of use. This obviously downgrades the preferred US sourcing rule, place of use.

In discussing this change, the Technical Explanation includes a rather startling example illustrating what it calls "a basic principle of tax treaty interpretation recognized by both Contracting States, the prohibition against so-called cherry-picking". In the example, a resident of Canada grants franchise rights to a resident of the United States for use 50 per cent in the United States and 50 per cent in Chile.

Domestic US law would treat only the 50 per cent attributable to US use as US source income subject to US withholding tax. The Technical Explanation says that if the Canadian resident wants to claim the benefit of the Canadian Treaty's reduced withholding rate, it must treat 100 per cent of the royalties as subject to US tax. Otherwise, the Canadian would be impermissibly "cherry-picking" between the favourable domestic law source rule and the favourable Canadian Treaty withholding rate.

The Technical Explanation acknowledges that the Canadian resident is generally permitted under Article XXIX(1) (Miscellaneous rules) of the Canadian Treaty[25] to apply US domestic law if it produces a more favourable result than the Canadian Treaty. The Technical Explanation cites only Rev. Rul. 84-17, 1984-1 C.B. 308, for this anti-cherry-picking principle, and Rev. Rul. 84-17 cites nothing.

Query how far this anti-cherry-picking principle is supposed to go. For example, the Technical Explanation makes a point of saying the Canadian resident may not cherry-pick with respect to "that single transaction". But what if there were two contracts between the US resident and the Canadian resident? Or what if the Canadian resident had contracts with two different US residents? Or what if the US and Chilean source payments were made in two separate taxable years?

22. That provision reads:
The provisions of paragraphs (a), (d) and (e) [which provide for a full or partial refund of the *avoir fiscal*] shall apply only if the beneficial owner of the dividends shows, where required by the French tax administration, that he is the beneficial owner of the shareholding in respect of which the dividends are paid and that such shareholding does not have as its principal purpose or one of its principal purposes to allow another person to take advantage of the provisions of this paragraph, regardless of whether that person is a resident of a Contracting State.
23. See, e.g. Para. 8 of Art. XXVI A (Assistance in collection) of the Canadian Treaty.
24. Para. (5) of Art. 28 (Assistance in collection) provides:
The assistance provided in this article shall not be accorded with respect to citizens, companies or other entities of the Contracting State to which application is made except in cases where the exemption from or the reduction of tax or the payment of tax credits provided for in paragraph 4 of Article 10 (Dividends) granted under the Convention to such citizens, companies or other entities has, according to the mutual agreement of the competent authorities of the Contracting States, been enjoyed by persons not entitled to such benefits.
25. Art. XXIX(1) provides as follows:
The provisions of this Convention shall not restrict *in any manner* any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of the tax imposed by that State. [Emphasis added]

D. Limitation on benefits article is added

1. In general

Canadian residents now can claim treaty benefits only if they qualify under a new limitation on benefits article (Article XXIX A). The article does not apply to US residents because Canada does not agree that there is a need for these limitations; it prefers to rely on its internal anti-abuse rules. The article acknowledges each country's right to invoke anti-abuse rules (e.g. anti-conduit rules) of its internal law in order to deny treaty benefits.[26]

Query whether this language means that Canada adheres to the view that the United States may invoke the now finalized anti-conduit regulations under Section 7701(l) to deny Canadian Treaty benefits to Canadian residents, without regard to whether the Canadian residents are the "beneficial owners" of the income in question under the traditional "dominion and control" concept.

The new article is similar to the limitation on benefits article of the Dutch Treaty and other recent treaties. The article provides all treaty benefits to "qualifying persons" and limited benefits to persons that satisfy either (1) an active business test, (2) a derivative benefits test, or (3) a requirement of seeking and obtaining competent authority relief. However, unlike the Dutch Treaty and some other recent treaties, there is no safe harbour provision for a headquarters company.

2. Derivative benefits

The article provides the most generous derivative benefit extension of the ownership/base erosion provision the United States has agreed to thus far. A Canadian entity that is more than 90 per cent owned by "qualifying persons" or residents of a third country may claim withholding tax benefits under the treaty provided (1) the third-country owners are residents of a country with which the United States has a tax treaty and the residents qualify for full benefits under that treaty, (2) the third-country owners either would be entitled to full benefits under the treaty if they were Canadian residents or would qualify under the active business test if they carried on their business in Canada, and (3) the withholding tax rate claimed under the Canadian Treaty is not lower than that under the third-country treaty.

The treaty is more generous in this respect than the US–Mexico treaty and the Dutch Treaty, which provide derivative benefits only to residents in NAFTA countries or European Union countries, respectively.

Note that the third-country shareholder must be a person that would qualify for Canadian Treaty benefits if that person were a resident of Canada. Problems can arise if the third country shareholder is a corporation that base erodes to other good residents of its own country, since the Canadian Protocol suggests that the third country shareholder is allowed to base erode only to good US and Canadian residents.

Note, too, that the Canadian resident itself is also allowed to base erode only to good Canadian and US residents. This compares unfavourably with the Dutch Treaty, which effectively allows a European-controlled Dutch company claiming US treaty benefits under the derivative theory to base erode to good residents of the United States, the Netherlands, or the European Union countries.

Questions remain as to what the inclusion of this fairly generous derivative benefits provision in a treaty with relatively high withholding tax rates signals for US treaty policy on derivative benefits for other treaty partners.

E. Death taxes

1. In general

The Canadian Protocol adds a new Article XXIX B (Taxes imposed by reason of death) that coordinates the US estate tax and the Canadian income tax due on gains deemed realized at death. The provision is significant because it is the first post-TAMRA estate tax agreement negotiated by the United States. TAMRA eliminated the marital deduction for bequests to non-resident spouses,[27] but permitted the estate tax to be deferred if the assets were held in a qualified domestic trust ("QDOT") during the life of the surviving spouse (or if the surviving spouse becomes a US citizen).[28] Some treaty partners considered the provision to be discriminatory, but the Treasury's position is that the denial of the marital deduction is not discriminatory because the estate, not the spouse, is the taxpayer and the rule applies to both resident and non-resident estates.

2. Relief for small estates

A special rule benefits small estates (those with a value not in excess of USD 1.2 million) of Canadian resident decedents that were not US citizens. For these estates, US estate tax is imposed only on property the gains from which would be subject to US tax at the time of disposition.[29] Thus, US stock and bonds owned by such an estate generally would not be subject to US estate tax, but real estate and business assets would be.

3. Unified credit

The credit against US estate tax that is allowed the estate of a decedent who is a US resident is USD 192,800. The new article allows a pro rated unified credit to the estate of a Canadian resident decedent (who was not a US citizen) that owns US situs property.[30] The credit is pro rated based on the ratio of the value of US property to worldwide property. For example, if 25 per cent of the value of the estate's property is US property, the estate would be allowed a credit against US

26. Para. 7 of Art. XXIX A (Limitation on benefits) provides:
7. It is understood that the fact that the preceding provisions of this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under the convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.
27. Sec. 2056(d).
28. Id.
29. Canadian Protocol, Art. 19.
30. Id.

estate tax of USD 48,200 (25 per cent x USD 192,800) under current law.

4. Marital deduction

The new article also provides a limited marital deduction that is targeted to benefit smaller estates. The deduction is limited to the lesser of the US estate tax due on the property left to the surviving spouse and the amount of the pro rated unified credit.[31] It is available only if the estate waives the QDOT marital deduction allowed under US domestic law.

5. Foreign tax credit

Under the new article, Canada agrees to allow the US federal and state estate and inheritance taxes as a credit against the Canadian income tax due at death. The United States provides the reciprocal benefit.[32] This is a case of the United States making a tax creditable by treaty (rather than merely guaranteeing its creditability) since the Canadian tax would not be creditable under Section 2014.

F. Coordination with the GATS

The General Agreement on Trade in Services (GATS), to which the United States and Canada are parties, requires a state to provide national treatment and most-favoured-nation (MFN) treatment to services and service suppliers of other states that are parties to the GATS.[33]

GATS provides a carve-out from *MFN treatment* for a difference in treatment resulting from a tax agreement. It also provides a carve-out from the *national treatment* obligation.[34] The latter carve-out is for certain measures aimed at ensuring the "equitable or effective" imposition or collection of direct taxes.[35]

GATS further provides that disputes concerning *national treatment* with respect to measures falling within the scope of a tax agreement should be resolved under the tax agreement (i.e. the non-discrimination article of a tax treaty) and not the GATS. The GATS also provides that whether a dispute falls within the ambit of such a tax agreement may be determined by either country bringing the matter before the Council for Trade in Services. However, if the tax agreement existed on the date the World Trade Organization was formed (1/1/95), both parties must consent to using this GATS mechanism, which is not well-developed, to resolve this jurisdictional issue.[36] The benefit of these GATS carve-outs is that tax experts rather than trade experts will negotiate the resolution of such disputes. These provisions were added as a result of active campaigning by the Treasury and other developed countries during the Uruguay Round.

The Canadian and US negotiators agreed that a protocol to a grandfathered tax treaty also is grandfathered. The negotiators added a special rule to coordinate the Canadian Treaty and Canadian Protocol with GATS in order to remove any ambiguity that might arise because the Canadian Protocol makes substantial changes to the treaty, including expanding the taxes covered. A new rule specifies that a measure falls within the scope of the Canadian Treaty if it relates to a tax covered by the non-discrimination article or the tax is dealt with in another article, but only to the extent that the measure relates to the tax dealt with in such other article. A second

31. Id.
32. Id.
33. GATS, Art. II (Most-Favoured-Nation Treatment) provides:
1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.
2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.
GATS, Art. XVII (National Treatment) provides:
1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.
34. GATS, Art. XIV (General Exceptions) provides in part:
Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:
(d) inconsistent with Article XVII [National Treatment], provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members;
(e) inconsistent with Article II [Most-Favoured-Nation], provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.
35. GATS, Art. XIV (General Exceptions) – Allowable Direct Tax Measures, footnote 6, provides:
Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:
(i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member's territory; or
(ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or
(iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or
(iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or
(v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or
(vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.
Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.
36. GATS, Article XXII (Consultation) provides in part:
3. A Member may not invoke Article XVII [National Treatment], either under this Article or Article XXIII [Dispute Settlement and Enforcement], with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between Members as to whether a measure falls within the scope of such an agreement between them, it shall be open to either Member to bring this matter before the Council for Trade in Services.* The Council shall refer the matter to arbitration. The decision of the arbitrator shall be final and binding on the Members.
* With respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to such an agreement.

new rule provides that disputes as to the ambit of the first new rule are to be determined under the Canadian Treaty's mutual agreement procedure.[37]

37. US–Canada Treaty, Art. XXIX (Miscellaneous Rules), the GATS coordination provision, provides:
6. For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that:
(a) A measure falls within the scope of the Convention only if:
(i) The measure relates to a tax to which Article XXV (Non-Discrimination) of the Convention applies; or
(ii) The measure relates to a tax to which Article XXV (Non-Discrimination) of the Convention does not apply and to which any other provision of the Convention applies, but only to the extent that the measure relates to a matter dealt with in that other provision of the Convention; and
(b) Notwithstanding paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, any doubt as to the interpretation of subparagraph (a) will be resolved under paragraph 3 of Article XXVI (Mutual agreement procedure) of the Convention or any other procedure agreed to by both Contracting States.

CUMULATIVE INDEX – 1996

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UNITED STATES

PENDING US EXPATRIATION TAX LEGISLATION

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I. CURRENT US ANTI-EXPATRIATE TAX REGIMES

Under current US tax rules, an individual who relinquishes his or her US citizenship with "*a principal purpose* of avoiding US taxes" is subject to special US income, gift and estate tax rules for a period of ten years after the expatriation. (Sections 877, 2501(a)(3) and 2107 of the Internal Revenue Code of 1986, as amended (the "Code").) There are similar, but more limited, special tax rules for individuals who have been US *tax residents* for at least three years. In such a case if the individual becomes a non-resident, but regains residency within three years; the individual's subjective intent is immaterial.[1] When these special US tax regimes apply to expatriates (the "US anti-expatriate tax regimes"), the expatriate remains subject to US tax on his or her US source income at the rates applicable to US citizens, plus the scope of items treated as US source income or US assets is broader than those items generally considered to be US source income or assets under the regular provisions of the Code. Thus, the expatriate can become subject to US income, estate and gift tax in circumstances where he or she might not otherwise be taxable if he or she were a regular non-resident alien. For example, the special anti-expatriate rule in the estate tax area (under Code Section 2107) provides that the individual's gross estate includes not only the US situs assets that ordinarily would be taxable in a non-resident alien's estate, but also includes his or her pro rata share of any US situs property held through a foreign corporation in which the decedent had a 10 per cent or greater voting interest, provided that the decedent and related parties together own more than 50 per cent of the voting power of the foreign corporation.

Under the current Code rules, if the Treasury Department establishes that it is reasonable to believe that the expatriate's loss of US citizenship would, but for the application of this provision, result in a substantial reduction in US income tax based on the expatriate's probable income for the taxable year, then the expatriate has the burden of proving that the loss of citizenship did not have as *one of its principal purposes* the avoidance of US income, estate or gift taxes.[2] However, in the first Joint Committee Report on "Issues Presented by Proposals to Modify the Tax Treatment of Expatriation",[3] it is acknowledged that the US anti-expatriate tax regime "has been applied in very few cases," because of the difficulty in proving the required tax-related motivation for the expatriation. In addition, the present anti-avoidance approach of Code Section 877 has not been that difficult to avoid. For example, because Code Section 877 is not coordinated with Code Section 367, a former citizen may, instead of selling stock in a US corporation directly, transfer the stock to a foreign (tax-haven) corporation and have that corporation dispose of the US stock, without being subject to gain recognition under either Code Section 367 or the various anti-deferral regimes[4], as these regimes only apply to US citizens or residents. Moreover, because Code Section 877 is limited to the *US source income* of former citizens, it may not apply to those former citizens who reside in countries with which the United States has an income tax treaty.[5]

II. CALENDAR OF KEY EVENTS LEADING UP TO CURRENT US EXPATRIATION TAX PROPOSALS

21 November 1994: *Forbes* cover article on "The New Refugees: As Their Tax Burdens Grow, Many Affluent Americans Are Abandoning Their Citizenship" (with cover pictures including Ted Arrison (Israel), Michael D. Dingman (Bahamas), John T. Dorrance, III (Ireland), Jane Siebels-Kilnes (Norway), and J. Mark Mobius (Germany)).

6 February 1995: President Clinton's Budget Message proposes that any American who relinquishes citizenship on or after 6 February 1995 will be treated as having sold all of his assets immediately before expatriating and would be taxable on the net unrealized gain, with exceptions for the first USD 600,000 of gains plus US real property interests (subject to FIRPTA in any event) and interests in US qualified retirement plans (also taxable on non-resident aliens). Long-term permanent resident aliens who give up their "green cards" would be similarly taxable.

16 February 1995: The proposed *Tax Compliance Act of 1995* (H.R. 981) would impose the expatriation tax outlined in President Clinton's budget message; an American would *not* be treated as relinquishing his citizenship for purposes of any US tax until the State Department issues to him a *Certifi-*

1. Code Sec. 7701(b)(10).
2. Code Sec. 877(c).
3. *JCX*-14-95 (20 March 1995)
4. Such as PFIC, Subpart F and FPHC.
5. See *Crowe v. Comr.*, 85 T.C. 376 (1985) (holding an expatriate living in Canada was entitled to protection from Code Sec. 877 under the US–Canada income Tax Treaty); but see Rev. Rul. 79-152, 1979-1 C.B. 237, in which the IRS expresses a contrary view.

cate of Lost Nationality ("CLN"), which might not occur until months or even years after the actual expatriation event; all deferred recognition of income and gains would terminate upon expatriation; existing income tax anti-expatriation rules would not apply to anyone who is subject to the new expatriation tax.

22 February 1995: *ABC News Primetime Live* aired a segment entitled "Make the Money and Run," in which Treasury Assistant Secretary, Leslie B. Samuels, is quoted as saying "if we didn't make the proposal effective the day we announced it, there would be a lot a people who would beat our rule".

28 February 1995: Criticisms of the proposed new expatriation tax begin appearing, with Marshall J. Langer writing a letter to House Ways and Means Committee Chairman, Bill Archer, describing the proposal as "one of the worse (*sic*) tax proposals in recent history;" Mr Langer noted that the proposal was not only poorly designed and inappropriately retroactive, but it also would discourage wealthy aliens from ever becoming US citizens and it might encourage many Americans to leave now, before future rules become even worse.[6] Similarly, the *American Bar Association* submitted the comments of some of its members, most of which were highly critical of the proposal.[7]

15 March 1995: *The Senate Committee on Finance* adds a modified version of the expatriation tax legislation to a *fast-track tax bill* (addressing the self-employed medical insurance deduction) that was expected to be passed by Congress prior to the 15 April 1995 individual income tax return filing deadline; the modified version made the proposed expatriation tax somewhat less retroactive and it dropped the proposal to tax departing "green card" holders.

21 March 1995: *The Senate Committee on Finance Subcommittee on Taxation and IRS Oversight* holds a hearing on the proposed expatriation tax, with Senator Orrin Hatch (Rep., Utah) presiding, with two government witnesses, a former Treasury International Tax Counsel (H. David Rosenblum), plus three private-sector witnesses (Marshall J. Langer, Ellen K. Harrison and Robert F. Turner), with the latter sharply criticizing the proposal while the government witnesses and Mr Rosenblum defended it. At the time of this Senate hearing, the *Joint Committee on Taxation* issued its first report entitled "Background and Issues Relating to Taxation of US Citizens who Relinquish Citizenship". *JCX*-14-95, 20 March 1995.[8]

24 March 1995: The Senate approves an amended version of the expatriate tax proposal as part of the fast-track tax bill to extend the health insurance deduction for self-employed individuals. The Senate version of the bill contains the amended version of the President's expatriation tax proposal (see above).

27 March 1995: The *House Ways and Means Oversight Subcommittee* holds a hearing on the expatriation tax proposal. At the time of this House hearing, *the Joint Committee on Taxation* issues a second report entitled "Background and Issues Relating to Taxation of US Citizens who Relinquish Citizenship and Long-Term Resident Aliens who Relinquish US Residency".[9] The Subcommittee Chairman, Nancy Johnson (Rep., Conn.), expresses great concerns about the effects of the expatriation tax proposal, which is not included in the House version of the fast-track self-employed health insurance deduction bill (H.R. 831).[10] A 27 March 1995 memorandum by individual members of the New York State Bar Association Section of Taxation (faxed to the Subcommittee before the hearing) also may have fuelled the negative attitudes at this Subcommittee hearing. The strongly-worded memorandum urged Congress to reconsider immediate passage of the expatriation tax, noting that "certainly in its current form the expatriation proposal is technically deficient in important respects, most notably its treatment of trusts ... We believe that enactment ... in its current form ... will leave many important and basic questions unanswered".[11]

30 March 1995: The *Conference Committee* drops the expatriation tax proposal from H.R. 831, substituting a requirement that the *Joint Committee on Taxation* study the issue and report on it by 1 June 1995. That version of H.R. 831 subsequently becomes law.[12] A special Joint Statement by House Ways and Means Committee Chairman, Bill Archer, and Senate Finance Committee Chairman, Bob Packwood, however, stresses that any future expatriation tax bill will be retroactive to 6 February 1995.[13]

6 April 1995: Senator Daniel Patrick Moynihan (Dem., N.Y.) introduces Section 700 (the "Moynihan Bill"), a materially revised version of the President's expatriation tax proposal, and vows to work for its passage.[14] Among other important changes, the Moynihan Bill reintroduces application of the expatriation tax to departing long-term resident aliens who have been lawful residents of the United States *in at least eight of the prior fifteen years*. A second key revision is allowance of a fair market basis adjustment for non-resident aliens, so that any tax imposed on leaving the United States would be only on those gains accrued while a resident of the United States. In addition, this bill provides that each expatriate is allowed to elect irrevocably, on an asset-by-asset basis, to continue to be taxed as a US citizen with respect to assets designated by the expatriate. However, an expatriate would have to provide security to insure payment of the

6. Langer letter republished in *Tax Notes International*, (6 March 1995) at 829-838.
7. See "ABA Takes Aim at Clinton Proposal to Plug Loopholes and Expatriate Rules" *Daily Tax Report*, (15 March 1995) G-1-2; see also "Former JCT Staffers and Treasury ITC discuss Expatriate Tax". *Tax Notes International*, (13 March 1995) at 922-923.
8. See also "Senate Finance Committee Approves Amended Version of Expatriate Tax Proposals" *Tax Notes International*, (27 March 1995) at 1090-1091, and "Senate Panel Receives Mixed Review of Proposed Tax on Wealthy Expatriates" *Daily Tax Report*, (22 March 1995) G-10-11.
9. *JCX*-16-95, (23 March 1995).
10. See ("Concerns Over Expatriation Tax Make Proposal Vulnerable in Conference") *Daily Tax Report*, (28 March 1995) G-5-6.
11. See "Put Expatriation Tax On Hold, NY Bar Urges" *Daily Tax Report*, (30 March 1995) G-9; see also "Full Senate Approves Expatriate Tax; House Panel Considers Alternatives" *Tax Notes International*, (3 April 1995) at 1215-16.
12. See "Expatriate Tax Confusion" *Daily Tax Report*, (30 March 1995) G-8-9.
13. See *Daily Tax Report*, (31 March 1995) L-2.
14. See "Moynihan Includes Long-Term Residents in Revised Expatriation Tax Proposal" *Daily Tax Report*, (10 April 1995) G-3-4.

deferred tax under the election.[15] Also on 6th April, the Senate voted 96 to 4 for a non-binding resolution in favour of acting to eliminate the ability of wealthy taxpayers' to renounce their US citizenship without paying taxes. The resolution was sponsored by Senator Edward Kennedy (Dem., Mass.) who was not satisfied with the assurances provided by the Chairman of the House and Senate tax writing committees (see above) and wanted a recorded vote on the matter. Moreover, the resolution provides that any changes made should take effect as if enacted on 6 February 1995.[16]

1 June 1995: *The Joint Committee on Taxation* issues its *Expatriation Tax Report*, pursuant to the statutory directive under H.R. 831; with appendices, it runs to about 450 pages. The Report offers not only various comments and critiques on the President's original proposals, as now evolved under the Moynihan Bill (and the companion bill introduced by Sam Gibbons (H.R. 1535)), but it also offers recommendations for alternative approaches, portions of which ultimately are adopted and incorporated in the "Archer Bill," discussed below.[17]

9 June 1995: House Ways and Means Committee Chairman, Bill Archer, (Rep., Tex.) introduces H.R. 1812, the *Expatriation Tax Act of 1995* (The Archer Bill). As explained in Part III below, the Archer Bill (which ultimately becomes the essential basis for the final Conference Bill passed by Congress in late November 1995) differs completely from the earlier Administration and Moynihan Bills. The Archer Bill essentially seeks to close alleged loopholes in the current anti-expatriation tax rules, rather than introduce a whole new tax approach (as in the case of the Moynihan Bill).[18]

13 June 1995: *The House Ways and Means Committee* approves the Archer Bill, after rejecting substitution of the Moynihan/Gibbons Bill proposed by the Democrats. However, the Committee does accept two amendments, including one which applies the revised expatriation tax regime to long-term residents who terminate their US residency (in the case of green card holders for at least eight of the prior fifteen taxable years).[19]

11 July 1995: *The Senate's Finance Committee* holds a hearing on all of the expatriation tax proposals. The Democrats sharply criticize the Archer Bill and seek bipartisan support for the Moynihan Bill.[20]

19 September 1995: *The House Ways and Means Committee* reports out its budget reconciliation recommendations on revenue items pursuant to the *Revenue Reconciliation Act of 1995* and the *Tax Simplification Act of 1995*, which include the Archer Bill as originally passed by the Ways and Means Committee on 13 June 1995. (The Archer Bill is discussed in Part III immediately below.)

23 October 1995: *The Senate Committee on Finance* reports out its version of the Revenue Reconciliation Act of 1995, including an expatriate tax bill modelled principally on the Moynihan Bill.

26 October 1995: *The House of Representatives* approves by a 227-203 margin (principally along party lines) the Republican-sponsored balanced budget and tax cut bills, including the expatriate tax bill modelled mainly on the Archer Bill.

28 October 1995: The *Senate* approves by a 52-47 margin (again, principally on party lines) its own version of the Republican-sponsored balanced budget and tax cut bills, including the expatriate tax bill modelled mainly on the Moynihan Bill.

6 November 1995: The *Conference Committee* commences a reconciliation of the House Bill and the Senate Bill on the myriad of budget and tax issues on which the two bills differ.

17 November 1995. The *House of Representatives* adopts the *Conference Committee's* 16 November 1995 Conference Bill and Report, but the Senate adopts a revised version (dropping two Medicare provisions).

20 November 1995. The House votes to adopt the Senate version of the amended Conference Bill, enabling the bill to be sent to President Clinton.

6 December 1995. President Clinton vetoes the Seven-Year Balanced Budget Reconciliation Act of 1995.

8 December 1995. President Clinton's proposed new Budget Bill again includes the administration's version of the expatriate exit tax (at Sections 13121-13123), which largely follows the Moynihan Bill passed by the Senate on 28 October 1995.

III. THE 1995 BUDGET ACT[21]

A. Overview

The 1995 Budget Act (which was passed by both Houses of Congress late November, 1995 and vetoed by President Clinton on 6 December 1995) largely follows the House Bill (Archer Bill) sponsored by William Archer (Rep.-Texas.), Chairman of the Committee on Ways and Means. The Archer Bill, in turn, was based principally on one of the alternative

15. See also "Expatriate Games: Politics Obscure Technical Issues" *Tax Notes*, (10 April 1995) at 158-161; and "Moynihan Bill Picks Up Clinton Expatriate Proposal" *Tax Notes International*, (17 April 1995) at 1387-88.
16. See "Sen. Kennedy Succeeds in Putting Senate on Record Regarding Expatriation Levy" *Daily Tax Report*, (7 April 1995) G-9-10.
17. See "JCT Report Challenges Treasury on Expatriate Tax Problem; Packwood Committed to Reform" *Tax Notes International*, (12 June 1995) at 1961-1962.
18. See "Archer Proposes Bill Modifying Tax Treatment of Expatriates" *Daily Tax Report*, (12 June 1995) G-4-6.
19. See "Ways and Means Approves Archer Plan to Stem Expatriation Tax Avoidance" *Daily Tax Report*, (14 June 1995) at G-7-9; see also "Archer's Expatriate Proposal Clears Ways and Means" *Tax Notes*, 1565-70 (19 June 1995); see also "Ways-Means Releases Report on Bill Taxing Expatriates; Democrats Dissent" *Daily Tax Report*, (19 June 1995) G-3-4; see also "House Ways and Means Committee Report on H.R. 1812, 'Expatriation Tax Act of 1995' (H. Rept. 104), Including Legislative Language, Issued June 16, 1995" *Daily Tax Report*, (19 June 1995) L-1-26.
20. See "Packwood Pledges Action as Finance Members Favor Moynihan Expatriate Bill" *Tax Notes International*, (17 July 1995) at 142-143.
21. H.R. 2491, The Seven-Year Balanced Budget Reconciliation Act of 1995 (Title XI, Subtitle I, Secs. 11348-11349 of the Act and Secs 877, 2107, 2501 and New Sec. 6039G of the Code).

approaches suggested by the Joint Committee on Taxation, namely, to expand the existing expatriation income tax provided for in Code Section 877 and its estate and gift tax equivalents. As indicated in Part I above, the current provisions subject US citizens who abandon their citizenship for tax avoidance purposes to ordinary US income tax on US source income for ten years after loss of citizenship. Expatriates are also subject to US estate and gift tax during the ten-year period in a manner more similar to resident Americans.

B. Key features of the 1995 Budget Act

- The 1995 Budget Act expands the existing expatriation provisions to cover not only US citizens, but also certain long-term residents.
- Most individuals would be subject to the tax without regard to the subjective reason for abandoning US citizenship or residency. Specified categories of citizens (not long-term residents) could establish that they did not have a principal purpose of tax avoidance by obtaining a ruling to that effect.
- The 1995 Budget Act extends significantly the types of income or gain that are treated as US source (and, therefore, that are subject to tax in the hands of the expatriate) and adds certain anti-avoidance provisions.
- The 1995 Budget Act provides a credit in cases where another jurisdiction imposes tax on an item that would be subject to US tax under new Code Section 877. However, the 1995 Budget Act also overrides treaties (for at least ten years) in the event that a treaty would prevent the expatriation tax from applying.
- The 1995 Budget Act includes enhanced information reporting requirements backed up by penalties for non-compliance.

C. Basic approach of the 1995 Budget Act

1. Persons subject to the expatriate tax rules

Under current law, the expatriation tax provisions are applicable to a US citizen who loses his or her citizenship *unless such loss did not have as a principal purpose the avoidance of taxes*. Under the 1995 Budget Act, US citizens who lose their citizenship and long-term residents[22],[23] who terminate residency are generally treated as having lost such citizenship or terminated such residency with a principal purpose of tax avoidance if either:

(i) the individual's average annual US federal income tax liability for the five taxable years ending before the date of the loss or termination is greater than USD 100,000 (the "tax liability test"); or

(ii) the individual's net worth as of the date of the loss or termination is USD 500,000 or more (the "net worth test").[24]

An individual who falls below these thresholds is subject to the expatriation tax provisions in accordance with the subjective test of current Code Section 877.

A US citizen who renounces citizenship and who meets either the tax liability test or the net worth test can still avoid the expatriation tax if he or she can establish that (a) the renunciation did not have a principal purpose of tax avoidance (the Service would make a determination on this issue by means of a ruling), and (b) he or she falls within one of five specified categories.[25] In practice, the only category commonly available to a departing American is likely to be the one that requires the individual to have been present in the United States for no more than 30 days during any year in the ten-year period immediately preceding the date of his or her loss of citizenship. Accordingly, it appears the most likely effect of the 1995 Budget Act is that well-off US individuals normally will be subject to tax on their US source income (and certain foreign source income) for ten years after they expatriate, whether or not their departure is tax motivated.

2. Income and assets to which new Code Section 877 would apply

Under current Code Section 877, an expatriating individual (if he or she meets the subjective avoidance test) is subject to tax on US source income or gains for a ten-year period at the graduated rates applicable to US citizens. The tax applies whether or not the assets giving rise to the income or gains were acquired prior to or after the date of departure.

Code Section 877 also currently recharacterizes certain foreign source gains as US source gains, thereby causing them to be subject to US income tax. Gains from the sale or exchange of stock of a US corporation or debt of a US person are treated as US source income. Assume the expatriate exchanges such property for other property that would not

22. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which the termination occurs. In applying the eight-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule.

23. Furthermore, a long-term resident may elect to use the fair market value basis of property on the date the individual became a US resident (rather than the property's historical basis) to determine the amount of gain subject to the expatriation tax provisions if the asset is sold within the ten-year period.

24. The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring after 1996.

25. The US citizen would have to establish that he belongs to one of the following groups: (1) the individual was born with dual citizenship and retains only the non-US citizenship; (2) the individual became a citizen of the country in which the individual, the individual's spouse, or one of the individual's parents, was born; (3) the individual was present in the United States for no more than 30 days during any year in the ten-year period immediately preceding the date of his or her loss of citizenship; (4) the individual relinquished his or her citizenship before reaching age 18-1/2; or (5) any other category of individuals prescribed by Treasury regulations. In order to qualify under the foregoing, the former citizen must, within one year from the date of loss of citizenship, submit a request for a ruling as to whether the loss had as one of its principal purposes the avoidance of taxes. The Ways and Means Committee expects that, in making a determination as to the presence of a principal purpose of tax avoidance, the Service will take into account factors such as the substantiality of the former citizen's ties to the United States (including ownership of US assets) prior to expatriation, the retention of US citizenship by the former citizen's spouse, and the extent to which the former citizen resides in a country that imposes little or no tax. Although the foregoing procedure is not available to long-term residents, the Service is authorized to adopt regulations to exempt certain categories of long-term residents from the proposed amendments.

normally give rise to US source income, in the course of a roll-over or reorganization transaction in which the gain was not recognized. In such a case, any gain realized from a subsequent sale of the property received in exchange would, by exception, be treated as US source.

Presumably, expatriates were attempting to avoid the foregoing rule by exchanging their US property for foreign property in a reorganization, and then never actually selling the foreign property. Instead, the foreign (tax haven) corporation would sell the US stocks or bonds that had been transferred to it, with the expatriate only receiving non-liquidating distributions from the foreign corporation (which normally should be free of US income tax under the current US tax rules). To counter this kind of planning, the 1995 Budget Act replaces the above rule with a more extreme one. Under the 1995 Budget Act, an expatriate who exchanges (within the ten-year period) property that produces US source income for property that produces foreign source income would be required to recognize immediately as US source income any gain on such exchange (determined as if the property had been sold for its fair market value on the date of the exchange).[26]

As an alternative, the individual can enter into a gain recognition agreement with the Service, under which any income or gain derived from the property received in the exchange during the subsequent ten-year period would be treated as US source income. If the third party who acquired the property from the expatriate in the exchange later sold the property, the expatriate would recognize the gain. This means that a transfer of, for example, the shares of a US company to a foreign company in a tax-free exchange for the shares of that foreign company would continue to be possible to effect. A subsequent sale of the shares of the US company by the foreign company itself, however, would trigger a taxable gain chargeable on the expatriate.

Income or gain derived from stock held in a foreign corporation also would be US source if the individual owned, directly or indirectly, more than 50 per cent of the vote or value of the stock of the corporation on the date of loss of citizenship or residence, or at any time during the two years preceding such date. This recharacterization would occur only to the extent of the amount of earnings and profits attributable to such stock earned or accumulated prior to the loss of citizenship or residency and while such ownership requirement is satisfied. It appears that income derived from foreign corporation stock, for the purposes of this rule, would not include what otherwise would be Subpart F income earned by the corporation, i.e. only actual distributions would be chargeable.[27]

3. Double tax relief

The 1995 Budget Act provides a credit against the taxes imposed under revised Code Section 877, and the corresponding estate and gift provisions. The credit corresponds to the amount of any foreign income, gift, estate or similar taxes, respectively, paid with respect to the items subject to US tax. The credit may not be used to offset any other US tax liability.

The Ways and Means Committee Report (adopted by the Conference Committee Report) emphasized that it does not intend the expatriation tax provisions to be defeated by any treaty provision. The Ways and Means Committee requested the Treasury Department to review all existing treaties to determine potential conflicts and to "eliminate any such potential conflicts through renegotiation of the affected treaties as necessary". Although there is no provision to this effect in the 1995 Budget Act, the Committee also specified it does not intend the treaty override to last more than ten years.

The Ways and Means Committee's proposal to override US treaty obligations was criticized by the Treasury in a 14 September 1995 letter by Leslie B. Samuels, Assistant Secretary (Tax Policy), to the Committee, commenting on an earlier version of the current 1995 Budget Act provisions. Treasury pointed out that, although the Constitution allows legislative overrides of tax treaties, the expatriation tax overrides violate US obligations under international law. By substituting a wealth test for a motivation test, Treasury found that the 1995 Budget Act would override (i) 22 income and estate tax treaties that allow continued US taxation of former citizens only if their expatriation was tax motivated, (ii) 8 estate tax treaties that restrict the ability of the United States to tax transfers by former citizens who are residents of the treaty partner at the time of death, and (iii) with respect to long-term residents, virtually all treaties.

Treasury noted that the override of tax treaties for a ten-year period was unprecedented. Treaty partners, knowing that the override would disappear after 2005, might attempt to drag out renegotiations and extract concessions from the United States, thereby interfering with the completion of protocols and amendments on other important topics.

In order to prevent tax avoidance by expatriates in a manner consistent with US obligations under international law, the Treasury letter recommends that the taxable event should occur while the individual is still a US citizen or resident, and not after his expatriation. This is essentially returning to the Treasury's proposal of last spring, which treated the expatriating taxpayer as having sold all of his property at fair market value immediately prior to the expatriation. Since then, the Joint Committee and others have proposed adjustments that would alleviate some of the inequities associated with that particular alternative.

26. The Treasury is authorized to issue regulations that provide similar treatment for nonrecognition transactions that occur within five years immediately prior to the date of loss of citizenship (or termination of US residency, as applicable). Treasury is also authorized to issue regulations that treat the removal of tangible personal property from the United States (and other transactions or events that result in a conversion of US source income to foreign source income) as taxable exchanges for purposes of computing gain subject to Code Sec. 877. The same gain recognition agreement alternative, described above, is available.

27. This appears to be the appropriate solution, although there is slight ambiguity because of an oblique reference to Subpart F in an example found in the Ways and Means Committee's explanation of the proposal.

4. Required information reporting and sharing

An individual who terminates citizenship or long-term residence would be required to provide a statement to the State Department containing various particulars, including, in the case of individuals with a net worth of at least USD 500,000, a balance sheet. The annual penalty for failure to provide the required statement would equal the greater of (i) 5 per cent of the individual's expatriation tax liability for such year, or (ii) USD 1,000. The information received by the State Department would then be shared with the Treasury (IRS). The Conference Committee Bill does not include the provisions of the Archer Bill with respect to the publication of the names of expatriates in the Federal Register and the direction to the Treasury Department to study tax compliance by individuals living abroad.

5. Effective date

The 1995 Budget Act generally would apply to any individual who loses US citizenship on or after 6 February 1995, and to any long-term resident who terminates US residency on or after 6 February 1995.[28] A special transitional rule would apply to an individual who expatriates within one year prior to 6 February 1995, but has not applied for a *certificate of loss of nationality* (CLN) as of such date. Such an individual would be subject to the 1995 Budget Act provisions as of the date of application for the certificate, but would not be liable retroactively for US income tax on his or her worldwide income. In order to qualify for the exceptions described above, for individuals within specified categories, the individual would have to submit a ruling request within one year after the date of enactment of the 1995 Budget Act.

28. The Archer Bill, on which the 1995 Budget Act is based, would have provided for an effective date of 13 June 1995 for long-term residents, but this is one of several changes made by the Conference Committee.

UNITED STATES

Some United States Aspects of Foreign Trust Proposals

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I. INTRODUCTION

The last major revision of the rules governing foreign trusts created or used by US taxpayers was enacted 20 years ago. Congress and the Treasury Department believe that since that time foreign trusts have become a favoured vehicle for tax abuse by US residents and citizens, using both legal and illegal methods. The trust proposals set forth below are aimed at attacking this practice.

II. IMPROVED INFORMATION REPORTING ON FOREIGN TRUSTS

A. Reporting

1. Reportable events

All US persons creating trusts or transferring property into trusts, or executors of the estates of deceased US citizens ("Responsible Parties") are required to file information reports of "reportable events."

Reportable events include:
– the creation of a foreign trust;
– the direct or indirect transfer of property, including property transferred by an executor to a foreign trust;
– the emigration of a domestic trust;
– the death of a citizen or resident who was treated as the owner of a foreign trust and was taxable under the income or the estate tax; and
– the immigration to the United States of a person who transferred property to a foreign trust within five years prior to immigration.

In the case of a transfer mentioned above a notice of transfer must be filed with the Treasury Department within 90 days, reporting:
– the property transferred;
– the identity of the trust;
– the identity of the trustees; and
– the identity of the beneficiaries.

The US person taxable on the income should also notify any foreign trustee of its information reporting responsibilities.

2. Annual reporting requirement

A US person taxable on the income of a foreign trust[1] is required to ensure that an annual information return is filed with the Treasury Department and that copies are forwarded to the foreign trust's beneficiaries. The IRS will be empowered to determine the amount to be included in the grantor's income unless the trust appoints a US agent for the purpose of supplying information and accepting a summons for examination.

Any US person who directly or indirectly receives a distribution from a foreign trust must file an annual report specifying the name of the trust, and the amounts received by beneficiaries as well as any other information the Treasury Department may require. No reporting is required upon the creation of a foreign trust by a foreign transferor unless an actual or deemed distribution to a US person is effected.

B. Penalties for failure to file information

1. Reporting on transfer

In addition to any criminal penalty, a failure to report transfers will result in a penalty of 35 per cent of the gross value of the assets transferred to a foreign trust (other than by death) and an initial fine of USD 10,000 triggered upon a failure to report, 90 days after the IRS notifies the responsible person of the trust's failure. An additional USD 10,000 penalty will be imposed for each month of continued non-compliance.

2. Annual reporting

A failure to ensure that a foreign trust files an annual return and supplies required information will result in a penalty of 5 per cent of the gross value of the portion of the trust treated as owned by the US person and USD 10,000 for each month's continued failure 90 days after notice from the IRS is mailed.

A failure to report the required information by a beneficiary who received a distribution will result in a penalty of 35 per cent of the gross amount of the distribution and USD 10,000 for each month of continued non-compliance after the initial 90-day period following the notice. Furthermore if a beneficiary does not provide adequate information on the trust, distributions will be treated as accumulation distributions from the year the trust was created and subject to an interest charge. (See V. Below.)

1. E.g. asset protection trusts and those trusts with US beneficiaries.

C. Exceptions

No reporting is required for transfers:
- where consideration equal to fair market value is received. Obligations of the trust, a grantor, a beneficiary, or persons related to such entities or persons are ignored until paid for purposes of testing fair market value;
- to certain trusts used for deferred compensation or for charitable purposes;
- if there is reasonable cause for the failure. Foreign secrecy law offers no protection.

The effective date for the application of the above proposals is the date of enactment.

III. EXPANSION OF TAXATION OF FOREIGN TRUSTS CREATED BY US GRANTORS FOR POTENTIAL US BENEFICIARIES

Under existing law a US grantor is taxed on the income of a foreign trust created for the benefit of a US person. There are a number of exceptions to this rule that the proposals would eliminate.

All transfers, including sales, are included unless the trust pays fair market value and all gain is recognized. Obligations and guarantees of the trust, grantor and related parties are ignored.

For the purposes of these provisions transfers include transfers by non-residents made during the five years preceding immigration, such transfers will be deemed to have occurred upon assuming residency. Transfers also include deemed transfers by US beneficiaries of testamentary foreign trusts created by US decedents.

A US beneficiary does not include one who was a foreign person for five years after the transfer to the foreign trust. A former US person may still be a US beneficiary under the Administration's proposal.

Outbound trust migrations are treated as transfers made by the grantor. The Administration's proposal additionally makes Section 1491 applicable to outbound migration.

The general effective date for these proposals is 6 February 1995.

IV. REPORTING RECEIPT OF A FOREIGN GIFT

Gifts from foreigners (including foreign decedents) valued at USD 10,000 or more must be reported by US recipients. Multiple gifts within the year are to be aggregated. The penalty for failure to report is 5 per cent of the gift per month, with a minimum penalty of 25 per cent, unless reasonable cause exists. The Treasury is also empowered to determine within its own discretion the tax treatment of such receipt.

The effective date for the application of the above proposal will be the date of its enactment.

V. INTEREST ON ACCUMULATION DISTRIBUTIONS FROM FOREIGN TRUSTS

Present law imposes a penalty of interest, in the amount of 6 per cent per annum, not compounded, on all accumulated income claimed to be received from foreign trusts. The bill would increase the rate to the interest rate on underpayment of taxes (now 10 per cent), and the rate would compound daily.
The method of calculating the interest charge would change. Interest will not be charged during intervals where the beneficiary is not resident in the United States. However, the implication of the proposal is that any accumulated income will be subject to tax.[2]

The pre-1996 interest rate remains the same (6 per cent not compounded).

The effective date is the date of enactment.

VI. LOAN OF TRUST PROPERTY

The fair market value of a loan made to a beneficiary or the grantor of cash or marketable securities owned by a foreign trust will be treated as a trust distribution. In this regard, a loan made to a party related to either the beneficiary or grantor will be treated as a loan made to such beneficiary or grantor. Provisions for repayment of the loan will be disregarded for this purpose.

The Administration's proposal treats the use of property as a distribution to the extent of its fair market value.

The effective dates for the application of these provisions, are 19 September 1995, for loans of cash and marketable securities and 31 December 1995, for the use of property.

2. This appears to be a change of treatment from that applying under current law.

UNITED STATES

ASPECTS OF MIGRATION TRUSTS

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I. MIGRATION TRUSTS

A. Introduction

Under existing law through an affirmative use of the grantor trust rules, one may create a trust for the benefit of an alien immigrant to the United States which will make distributions of income without US income tax consequences. This is achieved by the establishment of a trust by a non-resident alien who would remain subject to tax on the income under the grantor trust rules.[1] By investing the principal in non-US situs assets producing foreign source income not effectively connected with US business, there would be no US tax.[2] The Balance Budget Act of 1995 ("BBA '95") seeks to reverse this result. However, it is necessary to analyse what is actually accomplished by this legislation.

B. The existing law

Under existing law if a foreign person sets up a trust for his own benefit which, were he a US person, would result in exposure to income tax under the grantor trust rules, he would become taxable on the income when he becomes subject to income tax jurisdiction in the US.[3] The thought that a normal grantor could be used here has long since been rejected. Bixby, 586 T.C. 757 (1972). Indirect grantors have the same negative effect. See *Gradow v. US*, 87-1 USTC Paragraph 13,711 aff'd, (9th Cir. 1963).

Since 1990, if a non-resident alien donor makes a gift to a person who thereafter establishes a trust for the benefit of the donor, the donor is deemed the owner of the trust in the proportion that the gift relates to the corpus.[4] This is true whether or not the person making the gift or establishing the trust had a tax avoidance motive. In addition, the rule can apply to trusts created by corporate grantors.

There is confusion regarding when the donor will be treated as a beneficiary of the trust. Current income beneficiaries are clearly covered. The status of other types of beneficial interests is less clear. It is important to note that sham and similar doctrines can apply in determining who actually holds the beneficial interests.

The net effect of the above rules leaves for favourable tax treatment only those trusts created, on a bona fide basis, by real foreign grantors for beneficiaries who become US persons.

The effect for the foreign grantor under current law is that there is no US income tax on distribution, providing all the income is non-effectively connected income from foreign sources.[5] Also properly drafted, the trust arrangement should result in estate or generation skipping tax savings provided the corpus consists of non-US situs property.[6]

II. PROPOSED LEGISLATION: BALANCED BUDGET ACT OF 1995 (VETOED).

A. General

Under the Congressional proposal, the grantor trust provisions of the Code would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income (directly or through one or more entities) of an individual US citizen or resident or a domestic corporation. Thus, the grantor trust provisions of the Code generally would not apply to any portion of a trust where their effect would be to treat a foreign person as the owner of the trust. The effect of this legislation would be to make a foreign trust a non-grantor foreign trust. Thus, distributions from such a trust would be subject to income tax and surcharge on accumulation distribution at varying statutory rates. The President's proposal appears to be substantially in accordance with these provisions.

B. Exceptions

A foreign person would, however, nevertheless be regarded as the owner of trust property:

- if the trust is revocable solely by the grantor without the approval or consent of any person other than a related or subordinate party who is subservient to the grantor;[7]

1. IRC Secs. 671-679.
2. IRC Sec. 871(a); Rev. Rul. 69-70, 1969-1 C.B. 182; Rev. Rul. 81-244, 1981-2 C.B. 151; Rev. Rul. 80-15, 1980-1 C.B. 365, Rev. Rul. 79-116, 1979-1 C.B. 213.
3. IRC Secs. 671-678.
4. IRC Sec. 672(f)(1).
5. IRC Sec. 871(a).
6. IRC Sec. 2106; *Hamilton v. Commissioner*, T.C. Memo 1976-355; *Lee v. US*, 63-1 USTC Para. 12,128 (1962).
7. The meaning of these terms will be found in IRC Sec. 672(c) and the regulations thereunder; Proposed (Prop.) IRC Sec. 672(f)(2)(A)(i)(I).

- where, during the lifetime of the grantor, the only amounts distributable from the trust were distributable to the grantor or the grantor's spouse;[8]
- if the trust was established to pay compensation;[9] or
- if the trust was in existence on 19 September 1995 and is revocable by the grantor under Section 676 of the Internal Revenue Code (IRC) or if income is distributable to the grantor under IRC Section 677(a) (other than certain insurance trusts).[10]

Where a foreign trust holds assets through a foreign corporation, the effect of these rules is also to render US beneficiaries taxable under the CFC or FPHC rules because of the application of attribution rules not previously applicable.[11]

C. Special rules

If, but for the amendments, a foreign person was to be treated as the grantor and owner of the trust and a US person was to be the beneficiary of the trust and also had been the donor of a gift to the foreign grantor then the US beneficiaries to the extent of the gift are treated as the grantor of the trust.[12]

D. Treatment of certain types of foreign corporations

For the purposes of applying the amendments a controlled foreign corporation is a domestic corporation and the "no foreign grantor" rule does not apply for the purpose of applying the PFIC rules. Thus, if a CFC is treated as the owner of the trust assets under the grantor trust rules the amendments do not apply. The rationale here is that a US person would be subject to tax through the CFC rules. The provision relating to PFIC was designed to prevent avoidance of the PFIC rules. However, no mention is made of the PFHC rules. This was no doubt an oversight which has been rectified in the President's draft.

E. Distribution through nominees.

Under the proposed legislation, the role of an intermediary or nominee interposed between a foreign trust and a US beneficiary would be disregarded. That is, any amount paid to a US person by a third person would be treated as if paid by a foreign trust, if the amount paid was derived, directly or indirectly, from a foreign trust, unless the payer was the grantor of the trust.[13] Currently, this indirect distribution rule is limited to US created foreign trusts.[14]

The nominee rule would not apply to a withdrawal from a foreign trust by its grantor with a subsequent gift or other payment by the grantor to a US person.

Effective date. These provisions would be effected as of the date of enactment.[15]

III. RECHARACTERIZATION OF PURPORTED GIFTS BY FOREIGN CORPORATIONS AND PARTNERSHIPS

To avoid or by-pass the foreign trust rules, it has been suggested that the same effect could be accomplished through the use of tax-free gifts from entities other than trusts. Indeed, certain persons have suggested in the past that foreign grantor trusts could produce perpetual non-taxable distributions to US beneficiaries through the use of foreign corporate grantors.[16]

If there were any efficacy to this strategy, it will no doubt be eliminated by regulations under Prop. IRC Section 672(f)(4). This provision effective after date of enactment (BBA '95 Section 11343(d) is one of those broad anti-abuse provisions authorizing regulation to recharacterize gifts or bequests directly or indirectly from partnerships or foreign corporations in appropriate circumstances to prevent avoidance of the purposes of Section 672(f). One wonders about the extent to which this provision is required, since the concept of a trust is already defined most broadly under existing law.[17]

For gift tax purposes, a gift by a corporation is a gift by its shareholders.[18] The same result is often followed for income tax purposes.[19] In any case, a foreign corporation without authority to make gifts or which is thinly capitalized and formed solely for the purposes of acting as grantor of the foreign trust may be considered as a sham. See e.g. *Fullman v. US*, 355 F.2d 632 (Ct. Cl. 1966).

The proposed provision will be enforced through a requirement to submit a special notice of foreign gifts in excess of USD 10,000 received by a US person (other than a Section 501(c)(3) organization).[20] The USD 10,000 is subject to cost of living adjustment. The term "foreign gift" does not include qualified transfers for certain medical or educational expenses. Significant penalties of up to 25 per cent of the amount of the gift will exist for failure to report. Also, the Secretary may determine at his or her sole discretion the tax consequences of the receipt of the gift.

8. Prop. IRC Sec. 672(f)(2)(A)(i)(ii).
9. Prop. IRC Sec. 672(f)(2)(B)(ii).
10. BBA Sec. 11343(d).
11. "New York State Bar Ass'n Rept. on Proposed Legislation on Expatriation and Foreign Trusts" ("*NYS Bar Rept.*") at 49, (15 June 1995).
12. Prop. IRC Sec. 672(f)(5) (now IRC Sec. 672(f)(1)).
13. Prop. IRC Sec. 643(h).
14. IRC Sec. 665(c).
15. BBA Sec. 11343(d)(1).
16. Treas. Reg. Sec. 1.671-2(e); See also Rev. Rul. 57-390, 1957-2 CB 326; Rev. Rul. 77-349, 1977-2 CB 20.
17. Treas. Reg. Sec. 301.7701-4(a).
18. Treas. Reg. Sec. 25.2511-1(h)(1).
19. See, e.g. *Engineering Sales, Inc. v. US*, 510 F.2d 565 (5th Cir. 1975); *58th Street Plaza Theater, Inc. v. Commissioner*, 195 F.2d 724 (2nd Cir. 1952), *aff'g*, 16 T.C. 469 (1951).
20. Prop. IRC Sec. 6039F.

IV. RESIDENCE OF ESTATES AND TRUSTS

A. Existing law

The current statutory rules on situs of trusts and estates are difficult to rationalize. An estate or trust is treated as foreign if it is not subject to US income taxation on its income that is neither derived from US sources nor effectively connected with the conduct of a trade or business within the United States.[21] Any other estate or trust is treated as domestic.[22] There are no specific characteristics specified in the Code which have to exist before a trust is treated as foreign. Rather, through a series of rulings and court cases, the status of a trust depends on various factors such as the residence of the trustees, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries. If an examination of these factors demonstrates that the trust has sufficient foreign contacts, it is regarded as a foreign trust.[23] Nevertheless, the residence of the trustees and the place of administration seem to be primary factors. The residence of an estate under existing law places heavy emphasis on the domicile of the decedent. The IRS rules that there can only be one estate and that is the domiciliary estate.[24]

B. Congressional bill

The proposed legislation would establish a dual test for determining whether a trust is foreign or domestic for US income tax purposes only. A trust will be regarded as domestic only if a US court is able to exercise primary supervision over the administration of the trust. This test may be satisfied by any trust instrument that specifies that it is to be governed by the laws of a US state. The Senate Finance Committee expects that this test may also be satisfied through registration of the trust or estate under a state law similar to *Article VII of the American Law Institute's Uniform Probate Code*.[25]

In order for a trust to be treated as domestic, one or more US fiduciaries must have the authority to control all substantial decisions of the trust. The legislative history suggests that this test would be satisfied in any case where the US fiduciaries hold a majority of the fiduciary powers (whether by vote or otherwise) and where no foreign person acting as a fiduciary (including a trust "protector") had the power to veto important decisions of the US fiduciaries.[26]

If a domestic trust were to change its status and become a foreign trust, the trust would be treated as having made a transfer of its assets to the foreign trust and would be subject to a 35 per cent excise tax under IRC Section 1491.[27] However, if because of the amendments made regarding migration trusts, any person other than a US person ceases to be treated as the owner of a portion of a domestic trust and, before 1 January 1997, the trust becomes a foreign trust or its assets are transferred to a foreign trust, no Section 1491 tax will be applicable.[28]

The US grantor would be required to report the transfer as a transfer to a foreign trust and a heavy penalty for failing to file Form 926 has been enacted.[29] The President's proposal extends the penalty to failure to file Form 926 in the case of transfers to foreign partnerships and corporations. BBA '95 limited the penalty to trusts.

Effective date. These provisions would apply to taxable years beginning after 31 December 1996 or, if the trustee so elects, to taxable years ending after the date of enactment.[30] In the case of the Section 1491 amendments, the effective date is the date of enactment.[31]

It should be noted that the new law will make it easier to determine the residency of a trust. It also may represent a significant departure from prior practice in the case of estates. Under the new rule, it appears on the surface that the domicile of the decedent is of less importance. However, since the domicile of the decedent determines the place of probate and since the unitary nature of an estate for tax purposes is not necessarily overridden, the departure may be more apparent than real.

V. PRESIDENT'S BUDGET PROPOSAL

Except as noted above, as to the points discussed, the President's Budget Plan is substantially the same as the provisions set out in the Balanced Budget Act of 1995. However, the divergence of the President's proposal from the Balanced Budget Act of 1995 indicates a shift away from the Senate compromise and back towards the original Administration proposal made in February. If that trend continues the Administration may ultimately back away from the exclusion from coverage under the new rules for "wholly revocable trusts".

21. IRC Sec. 7701(a)(30).
22. IRC Sec. 7701(a)(3).
23. See, e.g. *B.W. Jones Trust v. Commissioner*, 46 BTA 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943); Rev. Rul. 87-61, 1987-2 C.B. 219, Rev. Rul. 81-112, 1981-1 CB 598, Rev. Rul. 60-181, 1960-1 CB 257.
24. Rev. Rul. 64-307, 1964-2 CB 163; Ltr. 8527065.
25. Sen. Rept. at 188.
26. Sen. Comm. Rept. at 188.
27. BBA '95 Sec. 1134(b).
28. BBA '95 Sec. 11343(e).
29. BBA '95 Sec. 11346(b).
30. BBA '95 Sec. 11346(a)(3).
31. BBA '95 Sec. 11346(b)(3).

UNITED STATES

PERMANENT TAX EXILE – THE PLIGHT OF FORMER US CITIZENS[1]?

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I. DISCUSSION

H.R. 2202 (a bill amending the immigration laws) was ordered reported by the House Judiciary Committee on 24 October 1995. During its consideration by the Committee, an amendment (Section 815 of the bill) was proposed by Congressman Jack Reed (Democrat Rhode Island) and it was adopted. While the bill (H.R. 2202) was ordered reported on 24 October 1995, the Committee only recently filed its official report. Information regarding this provision includes the actual language of the amendment and information available from telephone conversations with various staff members.

This provision would add a new subparagraph to 8 US Code Section 1182(a)(9). Section 1182(a) describes certain classes of excludable aliens who are ineligible to receive visas and who will be excluded from admission into the United States. The general listing includes, among others, aliens who have certain communicable diseases, convicted criminals, terrorists, participants in Nazi persecutions or genocide, certain draft evaders, and under the category of "miscellaneous," practising polygamists and international child abductors. The subject provision would be added under the "miscellaneous" category, after international child abductors.

The amendment would provide that any alien who is a former citizen of the United States who "officially renounced" US citizenship and who is determined by the Attorney General to have renounced for purposes of avoiding taxation by the United States is excludable. This means that the individual could be denied a visa or could be denied admission at any port of entry.

There are a number of questions that arise with respect to this provision. Would a former US citizen who lost his US citizenship due to some form of conduct, such as, service in a foreign army be considered to have officially revoked his citizenship? Can it be assumed that the Attorney General will determine that every individual who renounced and became subject to taxation under one of the anti-expatriation tax provisions automatically be excludable? For example, some moderately well-to-do individuals will renounce but, under one of the new tax proposals, not be subject to a great deal of tax because his or her net worth only slightly exceeds the exempt amount. In these circumstances will the individual be barred from travel to the United States? Also, it is unclear what the effective date of this provision will be. It is also unclear as to whether the definition of "former citizen who renounced for tax purposes" be the same for purposes of this immigration law provision as it is for the tax laws.

An individual on Congressman Reed's staff confirmed that Congressman Reed sponsored the amendment. She said that the provision was intended to prevent expatriation for tax purposes. She said that she was not aware of the anti-expatriation provisions in the tax law and the proposed amendments to those provisions in the Revenue Reconciliation Bill and President Clinton's proposals. She said that Congressman Reed might not have been aware of these provisions and proposed revisions. She was not able to give an opinion as to whether the provision would have retroactive effect.[2]

An attorney on the staff of the Immigration and Claims Subcommittee, House Committee on the Judiciary, has provided some additional information. He was the Subcommittee staff person most familiar with this provision. He said that the amendment was introduced somewhat "out of the blue". He was not aware of the tax provisions and proposed amendments to those provisions. As to retroactivity, he acknowledged that the amendment is silent on this subject. The Committee report is being written at this time. He said that he would look into the retroactivity issue and there might be some clarification put into the Committee report. He stated that amendments to the immigration laws were generally prospective; but he also noted that a provision like the one aimed at participants in Nazi persecutions and genocide obviously were retroactive.

There are no provisions in the amendment for relaxation of these rules or for waivers where an individual requests a waiver from the Attorney General. The tax provisions can be triggered by the application of an objective ("wooden") test; that is, if taxes are saved, it is assumed that saving tax was the principal purpose for the renunciation. In fact, there can be other reasons that are the principal motivation.

The Committee report was filed recently, and it states that this provision will not be retroactive. The bill passed the

1. Provision in H.R. 2202 (A bill amending the immigration laws) prohibiting the issuance of visas to former citizens who renounced citizenship to avoid US taxation.

2. The House Judiciary Committee Report on H.R. 2202 has been filed. It stated that the Reed amendment would not be retroactive to a date prior to enactment.

House on 27 March 1996. The dates for Senate consideration have not yet been set.

II. COMMENTS

Many individuals may violate the anti-expatriation tax provisions and pay some tax. When they do so, the tax savings or tax avoidance will be eliminated. This provision, however, additionally would bar them from travel to the United States. Such a bar would appear to run contrary to the United States' general policy in favour of the free flow of individuals, services and goods. Exceptions to this policy are made in extraordinary cases involving individuals such as war criminals and child abductors. It seems that renouncing citizens should not be put in this category, especially since as pointed out above the individual will have paid the taxes occasioned by the anti-expatriation provisions.

The author knows of no other country that bars former citizens who renounced citizenship. The Deputy Attorney General Gorelick wrote a letter to the House leadership urging the Congress not to adopt this provision but leave the subject for amendments to the tax law. The House of Representatives obviously ignored this request.

III. CONCLUSION

The fact that legislation aimed at renouncing US citizens is being considered in different, uncoordinated forms is unfortunate. There are a number of proposals pending aimed at taxing these individuals. These proposals have the support of both Congress and the Administration. There would appear to be no need for immigration measures.

The fact that there are immigration-related proposals which, in effect, ban former US citizens from travelling back to the United States, may have surprising results. For example, should a relatively young adult choose to renounce today, possibly trigger a little US tax under existing or retroactive new tax rules, but avoid the retroactive application of any new immigration rules?

It seems that government really should not be affecting peoples' lives to this extent. With its proposals, government should not be creating a game that looks like some form of baccarat.

It is noteworthy that the Administration does not support the anti-expatriation *immigration* proposal, while it strongly pushes for the parallel *tax* proposals.

Also, it should be appreciated that the United States has long benefited from immigration. Much of the vitality of US society is traceable to the influx of individuals and their families. Why should it be so distasteful to contemplate individuals leaving the United States to relocate elsewhere? If the requirement to pay income tax on income earned while a US taxpayer and, perhaps, US estate taxes where appropriate, is met, why should the individual be treated like a war criminal or other heinous person?

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

MAY 1996

Tax Planning for Expatriates resident in the UK, Royal Lancaster Hotel, London, 13 May 1996 (English):

Juliet Neckar, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

International Tax Conference – Minimising your Global Tax Burden, The Queen Elizabeth II Conference Centre, London, 14 May 1996 (English):

Becky Brown, Ernst & Young, Becket House, 1 Lambeth Palace Road, London SE1 7EU, Tel.: 44-171-931 3248.

US International Taxation & Transfer Pricing APAs, Amsterdam, the Netherlands, 13-14 May 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Mergers & Acquisitions Conference, The Kensington Hotel, London, 30 May 1996 (English):

Vicki Goffin or Athina Bradley, IBC Legal Studies and Services Limited, Gilmoora House, 57061 Mortimer Street, London WIN 8JX, United Kingdom, Tel.: 44-171-453 2708, Fax: 44-171-631 3214.

JUNE 1996

International Taxation of Permanent Establishments, Amsterdam, 10-11 June 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1996

Offshore Tax Planning in a Radical New Environment, Dorchester Hotel, London, 9 July 1996 (English):

Juliet Neckar or Sarah Avian, IBC Group plc, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 2070, Fax: 44-171-436 2450.

AUGUST 1996

Summer Course on Principles of International Taxation, Amsterdam, the Netherlands, 19-30 August 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Indonesian Tax and Foreign Investment Seminar, Singapore, 23 August 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1996

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

UNITED STATES

REVENUE PROCEDURE 96-13 NEW COMPETENT AUTHORITY PROCEDURES

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I. BACKGROUND

Revenue Procedure (Rev. Proc.) 96-13, 1996-3 I.R.B. 1, issued at the end of 1995, updates and supersedes Rev. Proc. 91-23, 1991-1 C.B. 524, as the governing Revenue Procedure for Competent Authority (CA) requests involving both US and foreign initiated adjustments, and other matters relegated to CA procedures. The new Rev. Proc. is effective for requests filed after 16 January 1996 and is a modified version of Announcement 95-9, 1995-7 I.R.B. 57,[1] issued in February 1995.[2]

II. SCOPE

The scope of the new provisions is set out in Section 2 of the new Rev. Proc. In particular it is confirmed that the Rev. Proc. governs requests, except to the extent that the requests are inconsistent with specific treaty procedures.[3] Subsection 1 lists the expanding range of matters for which CA assistance may now be requested under the mutual agreement article. They include determinations under limitation on benefits articles, Advance Pricing Agreements, etc. The Subsection also confirms that the Rev. Proc. does not limit or expand treaties.

The IRS Assistant Commissioner (International) is identified as the CA. However, when exercising the CA's interpretative function the Assistant Commissioner generally requires the concurrence of the Assistance Chief Counsel (International).[4]

Normally when a case is accepted, the US CA will consult with the foreign CA and attempt to reach agreement.[5] The US CA may initiate CA negotiations to protect US interests, e.g. where the taxpayer agrees to foreign or US adjustments contrary to the treaty or otherwise fails to secure available correlative relief.

It should be noted that in cases where there has been failure to request CA Assistance[6] the Rev. Proc. stipulates that failure to pursue an available CA remedy may cause denial of all or a portion of the foreign tax credit.

III. GENERAL CONDITIONS TO CA ASSISTANCE[7]

A. General

CA relief is only available under the authority of an applicable treaty.[8] In addition, unless the particular treaty provides otherwise (e.g. in the case of certain limitation on benefits article determinations regarding foreign taxpayers), only US persons (under Sec. 7701(a)(30) of the Code) may request US CA assistance.[9]

Where particular treaties contain limitations on the availability of CA relief, the taxpayer should be aware of statutes of limitation and other procedural barriers potentially limiting CA relief under foreign or US law, and should take appropriate protective measures.[10]

The US CA will be guided by the arm's length standard, as reflected in Section 482 of the Code, and will take into account all of the facts and circumstances and the purpose of the treaty to avoid double taxation. This is a change from Rev. Proc. 91-23's reference to "equivalent standards applicable to dealings between independent persons (referred to in a number of treaties)". Rev. Proc. 96-13 clarifies the IRS view that the domestic and treaty/international standards applicable to allocation cases are identical.[11]

B. Other matters

Closed Cases.[12] Once a case is closed after examination it generally will not be reopened to make an adjustment unfavourable to the taxpayer unless the exceptional circum-

1. The new Rev. Proc. reflects comments received during the past year.
2. Announcement 95-9, 1995-7 I.R.B. 57 had in turn expanded upon Announcement 93-144, 1993-39 I.R.B. 12, issued in December 1993.
3. Sec. 2.02. of the Rev. Proc. 96-13 (Sec 2.02).
4. Sec. 2.03.
5. Sec. 2.04.
6. Sec. 2.05.
7. Sec. 3.
8. Sec. 3.02.
9. Sec. 3.04.
10. Sec. 3.01.
11. Sec. 3.03.
12. Sec. 3.05.

stances described in Rev. Proc. 94-68, 1994-2 C.B. 803 are present. The US CA may, but is not required to, accept a CA request that will require the reopening of a case closed after examination.

Foreign Initiated CA Request.[13] The US CA may require a US related person (in Section 482 cases) or a foreign taxpayer to file a request under this Rev. Proc. when the case is referred to the US CA directly by the foreign CA.

Residence Issues.[14] CA assistance may be available to establish US resident status when this is necessary to avoid double taxation or qualify for treaty benefits and to establish consistent treatment between the US and the treaty partner.

Limitation on Benefits.[15] While the US CA will not generally issue determinations of a taxpayer's status under an applicable limitation on benefits article, where the CA is specifically granted discretion to make such determinations under a particular treaty (e.g. United States–Netherlands Treaty, Art. 26(7)), requests should comply with this Rev. Proc. and any other specific procedures issued to govern such cases (e.g. Notice 94-1).

IV. PROCEDURES FOR REQUESTING CA ASSISTANCE[16]

A. Time for filing[17]

Regarding a US initiated adjustment, a request may be submitted as soon as practicable after the amount of proposed adjustment is communicated in writing to the taxpayer (i.e. in a Form 5701). Where a US adjustment has not yet been communicated, the US CA generally will deny the request as premature. Comments on Announcement 95-9 noted exceptional cases in which the taxpayer had reason to expect that the proposed adjustment and delay in initiating the CA procedure could jeopardize foreign relief. The IRS's apparent view is that the term "generally" should accommodate such exceptions. Regarding a foreign examination, a request may be submitted as soon as the taxpayer believes filing is warranted based on the foreign country's actions. In reallocation cases, the request should not be filed until the "probability of double taxation" can be shown. (A request may be denied absent such showing, e.g. where the reallocated income is not taxed either in the United States or in the foreign country.) Comments to Art. 95-9 suggested this could be problematic in operating loss cases, where potential double taxation is deferred, but the IRS view is that adequate discretion is present to evaluate the existence and extent of probable double taxation in each case. If no examination is involved, a request may be made when action or potential action warrants filing, e.g. a foreign tax ruling (or equivalent), or the withholding of tax, etc. Except where the treaty provides specific time limitations, taxpayers have discretion as to when to file, but delay may preclude effective relief.

B. Place of filing, form and information required[18]

The Rev. Proc. describes the place for filing CA requests, the required filing of a copy with the relevant District in US adjustment cases, or with the Chief Counsel in docketed or designated cases, and the prescribed form and content of the request, including updates as appropriate of all information or documents provided as part of the request.

C. Conferences[19]

Rev. Proc. 96-13 formally adopts the pre-filing conference proposed in Announcement 95-9, in addition to the post-resolution conference.

V. SMALL CASE PROCEDURE[20]

The Rev. Proc. contains a special, streamlined CA request procedure for small cases (i.e. where the proposed adjustment is under USD 200,000).

VI. FOREIGN-INITIATED ADJUSTMENTS[21]

Requests in such cases should be filed with the US CA. Where the years are under audit in the District or are in Appeals, taxpayers will be advised to contact the US CA. In appropriate cases, the US CA will advise the District or Appeals on appropriate action. As mentioned above, the failure to request CA assistance may result in the denial of correlative relief, including foreign tax credits.

VII. COORDINATION WITH OTHER ADMINISTRATIVE OR JUDICIAL PROCEEDINGS[22]

A. Suspension of administrative action[23]

When the CA request is accepted, the IRS will suspend administrative action on the CA issues, except (i) where the CA requests otherwise or (ii) in docketed cases or other situations where action is necessary to avoid prejudicing the US Government's interests. Normal administrative procedures apply to non-CA issues. For example, the taxpayer will normally receive a thirty-day letter, file a protest and pursue

13. Sec. 3.06.
14. Sec. 3.07.
15. Sec. 3.08.
16. Sec. 4.
17. Sec. 4.01.
18. Sec. 4.02-4.
19. Sec. 4.09.
20. Sec. 5.
21. Sec. 6.
22. Sec. 7.
23. Sec. 7.01.

Appeals procedures on all unagreed issues other than those in CA.

B. Coordination with Appeals[24]

Adopting the Announcement 95-9 elimination of the Rev. Proc. 91-23 "Appeals First" rule, Rev. Proc. 96-13 gives taxpayers disagreeing with a proposed US adjustment the following options: (1) to pursue Appeals before requesting CA assistance, (2) to request CA assistance immediately, or (3) to elect the new simultaneous Appeals-CA procedure described in Section 8 (discussed below at VIII). As under Rev. Proc. 91-23, Appeals consideration of potential CA issues is to be without regard to other issues, i.e. Appeals should not resolve the case based on "horse trading". (Section IRM 8732(4).) This last point presumably does not affect the traditional approach of Appeals which is to take "hazards of litigation" considerations into account in attempting to settle potential CA issues.

C. Coordination with litigation[25]

The CA will not accept (or continue to consider) a request involving docketed periods or docketed or designated matters, without Chief Counsel consent. If a case is pending in the Tax Court, the taxpayer may be asked to join the IRS in a motion to sever issues or delay trial pending the completion of the CA proceedings. Analogous procedures apply for cases in other courts.

D. Coordination with APAs[26]

Taxpayers are encouraged to file a CA request in APAs, including a request for any "roll-back" period to be covered by the APA. (See Announcement 95-49, 1995-24 I.R.B. 13.)

E. Effect of agreements or court decisions[27]

The CA's authority will be limited to obtaining a correlative adjustment from the foreign CA, and the CA "will not undertake any actions that would otherwise change [the pre-CA] agreement" reached by the taxpayer, if the taxpayer has executed a closing agreement (e.g. Form 870-AD) with the District (whether or not contingent on CA relief), or a closing agreement or other written settlement agreement with Appeals or counsel (whether or not contingent), or has obtained a court decision regarding its tax liability for the relevant period. This rule, adopted without change from Announcement 95-9, is intended to prevent the "two bites at the apple" problem, by forcing the CA into a "take it or leave it" position with the foreign CA in the bilateral negotiations. If the taxpayer has chosen its remedy by taking the case first to a written agreement with Appeals the taxpayer may be precluded from CA relief, even if the written agreement is purportedly contingent on a potential further reduction of the adjustment in the CA process. Given the sensitivity of foreign CAs, this rule could severely increase the risk of double taxation.

F. Accelerated CA procedure[28]

Taxpayers requesting CA assistance on an issue may ask the CA to resolve the same issue for subsequent periods (i.e. to "roll forward the CA Agreement"). Such roll-forward is analogous to the Accelerated Issue Resolution (AIR) process set forth in Rev. Proc. 94-67, 1994-2 C.B. 800 (see also Dele. Order 236 (Rev. 1), 1994-1 C.B. 326), and is dependent upon District consent as well as foreign CA agreement. The taxpayer must provide all the information required under Rev. Proc. 96-13 for such subsequent periods. The roll-forward request may be made at any time prior to the conclusion of the original period, but taxpayers are encouraged to make the request as early as practicable. It is not clear how similar to the prior year the subsequent year's facts and issues must be in order to qualify for this procedure.

VIII. SIMULTANEOUS APPEALS-CA PROCEDURE

A. General[29]

Taxpayers requesting CA assistance may at the same time or at a later date request the simultaneous Appeals-CA procedure. The US CA may also request Appeals' involvement. Whether this could effectively eliminate the taxpayer's option to forego this procedure is unclear. Taxpayers may request a pre-filing conference with the National Director of Appeals and the US CA to discuss the simultaneous procedure.

B. Time for requesting simultaneous Appeals-CA procedure[30]

The taxpayer may request the simultaneous procedure in the following cases:

- when the CA request is filed after the proposed adjustment is received, but before the protest is filed;
- when the protest is filed and it is decided to sever and request CA assistance on certain issues; or
- when the case is in Appeals, before settlement, and it is decided to request CA assistance on certain issues.

Taxpayers are encouraged to invoke the simultaneous procedure as soon as possible after the first Appeals conference. The simultaneous procedure may be requested while the case is in CA, but the request generally will be denied if it is made

24. Sec. 7.02.
25. Sec. 7.03.
26. Sec. 7.04.
27. Sec. 7.05.
28. Sec. 7.06.
29. Sec. 8.01.
30. Sec. 8.02.

after the US position paper is sent to the foreign CA, unless the US CA considers the procedure to be in the IRS's best interest.

C. Docketed or designated cases[31]

If jurisdiction has been released to the CA, the request must have Chief Counsel consent.

D. Form of request[32]

The request filed with the CA must disclose whether the issue was previously protested to Appeals even when the protest was made for prior periods. Copies are sent to the National Director and Regional Director of Appeals. The US CA has jurisdiction over the case when the simultaneous procedure is initiated.

E. Role of Appeals in the CA process[33]

The Appeals representative will consult with the taxpayer and the US CA for the purpose of resolving the unagreed issue before presenting the issue to the foreign CA, and ensuring that the terms of a tentative resolution and the principles and facts on which it is based are compatible with the position the US CA intends to present to the foreign CA. Although the Rev. Proc. is unclear, Appeals presumably may take into account litigation hazards in the context of the simultaneous procedure. Any resolution reached under this procedure is subject to the CA process. Such resolution is tentative and not binding on either the IRS or the taxpayer, although the tentative resolution will be reflected in the US CA position paper presented to the foreign CA. Taxpayers that have already had substantial Appeals consideration may not use this procedure to obtain fresh Appeals consideration. The simultaneous procedure generally will not change the manner in which taxpayers are involved in the CA process.

F. Denial or termination of simultaneous procedure[34]

The taxpayer may withdraw at any time, and the CA or Appeals may deny or terminate the procedure if it is considered prejudicial to the CA or Appeals process (e.g. in the case of taxpayers who had prior substantial but unsuccessful Appeals consideration). The taxpayer may request a conference in such a case.

G. Return to Appeals[35]

If the CAs fail to agree or the proposed agreement is not acceptable to the taxpayer, the taxpayer may return the issue to Appeals for further consideration.

IX. PROTECTIVE MEASURES

A. General[36]

The taxpayer (or related person) must take all necessary US and foreign protective measures to prevent the statute of limitations (SOL) or other procedural barriers from blocking CA relief before or after the CA request is filed. Such measures include filing amended returns or protective refund claims, staying SOL expiration, avoiding the lapse of taxpayer's appeal rights, complying with applicable CA procedures including treaty time limits, and contesting an adjustment or seeking appropriate correlative adjustment. In a liberalization of the Announcement 95-9 rule that such measures must be taken as soon as an adjustment is proposed, Rev. Proc. 96-13 urges taxpayers to act as early as possible to ensure that time does not become a barrier to the CA process. Taxpayers are invited to discuss this matter in advance with the CA.

B. Amended returns[37]

Amended returns, (copies of which should be attached to the CA request,) must be filed in order for the taxpayer to claim refunds or credits with respect to taxes attributable to the CA issues.

The amended return only allows a refund to the extent agreed to bilaterally or unilaterally allowed by the US CA.[38]

C. Protective claims[39]

Protective refund claims, in the form of amended returns (See above), should be filed before filing the CA request, in cases in which foreign adjustment is expected, the foreign adjustment is being contested locally, or the treaty time limits for notification so require. The taxpayer should notify the CA of the status of the case at six-month intervals thereafter. The CA will hold the case in suspense, and will generally not consult with the foreign CA until a formal CA request is filed (or the case is withdrawn).

D. Treaty waivers of procedural barriers[40]

Taxpayers should take appropriate protective measures even where the treaty waives SOL and other procedural barriers to bilateral negotiations and CA relief.

31. Sec. 8.07.
32. Sec. 8.04.
33. Sec. 8.05.
34. Sec. 8.06.
35. Sec. 8.07.
36. Sec. 9.01.
37. Sec. 9.02.
38. Sec. 9.04.
39. Sec. 9.03.
40. Sec. 9.05.

X. REV. PROC. 65-17

Taxpayers should request Rev. Proc. 65-17 relief (i.e. tax free repatriation of amounts allocated between related persons under Section 482) at the time the CA request is filed. (See Rev. Proc. 96-14.)

XI. DETERMINATION OF CREDITABLE FOREIGN TAXES

Acts or omissions by the Taxpayer that preclude effective CA assistance, including failure to take protective measures (per Sec. 9) or to request CA assistance, may constitute failure to exhaust all effective and practical remedies for foreign tax creditability purposes. Any foreign taxes that would not have been due if foreign correlative relief had been granted may then not constitute creditable foreign taxes. (See Rev. Proc. 92-75, 1992-1 C.B. 197). Any determination that CA remedies have been exhausted must be made in consultation with the US CA.

XII. ACTION BY THE US CA[41]

A. Denial of assistance[42]

The CA will notify the taxpayer upon receiving the CA request when the facts provide the basis for assistance.[43] The CA has the power to deny a request or cease providing assistance if the taxpayer:

- is not entitled to relief;
- is only willing to accept agreement on conditions which are unreasonable or prejudicial to the United States;
- rejected the CA resolution of a similar issue in a prior case[44];
- refuses to agree that CA negotiations are government-to-government;
- fails to provide sufficient information;
- acquiesced to a foreign adjustment which involved significant legal or factual issues and unilaterally made a correlative adjustment or claimed increased foreign tax credit without requesting CA assistance; or
- fails to comply with the Rev. Proc., or fails to cooperate with the CA or Exam, thereby significantly impeding the CA's ability to conclude an agreement.

In addition to denying relief on the grounds set out above, the CA may require the taxpayer to grant a SOL extension as a condition to CA acceptance of the case.[45]

The docketing or designation of a CA issue or case does not appear to require denial of CA assistance as was generally the case under Rev. Proc. 91-23 practice (see *Yamaha Motor Corp v. U.S.*, 779 F. Supp. 610 (D.D.C. 1991), *appeal dismissed*, (D.C. Cir. Dec. 1, 1992), but only seems to limit the CA's ability in the bilateral negotiations to obtain correlative adjustment.

The CA's decision to deny a request or discontinue a CA case is final and not subject to administrative review.[46]

B. Notification[47]

The CA will notify the taxpayer of the proposed agreement with the foreign CA. If the taxpayer accepts, the agreement will be final and not subject to administrative or judicial review. If the CAs fail to agree or if the proposed adjustment is unacceptable, the taxpayer can withdraw from the CA procedure and pursue all available remedies or (in certain treaties, e.g. United States–Germany, Art. 25(5)), request arbitration under the treaty.

C. Unilateral withdrawal or reduction of US adjustments[48]

Unilateral withdrawal or reduction of US adjustments generally will not be granted by the US CA, regardless of whether the foreign SOL has expired and the foreign CA was denied relief. In extraordinary circumstances, the CA has discretion to withdraw or reduce adjustments in order to avoid actual or economic double taxation. Even where such relief otherwise would be granted, the CA normally will not do so unless the treaty country grants similar relief in equivalent cases.

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41. Sec. 12.
42. Sec. 12.02.
43. Sec. 12.01.
44. This was not a basis for denial under Rev. Proc. 91-23.
45. Sec. 12.03.
46. Sec. 12.04.
47. Sec. 12.05.
48. Sec. 12.07.

INTERNATIONAL

TRANSFER PRICING SURVEY OF MAJOR TRADING NATIONS

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I. INTRODUCTION

In order to avoid the loss of tax revenue that could result when goods, technology, services and loans are transferred between affiliated companies using uncontrolled prices, governments around the world have enacted in recent years transfer pricing legislation requiring multinational enterprises to use specific methods and rules for calculating the prices at which such transfers should be reported for income tax purposes.

Except for the United States which has opted for legislation based on its own methods and principles, developed countries have enacted legislation largely based on the transfer pricing guidelines issued by the Organization for Economic Co-operation and Development (OECD). Most emerging nations, on the other hand, have not enacted transfer pricing laws, but those few which have done so have enacted ambiguous legislation which follows neither the US nor the OECD methods.

As a result, transfer pricing laws vary widely around the world due to the diversity of rules enacted by different countries. This survey is a first attempt to examine the extent to which transfer pricing rules differ among major trading nations. Readers should be aware, however, that no attempt is made in this article to recommend alternatives for uniform transfer pricing laws. The purpose of this article is to present an overview and to highlight the major differences in legislation.

II. SURVEY

This article presents a survey of transfer pricing rules in 35 major trading nations, including 21 OECD member countries and 14 emerging market nations, which together account for more than 90 per cent of all world trade. Most Western European nations have been included in this survey, as well as all three NAFTA countries, several South American nations and a few Eastern European countries, plus a majority of Asia-Pacific countries, particularly the so-called NICs (or newly industrialized countries) and emerging NICs.

The survey took the form of a questionnaire covering major transfer pricing areas such as legislation, methods, documentation requirements, use of advance pricing agreements and specific penalties. The questionnaire was answered by the international offices of Deloitte & Touche according to legislation in effect as of 31 December 1995, unless otherwise indicated. The results have been summarized and tabulated in tables drawn up by the author and included as an integral part of this article.

It is worth noting that there are various transfer pricing proposals currently under way in several countries such as France, Korea, New Zealand and Spain. Therefore, readers should be cautioned that some of the information presented in this survey could be modified during 1996 as a result of the proposed reforms.

III. LEGISLATION

The enactment of specific transfer pricing legislation has been a recent phenomenon, though several countries such as Belgium, Denmark, France, Germany, Ireland, Sweden, the United Kingdom and the United States have had related party provisions and anti-avoidance provisions since the early part of the century. In most OECD countries, transfer pricing legislation was enacted during the late 1980s and early 1990s, while transfer pricing legislation has yet to be adopted in most emerging nations.

As illustrated in Table 1 of this article, the majority of the OECD countries surveyed have enacted one form or another of transfer pricing legislation. Australia, Canada, Germany, Japan, Mexico, New Zealand, Spain, the United Kingdom and the United States have enacted detailed and comprehensive legislation. Others have general transfer pricing rules largely based on anti-avoidance and related party provisions. Still others such as Austria, Denmark, Luxembourg and the Netherlands have decided to simply follow the transfer pricing guidelines issued by the OECD.

As far as emerging countries are concerned, China and Korea are the only countries surveyed with detailed and comprehensive transfer pricing laws. Most others do not have transfer pricing laws and do not follow OECD guidelines, but apply instead the general anti-avoidance rules to related party trans-

The author is grateful to Deloitte & Touche for the information provided by its international offices in connection with this survey, and to Professor Reuven Avi-Yonah at Harvard Law School for his review and comments.

actions. In most emerging markets, the emphasis with respect to related party transactions is not yet on transfer pricing, but on management fees and cost sharing agreements.[1]

IV. METHODS

As indicated above, multinationals are required to calculate transfer prices as if the affiliated companies were independent parties doing business in the open market ("arm's length principle"), rather than under the favourable conditions which may result from common ownership. Accordingly, multinationals may use the traditional transaction-based methods (the comparable uncontrolled price method "CUP method"; the cost plus method; and the resale price method) and the profit methods (the profit split method; and the comparable profits method or transactional net margin method, "CPM/TNMM methods").[2]

Table 2 of this article shows that the CUP method is the only transfer pricing method accepted by all countries in the survey, whether OECD or emerging countries. Its wide acceptance is attributable to the fact that, where it is possible to locate comparable uncontrolled transactions, the CUP method provides the most direct and reliable way to apply the arm's length principle to related party transactions.

With the exception of Ireland and Portugal, the cost plus method and the resale price method are specifically accepted by 19 of the 21 OECD countries included in the survey. By comparison, in emerging markets, the cost plus method is recognized by only seven countries (China, Hong Kong, Indonesia, Korea, Malaysia, Taiwan and Thailand), while the resale price method is accepted by just five countries (China, Hong Kong, Indonesia, Korea and Taiwan).

Though the traditional transaction-based methods are indeed preferred over the profit methods, it is important to note that the profit split method and the CPM/TNMM methods do enjoy wider acceptance than normally believed, albeit as secondary methods or methods of last resort. In fact, of the 35 countries in the survey, 13 specifically accept the profit split method, while eleven explicitly recognize the CPM/TNMM methods. In the foreseeable future, these numbers could be dramatically increased, especially now that the OECD has endorsed, subject to certain qualifications, the profit methods advocated by the United States.

With respect to the global formulary apportionment method, most OECD and emerging countries included in the survey reject this method. France, Indonesia, Mexico and Switzerland, however, are an exception in the sense that these countries accept the global formulary apportionment method exclusively in cases involving transactions with permanent establishments. In connection with financial services, a *modified* global formulary apportionment method is accepted in certain situations by a few countries including New Zealand and others.

V. DOCUMENTATION

Without exception, all countries included in this survey require taxpayers to submit to the tax authorities, upon request, the records, accounts and contractual agreements maintained during the regular course of business, and which are necessary to determine the arm's length price. Examples of such documentation include accounting books and records, invoices, purchase orders, consolidated financial statements, licensing agreements, financing agreements, cost sharing agreements, tax returns and other documentation.

As seen in Table 3 of this article, Australia, Canada, Korea and the United States go one step further by explicitly requiring taxpayers to prepare and maintain specific documentation to support the method and calculations used to set transfer prices. These countries specifically require taxpayers to maintain contemporaneous documentation[3] such as pricing policies for intra-group transactions; description and assessment of transfer pricing methods; list of third-party comparable transactions; risk, functional and economic analysis; and rationale for the selected method.

With respect to information involving foreign related parties, China, Korea and the United States require a description of affiliated transactions (including the terms of sale), as well as a description of the taxpayer's organizational structure. In the United States, regulations also require foreign-owned taxpayers to make available to the tax authorities, on request, the records and data kept overseas. Likewise, in Denmark, a Danish parent is required to submit to the authorities, on request, the accounting documentation of its foreign subsidiaries when the foreign subsidiaries have been included in cross-border tax consolidation with the Danish parent.[4]

In most countries, whether those with specific documentation requirements or not, the burden of proof is on the taxpayer to show that transfer prices have been determined on an arm's length basis. In Belgium and Denmark, interestingly enough, the burden of proof does not lie with the taxpayer but with the tax authorities.

VI. ADVANCE PRICING AGREEMENTS

An advance pricing agreement (APA) is a binding legal agreement between the taxpayer and the tax authorities, establishing the transfer pricing methodology and critical assumptions necessary to produce arm's length prices in

1. According to conversations with senior tax officials from various emerging nations currently attending the International Tax Program at Harvard Law School, audit and enforcement of related party transactions is primarily focused on the payment of management fees and cost sharing participation to foreign affiliates.

2. The TNMM method described in the 1995 OECD guidelines is meant to be essentially similar to the CPM method promulgated by US regulations. Therefore, throughout this article, the author refers to the CPM/TNMM methods.

3. Contemporaneous documentation is defined as documentation in existence at or prior to the date in which the income tax return is filed.

4. Denmark allows foreign subsidiaries to be included in the consolidated return of the Danish parent.

transactions with related parties for periods of time normally exceeding one year.

APAs were first introduced by the United States in 1991. Thereafter, Australia, Canada, Germany, Japan, Spain and the United Kingdom have also adopted APAs into their laws and regulations, while Korea and New Zealand are expected to have APAs in place starting 1997. As shown in Table 3 of this article, all other countries in this survey presently lack APAs, though a number of them do offer the possibility of an advance ruling for specific related-party transactions. Advance rulings are usually issued for a specific transaction at a specific point in time, and not for a series of transactions throughout an extended period of time as in the case of APAs.

One major reason for the recent rise in the number of countries offering APAs, particularly OECD countries, is the fact that less manpower is generally needed on the part of the tax authorities in negotiating and monitoring compliance of an APA than in conducting a fully-fledged audit of a transfer pricing issue, thus allowing tax authorities to better utilize their scarce resources in other areas of tax administration. In emerging markets, however, APAs are likely to be adopted at a much lower pace given that APAs generally require highly skilled professionals, who are costly and difficult to hire and retain.

As a result of the initial success of its APA programme, the United States began efforts in 1994 to implement bilateral APAs and even multilateral APAs with its major trading partners. The rise in bilateral and multilateral APAs will depend largely on how soon other countries adopt and implement APAs as part of their overall transfer pricing policy.

VII. PENALTIES

With the exception of Australia, China, Korea, New Zealand and the United States, all other countries included in this survey do not levy specific penalties on transfer pricing violations. Most countries apply instead the regular income tax penalties to transfer pricing cases.

As illustrated in Table 4 of this article, OECD countries with penalty provisions, normally impose penalties of less than 100 per cent of the additional tax due in cases not involving gross negligence or fraud, except in Belgium, Italy and Spain where penalties may go as high as 200 per cent. By contrast, in several emerging nations, penalties generally start at 100 per cent of the additional tax due and go as high as 400 per cent. In both OECD and emerging countries, however, the high-end penalties tend to apply primarily to gross negligence cases.

The penalties presented in this survey are those penalties that apply to cases in which there is additional tax due as a result of understated income due to the improper use of transfer prices. All other situations (i.e. non-filing of tax return, late filing etc.) are not contemplated here, although the same penalties may also apply to some of these cases.

VIII. CONCLUSIONS

The major differences in transfer pricing legislation are between OECD and emerging nations, although rules also vary among OECD countries. At one extreme is the majority of emerging nations with no transfer pricing laws. At the other extreme are several OECD countries (and a few emerging nations) with detailed legislation. In between lie most OECD countries with general rules.

With respect to transfer pricing methods, there is consensus between OECD and emerging countries on the use of the CUP method. Most emerging nations, however, remain unclear about the use of other transfer pricing methods. OECD countries continue to be divided about the appropriateness of the profit methods, although they agree almost unanimously on the use of the traditional transaction-based methods.

In the area of APAs and documentation, a two-track system has developed. On the one hand the OECD and emerging countries with detailed transfer pricing legislation have APAs and specific documentation provisions. On the other hand OECD and emerging nations with general transfer pricing legislation have no APAs and no specific documentation requirements.

As far as penalties are concerned, the vast majority of OECD and emerging countries apply the regular income tax penalties to transfer pricing violations, while few levy specific transfer pricing penalties. In either case, the penalties imposed in most emerging nations are substantially higher than in OECD countries.

While standard transfer pricing rules would be in the best interest of all trading nations, discrepancies continue to exist among OECD countries, and most significantly between OECD countries and emerging nations. Thus, uniformity on a worldwide basis is far from sight. However, among OECD countries, the goal of standardized rules is much closer to being achieved largely as a result of the OECD's efforts. In the years ahead, the critical challenge will be to close the gap between OECD countries and emerging nations, particularly as the latter continue to increase their share of world trade.

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Table 1: LEGISLATION

OECD COUNTRIES	*DOES YOUR COUNTRY HAVE SPECIFIC TRANSFER PRICING LAWS?*
AUSTRALIA	Yes, under Income Tax Assessment Act (ITAA), Part III, Division 13 enacted 1981.
AUSTRIA	No. However, Austria follows OECD guidelines.
BELGIUM	No. However, the general anti-avoidance provisions apply under Art. 26 Internal Tax Code (ITC) enacted 1938, and last amended 1989 and 1992; Art. 54 ITC enacted 1954 and last amended 1992; and Art. 344 ITC enacted 1954 and last amended 1993.
CANADA	Yes, under Income Tax Act, subsecs. 69(2), 69(3) enacted 1971.
DENMARK	Yes, under Company Taxation Act, Sec. 12; State Taxation Act of 1922, Secs. 4, 5 and 6. Also, under 1983 Circular issued by Inland Revenue Directorate, Denmark follows OECD guidelines.
FRANCE	Yes, under French Tax Code, Arts. 57, 209B and 238A first enacted 1933.
GERMANY	Yes, under Sec. 8II AStG first enacted 1920 and last amended 11 March 1991; BGBi 1991, I p.638; Sec. 1 AStG 8 Sept. 1972 and BGBi 1972, I p.1713; Administrative Principles 23 Feb. 1983 and BStBi 1983, I p.218.
IRELAND	Yes, under Income Tax Act of 1967 (ITA), Sec. 202 first enacted 1918.
ITALY	Yes, under Art. 76 of Presidential Decree of 22 Dec. 1986, No. 917. Ministerial Instruction N9/2264 of 22 Sept. 1980.
JAPAN	Yes, under Special Taxation Measures Law (STML), Art. 66-4 enacted 1986.
LUXEMBOURG	No. However, Luxembourg follows OECD guidelines.
MEXICO	Yes, under Income Tax Law, Arts. 64, 64-A and 65.
NETHERLANDS	No. However, the Netherlands follows OECD guidelines.
NEW ZEALAND	Yes, under Income Tax Act, sGD13 and revised sGC1 of December 1995.
NORWAY	No. However, the general related party provisions apply under General Tax Act, Sec. 54.1.
PORTUGAL	Yes, under Corporate Income Tax Code (CITC), Art. 57 enacted 1989.
SPAIN	Yes, under Corporate Income Tax Act, Law 43/1995, Sec. 16 enacted January 1996.
SWEDEN	No. However, the general tax provisions apply under Municipal Tax Act, Sec. 43.1 enacted 1928 and last amended 1984.
SWITZERLAND	No.
UNITED KINGDOM	Yes, under Tax Act of 1988, Sec. 770 first enacted 1952.
UNITED STATES	Yes, under Internal Revenue Code, Sec. 482 and Treasury Regulations 1.482 first enacted 1928 and last amended 1994. Final cost sharing regulations under Sec. 482 issued December 1995.

Table 1 (Cont'd) LEGISLATION

EMERGING MARKETS	*DOES YOUR COUNTRY HAVE SPECIFIC TRANSFER PRICING LAWS?*
ARGENTINA	No. However, the general related party provisions apply under Art. 8 of Income Tax Law enacted 1943.
BRAZIL	No. However, the general related party provisions apply under Income Tax Decree 1041 of Nov. 1994.
CHILE	No.
CHINA	Yes, under Art. 13 of Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises (FEIT Law) adopted April 1991; Arts. 52-58 of the Regulations for the Implementation of FEIT Law promulgated June 1991; Art. 24 of Law Concerning the Administration of Tax Collection (Tax Collection Law) adopted Sept. 1992; Arts. 36-41 of the Regulations for the Implementation of Tax Collection Law promulgated August 1993.
CZECH REPUBLIC	No. However, the general related party provisions apply under Income Tax Act, Sec. 23(7) enacted 1993.
HONG KONG	No. However, the general related party provisions apply under Sec. 20(2) of Inland Revenue Ordinance (IRO) enacted 1947 and amended 1955 and 1986.
INDIA[1]	No.
INDONESIA	No. However, the general related party provisions apply under Income Tax Law No. 10 of 1994.
KOREA	Yes, under the International Tax Law (ITL) enacted 1995.
MALAYSIA	No.
POLAND	No. However, the general related party provisions apply under Art. 11 of the Corporate Income Tax Act enacted February 1992.
SINGAPORE	No. However, the general anti-avoidance rules apply.
TAIWAN	No. However, the general anti-avoidance provisions apply under Art. 43-1 of Income Tax Law enacted 1971, and Art. 22 of Rules Governing the Assessment of Profit-Seeking Enterprises Income Tax.
THAILAND	No. However, the general related party provisions apply under Sec. 65 bis(4), (7) of the Revenue Code of Thailand (RCT).

1. Information on India was provided by Mr Akhilesh Prasad, Director of Tax Policy and Legislation, Ministry of Finance of India.

Table 2: METHODS

WHICH OF THE FOLLOWING TRANSFER PRICING METHODS ARE ACCEPTED BY THE TAX AUTHORITIES?						
OECD COUNTRIES	CUP[2]	COST PLUS[3]	RESALE PRICE[4]	PROFIT SPLIT[5]	CPM[6]/ TNMM[7]	GLOBAL APPORT[8]
AUSTRALIA	Yes	Yes	Yes	Yes	Yes	No
AUSTRIA	Yes	Yes	Yes	No	No	No
BELGIUM	Yes	Yes	Yes	No	Yes	No
CANADA	Yes	Yes	Yes	Yes	No	No
DENMARK	Yes	Yes	Yes	Unclear	Yes	Unclear
FRANCE	Yes	Yes	Yes	Yes	No	Yes[10]
GERMANY	Yes	Yes	Yes	Yes[9]	Yes[9]	No
IRELAND	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
ITALY	Yes	Yes	Yes	Unclear	Unclear	Unclear
JAPAN	Yes	Yes	Yes	Yes	No	No
LUXEMBOURG	Yes	Yes	Yes	Unclear	Unclear	Unclear
MEXICO	Yes	Yes	Yes	No	No	Yes[10]
NETHERLANDS	Yes	Yes	Yes	Yes	Yes	No
NEW ZEALAND	Yes	Yes	Yes	Yes	Yes	Unclear
NORWAY	Yes	Yes	Yes	No	No	No
PORTUGAL	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
SPAIN	Yes	Yes	Yes	Yes	No	No
SWEDEN	Yes	Yes	Yes	Unclear	Unclear	Unclear
SWITZERLAND	Yes	Yes	Yes	Yes	Yes	Yes[10]
UNITED KINGDOM	Yes	Yes	Yes	Yes	Yes	No
UNITED STATES	Yes	Yes	Yes	Yes	Yes	No

2. Comparable Uncontrolled Price (CUP) Method
A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

3. Cost Plus Method
A transfer pricing method using the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate gross margin (cost plus mark up) is then added to this cost to make an appropriate profit in light of the functions and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

4. Resale Price Method
A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by an appropriate gross margin (resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product as an arm's length price of the original transfer of property between the associated enterprises.

5. Profit Split Method
A profit split method identifies the profit to be split for the associated enterprises from a controlled transaction, and then splits those profits between the associated enterprises based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Table 2 (Cont'd): METHODS

WHICH OF THE FOLLOWING TRANSFER PRICING METHODS ARE ACCEPTED BY THE TAX AUTHORITIES?						
EMERGING MARKETS	*CUP*	*COST PLUS PRICE*	*RESALE SPLIT*	*PROFIT APPORT.*	*CPM/TNMM*	*GLOBAL*
ARGENTINA	Yes	Unclear	Unclear	No	No	No
BRAZIL	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
CHILE	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
CHINA	Yes	Yes	Yes	Unclear	Unclear	Unclear
CZECH REPUBLIC	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
HONG KONG	Yes	Yes	Yes	Unclear	Unclear	Unclear
INDIA	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
INDONESIA	Yes	Yes	Yes	Yes	Yes	Yes
KOREA	Yes	Yes	Yes	Yes	Yes	No
MALAYSIA	Yes	Yes	Unclear	Unclear	Unclear	Unclear
POLAND	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
SINGAPORE	Yes	Unclear	Unclear	Unclear	Unclear	Unclear
TAIWAN	Yes	Yes	Yes	Unclear	Unclear	Unclear
THAILAND	Yes	Yes	No	No	No	No

(footnotes continued)

6. Comparable Profits Method (CPM)
A profit method that determines the level of profits that would have resulted from a controlled transaction, if the net return on those transactions (as indicated by various profit measures such as return on assets, operating income to sales and other suitable financial ratios) were equal to the return realized by a comparable independent enterprise.

7. Transactional Net Margin Method (TNMM)
A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction. TNMM, as described in the 1995 OECD guidelines, is meant to be essentially similar to CPM. Therefore, throughout this article, the author refers to CPM/TNMM.

8. Global Formulary Apportionment Method
A method to allocate the global profits of a multinational enterprise on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula normally based on assets, payroll or sales.

9. Germany allows the use of profit split and TNMM as methods of last resort. CPM, however, is not an accepted method.

10. For transactions with permanent establishments only.

Table 3: DOCUMENTATION AND APAs

OECD COUNTRIES	*IN ADDITION TO THE REGULAR BOOKS AND RECORDS AND CONTRACTUAL AGREEMENTS, WHAT SPECIFIC TRANSFER PRICING DOCUMENTATION IS REQUIRED?*	*ARE ADVANCE PRICING AGREEMENTS PERMITTED?*
AUSTRALIA	Contemporaneous documentation including pricing policies, list of comparables, functional analysis, assessment of methods, list of related party transactions (ITAA, Sec. 262A).	Yes (TR 95/23)
AUSTRIA	None.	No.
BELGIUM	None.	No, but advance ruling is available.
CANADA	Pricing policies, list of comparables, functional analysis, assessment of methods, details of related party transactions.	Yes (Information Circular 1C 94-4, Revenue Canada Guidelines).
DENMARK	None.	No, but advance ruling is available.
FRANCE	None.	No.
GERMANY	None, although there is a tendency towards greater documentation requirements.	Yes, but on a limited application basis (Secs. 204-207, AO).
IRELAND	None.	No.
ITALY	None.	No.
JAPAN	None.	Yes (Circular 5-1, 1987-4).
LUXEMBOURG	None.	No, but advance ruling is available.
MEXICO	None.	No, but advance ruling is available.
NETHERLANDS	None.	No, but advance ruling is available.
NEW ZEALAND	OECD guidelines apply until specific regulations are issued.	Yes, beginning 1996/1997.
NORWAY	None.	No.
PORTUGAL	None.	No.
SPAIN	None.	Yes (Sec. 16.6 of Law 43/1995).
SWEDEN	None.	No.
SWITZERLAND	None.	No, but advance ruling is available.
UNITED KINGDOM	None.	Yes.
UNITED STATES	Contemporaneous documentation including pricing policies, list of comparables, economic analysis, assessment of methods, description of organizational structure, list of controlled transactions (Treas. Regs. 1.6662-6(d)(2)(iii) & (3)(iii)).	Yes (Rev. Proc. 91-22)

Table 3 (Cont'd): DOCUMENTATION AND APAs

EMERGING MARKETS	*IN ADDITION TO THE REGULAR BOOKS AND RECORDS AND CONTRACTUAL AGREEMENTS, WHAT SPECIFIC TRANSFER PRICING DOCUMENTATION IS REQUIRED?*	*ARE ADVANCE PRICING AGREEMENTS PERMITTED?*
ARGENTINA	None.	No.
BRAZIL	None.	Unclear
CHILE	None.	Unclear
CHINA	Annual report on transactions between foreign investment enterprises/foreign enterprises and associated enterprises.	No
CZECH REPUBLIC	None.	No.
HONG KONG	None.	No, but advance ruling is available (Secs. 61A, 61B of IRO).
INDIA	None.	No, but advance ruling is available.
INDONESIA	Audited financial statements of head office are required together with a detail of turnover and head office expense allocated to each subsidiary and branch.	No
KOREA	Contemporaneous documentation including pricing policy for intra-group transactions; summary of third party comparables; statement of functions performed and risk assumed by related parties; list and status of overseas related parties.	Yes, beginning in 1997
MALAYSIA	None.	No, but advance ruling is available.
POLAND	None.	No.
SINGAPORE	None.	No.
TAIWAN	None.	No.
THAILAND	None.	No.

Table 4: PENALTIES

OECD COUNTRIES	*WHAT PENALTIES APPLY SPECIFICALLY TO TRANSFER PRICING CASES?*
AUSTRALIA	In cases of tax avoidance, 50% of additional tax due if there is no reasonably arguable position (RAP), and 25% if there is RAP. Other cases, 25% of additional tax due if no RAP, and 10% if there is RAP (Sec. 225 of the ITAA).
AUSTRIA	None, unless fraud is involved.
BELGIUM	Same as regular penalties of 10%-200% of additional tax due (Art. 444 ITC and Art. 225 Royal Decree on ITC).
CANADA	None. However, regular interest penalty applies at prescribed rates.
DENMARK	None.
FRANCE	None. However, monthly interest applies equal to 0.75% of understated income. Also, the understated income is treated as a dividend subject to withholding tax at 25% or applicable treaty rate.
GERMANY	None. However, regular late payment fines and interest charges apply.
IRELAND	Monthly interest equal to 1.25% of additional tax due (Sec. 550 ITA & Sec. 14 of Finance Act of 1988).
ITALY	100%-200% of additional tax due (Art. 46 of Presidential Decree 29 Sept. 1975 No. 600).
JAPAN	Same as regular income tax penalties of 5%-10% of additional tax due (General Rule 65), plus delinquency tax of 14.6% per annum (General Rule 60).
LUXEMBOURG	None, unless fraud is involved.
MEXICO	Same as regular penalties of up to 100% of additional tax due, plus interest at the prescribed rates, plus adjustment for inflation on additional tax due (Federal Tax Code).
NETHERLANDS	Same as regular penalty for filing incorrect tax return. In cases of gross negligence, up to 100% of additional tax due.
NEW ZEALAND	General regime is introduced from 1996/1997 with penalties ranging from 20%-100% plus interest.
NORWAY	Same as regular penalties for filing incorrect tax return. In regular cases, 30% of additional tax due. In cases of gross negligence, up to 60% of additional tax due.
PORTUGAL	Unspecified penalties plus compensatory annual interest equal to the basic rate of the Bank of Portugal plus 5% (Income Tax Code, Art. 80 and Tax Penalties Code).
SPAIN	Same as regular penalty of 35% of understated income, plus 35%-150% of additional tax due, plus late payment interest (Secs. 82 and 88 of Law 230/1963, modified by Law 25/1995).
SWEDEN	Same as regular penalty of 40% of additional tax due in cases of incorrect information. In cases of income/deductions reported in wrong period, 20% of additional tax due.
SWITZERLAND	None, unless fraud is involved.
UNITED KINGDOM	Penalties of up to 100% of additional tax due in case of fraud (TMA 1970, Sec. 95). No penalties in other cases. Interest, however, applies in all cases at commercial rates (TMA 1970, Sec. 88).
UNITED STATES	In cases of substantial valuation misstatement, 20% of underpayment. In cases of gross valuation misstatement, 40% of underpayment (Treas. Regs. 1.6662-6(b) and (c)).

Table 4 (Cont'd): PENALTIES

EMERGING MARKETS	*WHAT PENALTIES APPLY SPECIFICALLY TO TRANSFER PRICING CASES?*
ARGENTINA	Unclear.
BRAZIL	Unclear.
CHILE	Unclear.
CHINA	Distributions to foreign associated enterprises may be treated as dividends not entitled to withholding tax exemption. Failure to comply with documentation requirements carries a penalty between CNY 2,000 and CNY 10,000 (Art. 39 of the Tax Collection Law).
CZECH REPUBLIC	Same as the regular income tax penalty of 0.2% per day of additional tax due.
HONG KONG	Same as regular penalty for filing incorrect tax return: 300% of additional tax due plus HKD 5,000 (Sec. 80 IRO).
INDIA	None.
INDONESIA	Same as regular income tax penalties of 2% per month of additional tax due for up to 24 months. In case of negligence, up to one year detention and up to 200% of additional tax due. In case of wilful evasion, up to six years imprisonment and 400% of additional tax due.
KOREA	If taxable income is understated, 10% of additional tax due. If tax is underpaid, the greater of 10% of unpaid taxes or 0.04% per day (0.03% after 2 years) of unpaid tax. Under-reporting penalties may be waived if taxpayer has contemporaneous documentation. If taxpayer fails to submit pricing data to the tax authorities within 60-day time limit (plus additional 60-day extension period), a penalty of up to 30 million Korean won (approx. USD 40,000) applies.
MALAYSIA	Same as regular income tax penalties. Cases involving technical adjustments do not attract penalties. Other cases, 100% of additional tax due. In cases of wilful evasion, 300% of additional tax due and/or imprisonment.
POLAND	Same as regular income tax penalty of 0.14% per day of additional tax due, adjusted for inflation.
SINGAPORE	Same as regular penalties for filing an incorrect income tax return. In regular cases, 100% of additional tax due. In cases of negligence, 200% of additional tax due plus USD 5,000 or up to 3 years imprisonment. In cases of wilful evasion, 300% of additional tax due plus USD 10,000 or up to 3 years imprisonment (Secs. 95 and 96 of the Singapore Income Tax Act).
TAIWAN	None. However, penalties apply in cases of tax evasion.
THAILAND	Same as regular income tax penalty of 200% of additional tax due (RCT Sec. 26) plus monthly surcharge of 1.5% of additional tax due (RCT Secs. 27 and 67).

Documents drawn up by Guillermo Campos, Harvard University
Source: Deloitte & Touche

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BELGIUM

HYBRID ENTITIES FROM A US PERSPECTIVE*

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* In the first of two articles, examining the phenomenon of hybrid entities, Kurt Debrier examines the classification of Belgian entities from a US perspective. The second article will focus on US entities from a Belgian perspective.

I. INTRODUCTION

In the last few years the use of hybrid entities in international tax planning has increased dramatically. Especially in the United States, hybrid entities are used extensively in a variety of situations to accomplish a variety of tax goals (foreign tax credit planning, foreign loss utilization, etc.) This article focuses on the classification of Belgian entities from a US perspective.

A hybrid entity is defined as an entity which is taxed as a corporation in its home jurisdiction but viewed as a flow-through entity in another jurisdiction, or an entity which is treated as a flow-through in its home jurisdiction but considered a corporation by the second jurisdiction. Thus, for US–Belgium purposes, a Belgian commercial corporation (which is taxed in Belgium as a corporation) is a hybrid if that entity is viewed in the United States as a partnership. Conversely, a US partnership (which is taxed in the United States as a flow-through entity) is a hybrid, if the partnership is viewed in Belgium as a corporation.

The criteria which are used in the United States to classify a Belgian entity are fundamentally different from the ones which are used in Belgium to classify a US entity. In both countries however, the tax status in the home jurisdiction is irrelevant.

II. RELEVANCY FROM A TAX PERSPECTIVE

The main tax benefits which US investors may achieve by investing in non-US organizations that are treated as partnerships for US purposes are set out below.[1]

A. Foreign loss utilization

A US company cannot offset the losses of its foreign subsidiaries against its own income. If, however, the foreign subsidiary is a hybrid, it will be considered for US purposes to be a branch of the US company. Any losses generated by the foreign subsidiary will then therefore be treated as losses of the parent company.

As a counterpart, if in the future the losses are used in the foreign jurisdiction or another "triggering event", such as dehybridizing the subsidiary, occurs, the US company must recapture the previously deducted losses. However, the clawback costs associated with recapture of the losses may be mitigated where the subsidiary is located in a high tax jurisdiction and its income (against which the losses are used) is covered by foreign tax credits.

The above strategy is only appropriate where the US company has several foreign operations since, under the foreign loss recapture rules, at least 50 per cent of the income in profitable years is recharacterized as US source to the extent its losses have offset US source income in the past, if the hybrid is the *sole* source of foreign source income.

It should be noted that hybridizing may also make sense in low tax jurisdictions, as a means of sheltering Subpart F income. Where a foreign subsidiary with Subpart F income has a subsidiary with non-Subpart F start-up losses, then the earnings of the second subsidiary will be combined with those of its parent, if the loss company is hybridized. The down-side is that future profits of the loss making company may be recaptured as Subpart F income.

B. Foreign tax credit planning

The US foreign tax credit regime contains pitfalls such as the limitation of deemed-paid credits to the first three tiers of foreign subsidiaries, the restriction of the deemed paid credit to corporate investors, and the "10-50" basket. By using hybrid entities, each of these problems may be overcome.

1. Foreign tax credit tiers

The US method for avoiding double taxation of foreign source income is the direct foreign tax credit and the indirect or "deemed paid" foreign tax credit. The deemed paid credit allows a US corporate taxpayer to claim credits for taxes paid by its non-US subsidiaries, which meet certain ownership requirements. The deemed paid credit for taxes paid by non-US corporations is however only permitted three tiers down

1. For a more detailed analysis of the tax benefits of hybrid entities, reference is made to "Hybrid Entities" by James J. Tobin and William Seto, 48 *Bulletin for International Fiscal Documentation* 6/7 (1994), at 315-319.

the chain. Hybrid entities, because they are considered partnerships for US purposes, do not count as a tier in the chain of ownership (they rather represent branches of their shareholders). Each entity in a direct chain of ownership which is hybridized therefore eliminates a tier.

In some cases (e.g. the purchase of an existing non-US group), there may already be a four or more tier structure. One way to remove a tier without collapsing the structure and without incurring major taxation costs is to convert it to a partnership for US purposes.

2. Obtaining foreign tax credits for non-corporate investors

In the US, deemed paid tax credits are available only to the corporate shareholders of a foreign company. A US individual investing in a foreign corporation will therefore suffer a very high rate of tax on distributed profits from a foreign corporation.

However, a US individual investor in a foreign partnership, can claim a direct credit since the partner is considered to have paid the foreign taxes (i.e. his pro rata share of taxes imposed on the partnership) directly.

3. Avoiding the "10-50" problem

To determine a US taxpayer's entitlement to foreign tax credit, its foreign source income must be divided into various categories of income called "foreign tax credit baskets". The amount of the credit is limited to the sum of the credits allowed pursuant to the US rules as they apply to *each* of the baskets. One such basket is created for *each* "10/50" company.[2] This rule effectively denies a US taxpayer the ability to average high or low effective tax rates incurred by its 10/50 companies against other income of the taxpayer including income generated by other 10/50 companies within the group. When a US company has a 10 percent or greater interest in a foreign partnership however, look-through treatment generally applies to income from the partnership. This means that the foreign taxes may be blended with credits from other sources.

C. Avoidance of the 70 per cent full inclusion rule

Subpart F provides that where 70 per cent or more of a foreign corporation's gross income is Subpart F income, all of its income will be considered Subpart F income. In some cases, hybridizing may help to avoid the application of the 70 per cent full inclusion rule. For example, where a foreign holding company has two subsidiaries, one of which generates at least 70 per cent Subpart F income, while the other generates non-Subpart F income, each of the foreign subsidiaries is tested separately for purposes of the 70 per cent full inclusion rule. This means that, even if the group as a whole may generate less than 70 per cent, all of the first subsidiary's income would be considered Subpart F income. If the two subsidiaries were hybridized, the entity to be tested for purposes of the 70 per cent test (and all other Subpart F purposes) would be the holding company, whose earnings would include the earnings of both of its subsidiaries.

D. PFIC planning

A foreign company is considered a passive foreign investment company (PFIC) if either its income or its assets are deemed to be excessively passive. 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.

Hybridizing the foreign subsidiary may avoid classification as a PFIC. As a hybrid, the entity would be treated as a branch of its parent company, so that 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.

III. CLASSIFICATION IN THE UNITED STATES

A. Preliminary observation

On 8 May 1996, the IRS issued proposed regulations that would replace the existing regulations for classifying certain business organizations with an elective regime.

The Treasury Department and the IRS propose to replace Reg. § 301.7701-1 through 301.7701-3 to clarify which organizations are classified as corporations automatically under the Internal Revenue Code and to provide a simple elective regime for classifying other business organizations. The proposed regulations specify those business entities that automatically are classified as corporations for federal tax purposes. Any other business entity that is recognized for federal tax purposes may choose its classification.

The simplified system provided under the proposed regulations extends to foreign organizations as well. The proposed regulations classify as corporations certain foreign business entities that are listed in the regulations. The foreign business entities that appear on this list will *always* be classified as corporations. In Belgium's case only the NV is included on the list.

For the business entities that are not required to be classified as a corporation ("eligible entities"), the proposed regulations provide default classification rules that aim to match expectations. An eligible entity that wants the default classification needs to file an election. A foreign eligible entity is a partnership if it has two or more members and any member has unlimited liability. Only if all of the entity's members have limited liability will the entity's default classification be "association". In this respect, it is mentioned that a member of a foreign eligible entity has unlimited liability if the member has personal liability for the debts of or claims against the entity, by reason of being a member, based solely on the statute or law pursuant to which the entity is organized.

2. A 10/50 company is a non-US company in which the US taxpayer owns 10% or more but not more than 50% of the vote or value of the stock of such company.

Under the proposed regulations, the BVBA and the CVBA would normally be classified as a corporation, while the CVOA, the VOF, the GCV and the CVA would normally be classified as a partnership. (See below.)

A public hearing concerning the proposed regulations has been scheduled for 21 August 1996.

B. Criteria

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. Code Section 7701 (a) (2) defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation". Regulation Sections (Reg. §) 301.7701-2 and 301.7701-3 provide the guidelines for determining whether an organization will be classified as a partnership or as an association taxable as a corporation for federal tax purposes. Reg. § 301.7701-2 (a) (1) sets forth six basic characteristics of an association that will result in it being taxable as a corporation. The six characteristics (the so-called "Morrissey factors" set forth by the US Supreme Court in *Morrissey v. Commissioner*) are:[3]

- the presence of associates;
- an objective to carry on business and divide gains therefrom;
- continuity of life;
- centralization of management;
- limited liability and;
- free transferability of interests.

The classification of an organization will be determined by taking into account the presence or absence of each of these corporate characteristics. Reg. § 301.7701-2 (a) (2) provides that characteristics that are common to both partnerships and corporations are not relevant in determining if an entity is to be classified as a partnership or a corporation for federal income tax purposes. Thus, because partnerships and corporations both generally have associates and an objective to carry on business and divide the gains, these characteristics will not be relevant in determining whether an entity is to be taxed as a partnership or a corporation. The only characteristics relevant to the determination are therefore:

- continuity of life;
- centralization of management;
- limited liability and;
- free transferability of interests.

An entity will be classified as an association taxable as a corporation, if it possesses at least three of the four relevant corporate characteristics. Conversely, an entity will be classified as a partnership, if it has no more than two of the four relevant corporate characteristics.[4]

On 28 December 1994, the IRS issued Revenue Procedure (Rev. Proc.) 95-10 which establishes guidelines for obtaining private letter rulings on the classification of domestic or foreign LLCs as partnerships for federal income tax purposes. Rev. Proc. 95-10 applies to all organizations that are formed as LLCs under the laws of the United States, and to all organizations formed under foreign law when the foreign law provides for or allows limited liability to any of an LLC's members. Rev. Proc. 95-10 follows the partnership classification criteria set forth in Reg. § 301.7701 and applies these criteria to LLCs. The guidelines set forth in Rev. Proc. 95-10, however, may be more restrictive than the existing substantive law. Although Rev. Proc. 95-10 does not have the force and effect of a regulation, it offers valuable assistance in drafting LLC operating agreements by providing specific guidance on how far to extend the applicable LLC requirements without tempting the IRS to challenge the classification. This article will therefore quote Rev. Proc. 95-10 in so far as it could be relevant for the classification of Belgian commercial corporations.

Below follows a brief analysis of the four characteristics that are relevant in distinguishing between a partnership and a corporation.

1. Continuity of life

Under Reg. § 301.7701-2 (b) (1), an entity has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause dissolution of the entity. The reference to "any member" suggests that a specified dissolution event only needs to apply to a single owner of an entity. Also, since the regulation is stated in the disjunctive, it suffices that the occurrence of only one of the events triggers dissolution.

In Rev. Proc. 95-10, the IRS takes a more restrictive view of the requirements. Rev. Proc. 95-10 (Section 5.01 (4)) states that if fewer than all of the dissolution events are provided for, the Service will not rule that partnership classification exists unless there is a "meaningful possibility of dissolution". However, Rev. Proc. 95-10 does not explain what constitutes a meaningful possibility of dissolution. Some dissolution events (such as death for natural persons) should clearly meet the meaningful possibility standard. Satisfying the standard may be more difficult for corporate members of an LLC. The death or insanity of such entities would for example never be meaningful. In view of Rev. Proc. 95-10, taxpayers who are attempting to achieve partnership characterization should therefore include in the operating agreement all the dissolution events specified in the regulations, or should only include events that are realistic.

With regard to the members to whom the dissolution events should apply, Rev. Proc. 95-10 provides that the Service will not issue a ruling that the entity lacks continuity of life unless all members are subject to the specified dissolution events. In addition, Rev. Proc. 95-10 makes the distinction between dissolution events relating solely to member-managers and events relating to members. If the controlling statute or the operating agreement provides that the death, insanity, bankruptcy, retirement, resignation or expulsion of any member-manager causes dissolution (unless continued by the con-

3. 296 US 344 (1935).
4. See Reg. §301.7701-2; see also *Larson v. Commr*, 66 TC 159, 185 (1976) *acq* 1979-1 CB 448.

sent of not less than a majority of the remaining members), the Service will generally rule that the LLC lacks continuity of life. For this to apply it is only required that all member-managers must be subject to the dissolution events. The events therefore may be tied solely to all of the members-managers.

2. Centralization of management

Under Reg. § 301.7701-2 (c) (1), an entity has centralized management if any person (or any group of persons that does not include all of the members), has continuing exclusive authority to make the management decisions necessary to conduct the business of the entity.

To avoid centralized management, it is necessary that all members be able to bind the entity. Furthermore, that power should be exercisable in the members' capacity as members, as distinct from their capacity as managers. Reference can be made to Revenue Ruling 93-6, 1993-1 CB 229, where the IRS found that a Colorado LLC in which all of the members were designated as managers, possessed centralized management. The IRS distinguished between management authority following from the members' status as managers, rather than from their equity interests as members, and ruled that the LLC had centralized management because the members managed the LLC in their capacity as appointed managers rather than as owners of the LLC.[5]

3. Limited liability

Under Reg. § 301.7701 - 2 (d) (1), an entity has limited liability if there is no member who is personally liable for the debts or claims against the entity. Personal liability means that a creditor of an entity may seek personal satisfaction from a member of the entity to the extent that the assets of such entity are insufficient to satisfy the creditor's claim.

Rev. Proc. 95-10 provides that the IRS will generally rule that an LLC lacks limited liability if at least one member validly assumes personal liability for all obligations of the LLC "pursuant to express authority granted in the controlling LLC statute". This means that the voluntary assumption of liability by a member does not suffice. To obtain a ruling that an LLC lacks limited liability, the members assuming the liabilities of the LLC must also satisfy additional requirements (minimum ownership, net worth, substantial assets other than the interest in the LLC).

4. Free transferability of interests

Under Reg. § 301.7701-2 (e) (1) an entity has the corporate characteristic of free transferability of interests, if each of its members, or those members owning substantially all of the interests of the entity, have the power without the consent of the other members, to substitute for themselves in the same entity a person who is not a member of the entity.

The regulations also provide that free transferability will not exist if, under local law, a transfer of a member's interest will result in the dissolution of the entity. A taxpayer who wishes to achieve partnership classification should ensure that the Articles of association provide that the ownership interests in the foreign entity are not transferable without obtaining the prior consent of the other members.

But what if the consent requirement is limited? Rev. Proc. 95-10 provides that the Service will not rule that the LLC lacks free transferability of interests unless the power to withhold consent to the transfer constitutes a meaningful restriction on the transfer. Suppose that the transfer can occur without prior consent, but only to a transferee that satisfies certain standards. In such case, it will depend on whether there are other potential transferees that meet that requirement, to determine whether the conditions of Rev. Proc. 95-10 are met. If there are no such other potential transferees, it appears to be possible to argue that there is a meaningful restriction on the ability to transfer the interest in the foreign entity. Rev. Proc. 95-10 further provides that for LLCs that have designated or elected one or more members as managers, the IRS will generally rule that the LLC lacks free transferability of interests if the controlling statute or the operating agreement provides that each member or at least those members owning more than 20 per cent of all interests in the LLC's capital, income, gains, losses, deductions and credits do not have the power to confer upon a non-member all the attributes of the members' interest in the LLC without the consent of a "majority" of the non-transferring member-managers. If the members of the LLC do not designate or elect one or more members as managers, the IRS will generally rule that the LLC lacks free transferability of interests if the consent of a "majority" of the non-transferring members is required for each member or those owning a greater than 20 per cent interest to transfer an interest in the LLC.

C. Application to Belgian commercial corporations

Article 1832 of the Belgian Civil Code (BCC) gives the following definition of a company under Belgian law: "A company can be established by two or more parties who agree to carry out something in common with a view to sharing the benefit which may result therefrom or, in the cases determined by law, by one single party who sets aside goods to conduct a specific activity".

The Belgian Coordinated Laws on Commercial Companies (CLCC) quote several forms of commercial companies in Belgium:
- the public limited liability company (*Naamloze Vennootschap / Société Anonyme*);
- the closely held limited liability company (*Besloten Vennootschap met Beperkte Aansprakelijkheid / Société Privée à Responsabilité Limitée*);
- the cooperative company with limited liability (*Coöperatieve Vennootschap met Beperkte Aansprakelijkheid / Société Cooperative à Responsabilité Limitée*);
- the cooperative company with unlimited liability (*Coöperatieve vennootschap met Onbeperkte Aansprakelijkheid / Société Cooperative à Responsabilité Illimitée*);

5. See Harris & Writz, "Corporate Governance, Limited Liability Companies and the IRS's View of Centralized Management", 4 *Taxes* (April 1993), at 225, for a discussion on Revenue Ruling 93-6.

- the general partnership (*Vennootschap onder Firma / Société en Nom Collectif*);
- the limited partnership (*Gewone Commanditaire Vennootschap / Société en Commandite Simple*);
- the limited company with shares (*Commanditaire Vennootschap op Aandelen / Société en Commandite par Actions*).

All these companies have a distinct legal personality, and are subject to the Belgian corporate income tax regime. The Commercial Code also lists business enterprises which do not have legal personality. These enterprises will not be examined, since they are subject to taxation in Belgium as flow-through entities.

Each of the above Belgian commercial corporations will be analysed to determine whether they can be classified as a partnership in the United States. In this regard, particular attention will be paid to the impact that the drafting of the operating agreement can have on the outcome of the determination. As a preliminary observation, it should be mentioned that Rev. Proc. 95-10 applies to all of these corporations, except the VOF and the CVOA.[6]

D. The limited liability company (NV)

1. Definition

The NV is a company in which the shareholders' potential liability is normally limited to the capital they contributed to the company.[7]

2. Partnership characteristics of an NV

(a) *Continuity of life*

The death, insanity, bankruptcy, retirement, resignation or expulsion of a shareholder will not automatically result in the dissolution of the company. However, it is possible to provide for the opposite in the Articles of Association. It would therefore be possible to draft the Articles in such a way that the NV lacks continuity of life.

(b) *Centralization of management*

Complete authority to make management decisions in an NV is vested in the Board of Directors. The Board of Directors should make decisions collectively. This does not exclude however, the possibility of granting the authority of making management decisions to one or more Directors by a power of attorney.[8] Even in the event that all shareholders are appointed directors and that each director is given the authority to take management decisions, such authority would be derived from the position of director and not shareholder. This point of view is supported by the fact that if a shareholder/director took a business decision in his capacity as shareholder, the decision would be null and void. Since in order to avoid centralized management, all members should be able to bind the entity, and that this power should be exercisable in the members' capacity as members, as distinct from managers, it will not be possible for the NV to avoid centralized management.

(c) *Limited liability*

The shareholders only commit their own contribution.

(d) *Free transferability of interests*

In the NV, the shares are freely transferable. The only exceptions concern preferential rights given to existing shareholders and approval clauses provided for in the Articles of Association. However, even in these exceptions the non-transferability of the shares can not exceed a period of three months.

(e) *Conclusion*

It is not possible for a Belgian NV to be classified as a partnership for US tax purposes, since it will always possess three of the four relevant corporate characteristics.

E. The closely held limited liability company (BVBA)

1. Definition

The BVBA is a company incorporated by one or more parties who only commit their own contribution and in which the rights of the partners can only be transferred under specific conditions.[9]

2. Partnership characteristics of a BVBA

(a) *Continuity of life*

In principle, the death, insanity, bankruptcy, retirement, resignation or expulsion of a partner will not automatically result in the dissolution of the company. However, it is possible to provide for the opposite in the Articles of Association. In order to comply with the rules laid down in Rev. Proc. 95-10, all possible dissolution events should be provided for, or where fewer than all of the dissolution events are provided for, there should be a meaningful possibility of dissolution. It is important to ensure that all partners (or at least the partners-managers) are subject to the dissolution events.

(b) *Centralization of management*

The general meeting of the BVBA's shareholders will appoint one or more managers, who have the authority to take all actions necessary to accomplish the corporate purposes of the company, other than actions which fall within the scope of the powers expressly reserved to the general meeting of shareholders[10]. Centralized management can not therefore be avoided since it is not possible for members to bind the entity in their capacity as members.

(c) *Limited liability*

The shareholder's liability is limited to their own contribution.

6. The Rev. Proc. does not apply to either the VOF or the CVOA since Belgian law neither provides for nor allows limited liability to apply to these corporation's members.
7. Art. 26 CLCC.
8. Art. 54 §4 CLCC.
9. Art. 116 CLCC.
10. Art. 130, 1° CLCC.

(d) *Free transferability of interests*

Where a partner of a BVBA intends to transfer his shares to a third party, he is required to obtain the prior approval of at least one-half of the partners whose shares represent three-quarters of the capital.[11] The Articles of Association may even provide for stricter rules, subjecting the transfer of shares to, for example, the unanimous approval of all partners. This prior approval requirement is however not necessary for the transfer of shares to the following categories of parties (unless otherwise provided in the Articles):

- other partners;
- the spouse of the transferor or the deceased;
- the ascendants or descendants of the transferor;
- other persons mentioned in the Articles of Association.

The restriction laid down in the statute would not of itself suffice to dissatisfy the free transferability test, since no prior approval requirement would be necessary for the transfer of shares to the categories of parties mentioned above. Where however the Articles provide that the transfer is also subject to the restrictions laid down in the Commercial Code (i.e. prior approval of at least one-half of the partners whose shares represent three-quarters of the capital), the entity will normally lack free transferability of interests under Rev. Proc. 95-10, since the consent of a "majority" of the non-transferring members is required. In order to dissatisfy the free transferability test, the Articles could of course also provide that every transfer of shares is subject to the unanimous approval of the other partners.

(e) *Conclusion*

If the Articles of Association explicitly provide that the transfer of shares is subject to the unanimous approval of the other partners (or that the transfer of shares is subject to the approval condition included in the statute) and that the BVBA will be dissolved upon the death, bankruptcy (or any other event which creates discontinuity) of one of the partners, a BVBA could be considered a partnership for US tax purposes, since in such a case it lacks two of the relevant corporate characteristics.

F. The cooperative company with limited or unlimited liability (CVBA/CVOA)

1. Definition

The CVBA/CVOA are companies which are constituted by a variable number of shareholders who make varying contributions (...). In the cooperative company with limited liability, the shareholders' responsibility for the company's debts is limited to their contribution. (...) In the co-operative company with unlimited liability, the shareholders are jointly and severally liable for the debts of the company.[12]

2. Partnership characteristics

(a) *Continuity of life*

Unless the Articles of Association provide otherwise, the death, etc.,[13] does not automatically cause the dissolution of the CVBA/CVOA. It would therefore be necessary to draft the Articles in such a way that the entity lacks continuity of life. For the CVBA, all possible dissolution events should be included (or in cases where fewer than all of the dissolution events are provided for, there should be a meaningful possibility of dissolution) in order to satisfy the Rev. Proc. 95-10 test. However, including such dissolution clauses in the Articles would be contrary to the character of a CVBA.

(b) *Centralization of management*

The CVBA/CVOA is managed by one or more managers, who may, but need not, be shareholders. These managers have the authority to make business decisions and to bind the company towards third parties.[14] Centralized management can not be avoided since it is not possible for the shareholders to bind the entity in their capacity as shareholders.

(c) *Limited liability*

As mentioned in the definition itself, the CVBA is a limited liability company, while in the CVOA the shareholders are jointly and severally liable for the debts of the company. The CVOA therefore lacks the corporate characteristic of limited liability under Reg. § 301.7701. As already mentioned above, Rev. Proc. 95-10 should not apply to the CVOA.

(d) *Free transferability of interests*

The shares are transferable to other shareholders in the manner determined by the Articles of Association.[15] The shares can only be transferred to third parties explicitly named in the Articles or belonging to a specific category of potential transferees mentioned in the Articles. The statute therefore gives great flexibility to the taxpayer to set forth the rules under which the ownership interest can be transferred. By providing in the Articles that the ownership interest is not transferable without obtaining the prior consent of the other shareholders, one can make sure that the CVBA/CVOA lacks the corporate characteristics of free transferability. For CVBAs one should pay attention to the rules set out in Rev. Proc. 95-10, in case the consent requirement should be limited. Indeed, Rev. Proc. 95-10 provides that the IRS will not rule that an LLC lacks free transferability of interest, unless the power to withhold consent to the transfer constitutes a meaningful restriction to the transfer.

(e) *Conclusion*

On condition that the Articles of Association provide that the transfer of shares is subject to the approval of the other shareholders and/or that the company will be dissolved upon the death, bankruptcy (or occurrence of any other dissolution event) of one of the shareholders, the CVOA could be considered a partnership for US tax purposes. For its part the

11. Art. 126 CLCC.
12. Art. 141 CLCC.
13. I.e. insanity, bankruptcy, retirement, resignation or expulsion of a shareholder.
14. Art. 143 CLCC.
15. Art. 142 CLCC.

CVBA could theoretically be considered a partnership for US tax purposes but only if *both* conditions are met.

G. The general partnership (VOF)

1. Definition

The VOF is a partnership which is formed by two or more partners in order to conduct commercial activities under a common name.[16]

2. Partnership characteristics

(a) *Continuity of life*

A VOF will be dissolved upon the death, insanity or the bankruptcy of one partner, unless the Articles of Association provide otherwise.[17] The VOF therefore lacks the corporate characteristic of continuity of life under Reg. § 301.7701.[18] Furthermore, Rev. Proc. 95-10 (which is more restrictive in its requirements) does not apply to the VOF.

(b) *Centralization of management*

The VOF is presumed not to have the corporate characteristic of centralized management. It is not even necessary to grant a general power of attorney to each partner allowing that partner to bind the company as all partners are deemed to have reciprocally granted each other the authority to take management decisions.[19] Any action undertaken by one of the partners binds the other partners, even without their prior consent.

(c) *Limited liability*

The main feature of a VOF is that the liability of the partners for the debt of the partnership is unlimited, joint and several, even when only one of the partners assumed the debt in the name of the partnership.[20] The partners can however only be held personally liable for obligations of the partnership if the partnership itself was previously held liable (principle of subsidiarity).[21]

(d) *Free transferability of interest*

On the assumption that the Articles of Association do not provide otherwise, the shares of a VOF are in principle not transferable, unless all partners agree to the transfer. It will therefore not be necessary to enter a specific provision into the Articles limiting the transferability of the shares. Furthermore, the unapproved transfer of shares will cause the dissolution of the partnership.

(e) *Conclusion*

Subject to the Articles of Association, a VOF will be dissolved on the death, insanity or bankruptcy of a partner. In addition again subject to the Articles, shares can only be transferred if all partners agree. Furthermore, the VOF will not fulfil the corporate requirement of centralized management as all partners are deemed to have granted each other the authority to take management decisions (unless the Articles provide otherwise). Finally, the partners in a VOF have unlimited liability. The Belgian VOF therefore normally falls to be treated as a partnership for US tax purposes.

H. The limited partnership (GCV)

1. Definition

A GCV is a partnership concluded between one or more partners who are jointly and severally liable ("active" partners) and one or more partners whose liability is limited to their contribution (the "silent" or financing partners).[22] As a rule, the "active" partners will take care of the management of the GCV. The "silent" partners are expressly excluded from becoming involved in the management of the GCV.[23]

2. Partnership characteristics

(a) *Continuity of life*

The comments under G. 2.(a) relating to the VOF, also apply to the GCV. Special attention should be given to the restrictions contained in Rev. Proc. 95-10,[24] which states that if fewer than all of the dissolution events are provided for, the Service will not rule that partnership classification exists unless there is a meaningful possibility of dissolution.

(b) *Centralization of management*

As a rule, only active partners have the authority to take the management decisions needed to conduct the business. Silent partners cannot perform any act of management, not even by proxy. If they do perform acts of management, they will lose their limited liability. Where only one act is involved, they will be jointly and severally liable for that specific act. If however, the silent partners become generally involved in the management, they will be jointly and severally liable for all acts, even those in which they did not participate.[25] The GCV therefore exhibits the corporate characteristic of centralized management.

(c) *Limited liability*

Silent partners in a GCV are only liable for the debts and losses of the company to the extent of their contribution. Active partners on the other hand have unlimited liability. The GCV therefore lacks the corporate characteristic of limited liability, since both under Reg. § 301.7701 and Rev. Proc. 95-10, it suffices that only one member validly assumes personal liability. However to obtain a ruling that a GCV

16. Art. 15 CLCC.
17. Art. 1865, 3° and 4° BCC.
18. Under Reg. § 301.7701, all of the dissolution events need not be provided for to evidence a lack of continuity of life.
19. Art. 1859 BCC.
20. Art. 17 CLCC.
21. Art. 189 CLCC.
22. Art. 18 CLCC.
23. Art. 22 CLCC.
24. The Rev. Proc. is applicable to the GCV since Belgian law provides for the limited liability of the "silent" partners.
25. Art. 23 CLCC.

lacks limited liability, the members assuming the liabilities must also satisfy additional requirements (see above).

(d) *Free transferability of interests*

Subject to the Articles of Association the shares in a GCV can only be transferred with the consent of all partners. It will therefore not be necessary to enter a specific provision into the Articles limiting the transferability of the shares.

(e) *Conclusion*

If the Articles of Association do not provide for the free transferability of the shares and/or do not create continuity of life, the GCV can be considered a partnership for US tax purposes. Special attention should however be given to the restrictions of Rev. Proc. 95-10 concerning the continuity of life-condition.

I. The limited company with shares (CVA)

1. Definition

The CVA is a company with two classes of shareholders each with a distinct legal status. Shareholders of the first category are jointly and severally liable with the company for the company's obligations. Shareholders of the second category only commit their contribution to the company.[26]

2. Partnership characteristics

(a) *Continuity of life*

A distinction should be made between the shareholders with limited liability, and the ones with unlimited liability. If a limited shareholder dies, the CVA will not be automatically dissolved unless otherwise provided in the Articles of Association. Again subject to the Articles the death of a shareholder with unlimited liability who is appointed as manager will precipitate the dissolution of the company.[27] This implies that under Reg. § 301.7701, a CVA will lack continuity of life. To obtain a ruling from the Service, the restrictions included in Rev. Proc. 95-10 will need to be taken into consideration.

(b) *Centralization of management*

The managers of the CVA must be chosen from the category of shareholders who are jointly and severally liable. The shareholders with limited liability are precluded from interfering with the external management of the company unless they have received power of attorney to do so.[28] The CVA therefore possesses the corporate characteristic of centralized management.

(c) *Limited liability*

As indicated in the definition, one class of shareholders has unlimited liability. The CVA therefore lacks the corporate characteristic of limited liability both under Reg. § 301.7701 and Rev. Proc. 95-10.

To obtain a ruling that a CVA lacks limited liability, the members assuming the liabilities must however also satisfy additional requirements (see above).

(d) *Free transferability of interests*

The shares are freely transferable. The only exceptions concern possible preferential rights given to existing shareholders and approval clauses provided for in the Articles of Association. However, even in such cases the non-transferability of the shares cannot exceed a period of three months.

(e) *Conclusion*

Assuming that the Articles of Association do not contain specific provisions concerning the continuity of life, the CVA can be considered a partnership for US purposes. Special attention should however be given to the restrictions of Rev. Proc. 95-10 concerning the continuity of life-condition.

J. Summary

It is theoretically possible to classify all Belgian commercial corporations, except the NV, as partnerships for US tax purposes.

The VOF and the GCV are by their nature the legal entities which are closest to the concept of a US partnership. These types of companies are generally classified in Belgium as : "personal companies" (as opposed to "capital companies"), which implies that they are created *intuitu personae*. US partnerships are also created *intuitu personae*, meaning that the personal factor in the relationship between the partners is important.

"Exhibit 500-4" of the Internal Revenue Manual[29] considers the VOF, the GCV and the CVOA as partnerships while the other Belgian commercial entities are considered to be corporations. However, the IRM stated itself that this Exhibit is to be viewed as a source of information and not as evidence, and that "the final determination of the form of business organization depends on the circumstances of each case. The form of organization may not be in fact what it appears to be from generally accepted terminology. Therefore, it is important to consider the facts ... Accordingly, the classification in Exhibit 500-4 should never be construed as the position of the Service".

26. Art. 105 CLCC.
27. Art. 115 CLCC.
28. Art. 112 CLCC.
29. IRM 4233, Exhibit 500-4, Part IV-Audit. The Exhibit 500-4 was withdrawn in October 1991 because updating it would have been too time consuming. However, since no relevant changes have occurred in Belgian company law since then, it can still be used as an important source of information.

VIETNAM

VIETNAM–JAPAN TAX TREATY[1]

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I. INTRODUCTION

A. East Asian economies

From 1965 to 1990, the East Asian economies grew faster than the economies of any other region. To illustrate, during this period the average growth rate of gross national product (GNP) per capita of the 23 economies in East Asia was 5.2 per cent compared to the worldwide average growth rate of 1.8 per cent. With the advent of the 1990s, the gap widened further. Thus during the period 1990–1993, the average annual growth rate in GNP of the East Asia and Pacific region was 6.4 per cent,[2] as against a worldwide average of 1.2 per cent and the negative growth of the African countries.

B. Vietnamese economic background

Although Vietnam was reunified in April 1975 it was not until 1986, at the Sixth Congress of the Communist Party that a version of economic reform known as "Doi-Moi" was introduced. In order to facilitate this "renovation" policy, the Law on Foreign Investment in Vietnam was approved by the National Assembly in 1987.[3] As a result of these changes Vietnam is now undergoing the transition from a centrally planned to a free market economy.

In February 1994, the United States lifted its 19-year economic embargo against Vietnam. In July 1995 in an attempt to become part of the East Asian economic miracle Vietnam joined the Association of Southeast Asian Nations (ASEAN). In the following month, the United States and Vietnam resumed their diplomatic relations which were severed in 1975 when the government of South Vietnam fell at the end of the Vietnam war.

According to the forecasts made by the OECD, the growth of the dynamic Asian economies of South Korea, Taiwan, Hong Kong, Singapore, Thailand and Malaysia is projected to slow from 7.6 per cent and 7.8 per cent in 1994 and 1995, respectively, to an average of 6 to 7 per cent over the next two years. This deceleration of the dynamic economic growth is due to infra-structural bottlenecks and labour shortages resulting in higher cost pressures and demand for imported capital goods. In spite of the most recent less favourable economic circumstances of East Asia, Vietnam is expected to enjoy continued high growth, thus vying to be the next Asian "Tiger". Not surprisingly, Vietnam is now drawing more attention from foreign investors!

II. RELATIONS WITH JAPAN

A. Diplomatic relations

Japan established diplomatic relations with Vietnam in 1973 after the peace settlement for the Vietnam War was signed in Paris by the four parties involved. In April 1978, both countries agreed that Vietnam would repay the loans provided to the former South Vietnam government over an extended period and Japan would provide a greater amount of new loans and grants-in-aid. However, since Vietnam invaded Cambodia in December of the same year, Japan suspended all the official development assistance and diplomatic relations became dormant.

A peace accord with Cambodia was reached in Paris in October 1991, only then did Japan resume full-fledged aid negotiations. These negotiations resulted in the pledge of a JPY 45.6 billion loan in November 1992. In January 1993, to strengthen the economic ties between Japan and Vietnam, a Japanese Consulate General was opened in Ho Chi Minh City. In March of the same year, the Vietnamese Premier Vo Van Kiet came to Japan and in August 1994 Premier Kiichi Murayama, the Japanese Prime Minister, visited Vietnam.

B. Economic relations

After the Cambodian problems emerged, Japanese trade with Vietnam suffered a setback. But in 1982 it took a favourable turn and since then partly due to the increased import of crude oil, Japan has had an adverse trade balance. In 1991, Japan's exports to and imports from Vietnam were USD 217 million and USD 662 million, respectively. As shown in the table below trade between the two countries is growing at an impressive rate.

1. The author is much indebted to Katsumi Shinagawa, "Nihon-Vietnam Sozeijouyaku-no-Kaisetsu" (in Japanese), 1996, *Japan Tax Association*. He is also grateful to Mr Daisuke Kotegawa, Director, International Tax Affairs Division, Tax Bureau, Ministry of Finance of Japan for his helpful comments.
2. This rate was again higher than any of the other regions of the world.
3. For the Law on Foreign Investment in Vietnam, see Christopher Potter, "Introduction to Vietnamese Foreign Investment Tax Law", 49 *Bulletin for International Fiscal Documentation* 1 (1995), at 17-22.

Annual percentage increase in exports and imports between the two countries.

	Exports*	Imports**
1993	41.8%	22.9%
1994	9.1%	26.4%
1995	43.2%	27.1%

* Japanese exports to Vietnam
** Japanese imports from Vietnam

By 1995, these figures had risen to USD 921 million for exports and USD 1,716 million for imports. Major exports are automobiles, motor cycles, general machinery and textiles. Major import items are crude oil, frozen shrimps and squid and other marine products. As of now, Japan is Vietnam's largest trading partner.

According to the statistics on foreign direct investment, the cumulative total up to March 1978 of Japan's direct investments in Vietnam, were 33 in number and some USD 5.2 million in amount. As from 1989, Japan's direct investment was resumed after a decade's absence and has been accelerated since 1992. In 1994, the Japanese direct investment in Vietnam more than doubled in terms of project numbers and almost quadrupled in amount as compared with the previous year and this growth has continued. By the end of September 1995, the total number of investments stood at 106 (USD 296 million). By industry, oil exploitation, joint ventures in the hotel, textile, marine, machinery and food industries are major areas of direct investment.

In May 1994, an aviation convention was concluded between Vietnam and Japan and a direct flight between Ho Chi Minh City and Osaka was inaugurated in November of that year. In February 1996, the State Bank of the Socialist Republic of Vietnam approved the Bank of Tokyo's plan to open the first branch of a Japanese bank in the country since the termination of the Vietnam War by upgrading its representative office in Ho Chi Minh City to branch status.

III. THE TAX SYSTEM

The improvement and consolidation of Vietnam's tax system was started in 1989 and is yet to be completed. At the time of writing many uncertainties still remain.

A. Personal income tax

Personal income tax was introduced by the "Ordinance on Income Tax of High Income Earners" of 27 December 1990, replaced by the Ordinance of 19 May 1994. Vietnamese nationals are subject to this tax regardless of whether they are resident in Vietnam or not while foreigners resident in Vietnam are liable on all their Vietnamese-source income. Individuals are treated as residents if they have stayed in Vietnam for more than 183 days during a calendar year.

Regular income includes salaries, wages, allowances and bonuses and irregular income includes money or other items sent from overseas, income derived from the transfer of technology, income received from construction, engineering or industrial design and lottery prizes. The tax rates are as follows:

- resident Vietnamese nationals whose regular monthly income exceeds VND 1.2 million are liable to tax at rates ranging from 10 per cent to 60 per cent; and
- foreigners residing in Vietnam and non-resident Vietnamese nationals whose regular monthly income exceeds VND 5 million are liable to tax at rates ranging from 10 per cent to 50 per cent.

The tax is collected provisionally on a monthly basis and finalized at the end of the financial year. The annual tax return must be filed no later than 28 February. Irregular income tax is levied every time an income transaction occurs or when payment is made.

B. Profits tax

Business entities are taxed on profits from production and business activities and on any other income. While the tax rates applicable to Vietnamese entities are between 30 per cent and 50 per cent depending on the type of activity, those applicable to foreign business organizations are between 15 per cent and 25 per cent by virtue of the Law on Foreign Investment in Vietnam of 29 December 1987. The applicable rate will be greatly influenced by the State Committee for Co-operation and Investment (SCCI) created in March 1989. The SCCI will take into consideration the type of industry, the amount of investment, the geographical region of investment, the percentage of products exported, import substitution and duration of the activity. Profits derived from exploitation of oil and gas are subject to a rate in excess of 25 per cent.[4]

The foreign investor who reinvests part of its profits will receive a refund of the amount of profits tax already paid on that part of those profits. The tax is collected quarterly on a provisional basis. An enterprise must submit to the Tax Office a statement of account and profits tax declaration for that year no later than three months following the fiscal year-end (generally 31 December). If the SCCI approves, an alternative year-end may be elected.

Where the investment falls within certain categories of activity such as high-technology or labour intensive industries and foreign-currency-earning services and meets certain criteria such as the capital amount and timing of the investment, the SCCI may determine that reduced tax rates may be applied to the income derived from such investment. Various tax incentive measures are discussed below in connection with the provision of tax sparing credit incorporated into the Japan–Vietnam treaty.

4. For production-sharing contract on exploitation of petroleum, see Michael D. Cannon, "Vietnam", 1 *The Asia-Pacific Tax Bulletin*, 10 (1995), at 300-301.

C. Tax on the transfer of profits abroad (profit remittance tax)

Foreign enterprises are required to pay withholding tax on the repatriation of profits and dividend payments under the Law on Foreign Investment. The withholding tax rates are as follows:
- if a foreign enterprise's contribution to the capital of the transferring entity is equal to or exceeds USD 10 million, 5 per cent;
- if such contribution is equal to or exceeds USD 5 million but is less than USD 10 million, 7 per cent; and
- in all other cases, 10 per cent.

D. Withholding tax on royalties (royalty tax)

According to the "Ordinance on Royalties" of 30 March 1990, royalty payments made under a licensing contract to use inventions, industrial design, trademarks and the like are subject to withholding tax at the following rates:
- for a licensing agreement of less than five years or a lump sum payment, 10 per cent; and
- for a licensing agreement of five years or longer, 15 per cent.

E. Sales (consumption) tax

1. Turnover tax

The Law of 30 June 1990 as amended on 5 July 1993 provides for turnover tax. All business establishments with the exception of those engaged in agricultural production, production of commodities which are subject to special sales (new consumption) tax or production of goods for export are required to pay turnover taxes.

The turnover tax rates vary depending on the nature of the activity concerned and range from 0.5 per cent for the provision of vocational training, for example, to 30 per cent for activities such as lotteries and certain banking operations. Petroleum service contractors, however, will be taxed on turnover at rates different to those set out in the law on turnover tax. Since no mechanism for the avoidance of double taxation exists, the turnover tax is applicable to each separate enterprise. By virtue of Circular No. 30 dated 12 April 1995, a 25 per cent or 50 per cent reduction of turnover tax is granted to business entities operating in mountainous and highland areas.[5]

2. Special consumption tax

The Law on Special Sales Tax of 30 June 1990 as amended on 5 July 1993 provided for a special sales tax to be imposed on a limited range of consumer goods. Vietnam joined the ASEAN in July last year and hence has become a member of the ASEAN Free Trade Area, effective as from 1 January 1996. Under the agreement Vietnam is obliged to lower its import tariffs to 5 per cent or less by 2006. Partly in order to make up the expected loss of revenue, effective as from 1 January 1996, a special consumption tax on luxury consumer goods has been introduced. The goods affected are tobacco, alcoholic beverages (including beer) and firecrackers, which were hitherto subject to the special sales tax, and imported passenger cars and petroleum products. The rates vary from 15 per cent on petroleum to 100 per cent on imported passenger cars. This special consumption tax has a similar nature to a value added tax.

F. Taxation of foreign contractors

Circular No. 37 of 10 May 1995 issued by the Ministry of Finance under the Law on Foreign Investment in Vietnam replaced the single "contractor tax" regime which combined the current profits tax and turnover tax with the separate two taxes effective as from 1 June 1995. Thus, under the new regime, foreign contractors and subcontractors are liable to pay both profits tax and turnover tax. The Circular defines a subcontractor as an organization which, or individual who, provides services to a contractor or performs part of the work of a contractor. In addition, contractors and sub-contractors must pay customs duty, personal income tax and taxes on royalties etc., in accordance with the current law.[6]

In connection with the move to the separate imposition of profits tax and turnover tax, the following should be noted. Even though profits tax is calculated as a percentage of turnover, the turnover for turnover tax purposes and the turnover for profits tax purposes are not necessarily the same. Unlike profits tax, turnover tax is not creditable for foreign tax credit purposes. A foreign contractor would probably be entitled to claim foreign tax credit in his home country only in respect of the profits tax paid.

G. Export and import duties

The Law on Export and Import Duties on Commercial Goods of 26 December 1991 provides for two rates for each category: the standard rate and the preferential rate. The latter rate is applicable to imports from countries with which Vietnam has signed terms for preferential trading relations (formerly Member nations of the Council for Mutual Economic Assistance – commonly known as COMECON) and any country determined by the State.

H. Taxes on natural resources

A royalty tax of between 1 per cent and 40 per cent is imposed on enterprises or foreign contracting parties that exploit any of the natural resources of the country. The actual rate set depends on the conditions of exploitation, quality of the natural resources, transport and exploitation expenses and accepted international practices. Metal minerals are subject to rates ranging from 2 per cent to 10 per cent and products of

5. "VAT Around the World, Vietnam", 6 *International VAT Monitor* 5 (1995), at 322-324.
6. Ibid., and 6 (1995).

natural forests to rates ranging from 10 per cent to 40 per cent.

IV. DOUBLE TAXATION TREATY

A. Conclusion of a treaty

On 24 October 1995, the "Agreement between the Government of Japan and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income" was signed by the Vietnamese Minister of Finance Ho The and the Japanese Ambassador Katsunari Suzuki in Hanoi. In view of its overriding necessity, the treaty was processed with unprecedented speed by both parties. Thus, the Agreement came into force as from 31 December 1995 and is applicable with respect to taxes on income for any taxable year beginning on or after 1 January 1996.

Vietnam signed its first double taxation agreement with Australia on 13 April 1992. As of the end of December 1995, Vietnam has concluded double taxation treaties with the following nine countries: Australia, Thailand, the Republic of Korea, Singapore, France, the United Kingdom, Sweden, the Netherlands and India. Japan on the other hand has concluded 42 such treaties. The geographical distribution being as follows: North and South America 3; Western Europe 15; Eastern Europe 6; Asia 12; Oceania 2; Africa 2 and the Middle East 2.[7]

The Agreement is intended to eliminate double taxation between the contracting parties, to clarify taxation in other contracting states and to improve cooperation between the tax authorities, thereby contributing to the promotion of international economic, cultural and personnel exchange. Basically, the provisions of the Agreement follow those of the OECD Model Tax Convention and other recent treaties to which Japan is a party.

B. Scope of the treaty

1. Personal scope

A person who is a resident of one of the contracting states of this Agreement is primarily liable to tax in his country of residence. For the purposes of this tax treaty, the term "person" includes both an individual and a company and any other body corporate. In case any individual is a resident of both contracting states, his status shall be determined by the criteria set forth in the OECD Model Income Tax Convention. However, in other cases the country in which the company's head or main office is located is deemed to be the company's country of residence.

According to paragraph 4 of the Protocol (which forms an integral part of the Agreement,) the exemption or reduction of tax provided for in the treaty does not apply unless the person has a fixed facility necessary for conducting its principal business and manages and controls such business by itself in the other country. In other words, the tax benefits from this Agreement are not available to the so-called paper company.

2. Taxes covered

The Agreement covers taxes on income, these taxes are enumerated individually for each contracting state. In connection with Vietnam's foreign contractor tax and the foreign petroleum sub-contractor tax, the following points should be mentioned:

- since both taxes include the turnover tax, as regards both taxes, the Agreement is applicable to the extent to which the taxes are considered imposed on profits; and
- a Japanese enterprise carrying on business in Vietnam through a permanent establishment there may claim a refund for the difference between the amount considered to be tax imposed on profits and the final profits tax liability filed if that permanent establishment provides proper information according to paragraph 2 of the Protocol.

The article concerning the taxation of profits from international transport also covers the enterprise tax of Japan and the similar tax, (if any,) of Vietnam. Article 25 concerning the exchange of information logically covers other relevant taxes.

C. Business profits

1. Permanent establishment

The profits of an enterprise resident in one country are not taxed in the other country unless the enterprise carries on a business through a permanent establishment (PE) situated therein. Only the income attributable to a PE,[8] is taxable.

As under the United Nations Model Double Taxation Convention between Developed and Developing Countries of 1979 (UN Model), a building site, installation or assembly project or supervisory activities thereof which last more than six months and consultancy services which aggregate more than six months within any 12-month period constitute a PE. This treatment should be compared with that applying under the OECD Model where only if a building site or construction or installation project lasts more than 12 months does it constitute a PE. In addition, under paragraph 1 of the Protocol, offshore activities for exploration of natural resources are also deemed to constitute a PE if they aggregate more than 30 days within any 12 month period.

An insurance enterprise which collects premiums or insures risks in the other country, except in regard to reinsurance, is deemed to have a PE in that other country. Like the OECD Model, the Agreement provides that an independent agent who acts in the ordinary course of his business on behalf of an enterprise of the other contracting state is not deemed to

7. Besides double taxation treaties with respect to income, Japan has a convention for avoiding double taxation and preventing fiscal evasion with respect to taxes on estates, inheritances and gifts with the United Sates which was signed in April 1954 when Japan concluded its first income tax treaty on income.
8. Such as a place of management, branch, office or a factory.

be a PE. However, an agent acting on behalf of a enterprise of the other country is deemed to be a PE, if such an agent habitually concludes contracts in the name of that enterprise or maintains a stock of goods from which he regularly delivers goods on behalf of that enterprise.

2. International transport

Profits from international transport businesses are taxed only in the country of residence of the enterprise as provided for by the OECD Model. In this connection, it should be remembered that some portion (the percentage is to be established through bilateral negotiation under the UN Model and 50 per cent under most of the Japanese treaties with the developing countries in Asia) of the profits from international ocean transport are exempt from taxation in the country of source. In the interest of furtherance of tax exemption on a reciprocal basis, the enterprise tax of Japan and the similar tax, (if any), of Vietnam are included in the scope of this mutual tax exemption.

3. Associated enterprises

Like the OECD Model, the Agreement provides that profits from the transactions between parent and subsidiary companies and companies under common control may be recomputed using an arm's length basis. This is closely related to the recent important issues of the transfer pricing of goods, technology, trade marks, and the services of multinational enterprises.

The rewriting of transactions between associated enterprises gives rise to economic double taxation (taxation of the same income in the hands of different persons). In these circumstances, the resident country of the parent company has to make an appropriate corresponding adjustment so as to relieve the double taxation.

D. Income from capital

1. Dividends

The maximum rate on dividends is 10 per cent, this rate applies to all dividends, i.e. no reduction is available in the case of dividends paid by subsidiaries to their parent companies. Under the OECD Model, the maximum rate between parent and subsidiary companies is 5 per cent and in all other cases 15 per cent and under most tax treaties to which Japan is a party the former is 10 per cent as of now. All other provisions, including the definition, the treatment of dividends attributable to a PE and a fixed base and prohibition of taxation on dividends from profits derived from a source in the other contracting state by an enterprise operating without a PE there (subject to certain conditions), follow those of the OECD Model.

2. Interest

As under the OECD Model and like most of the tax treaties to which Japan is a party the maximum tax rate on interest is 10 per cent.[9] However, the interest which the national and local governments, the central bank and government-affiliated institutions receive is exempt from taxation in the source country. Other provisions follow those of the OECD Model.

3. Royalties

The maximum tax rate on royalties is 10 per cent. While the OECD provides for tax exemption in the source country, Japan reserves the right to tax royalties at source.[10] In addition to the definition of the OECD Model, the term "royalties" in the Agreement specifically includes software, films or tapes for radio or television broadcasting. It clarifies that, in principle, like interest, royalties are deemed to arise in the country of residence of the payer of such royalties. The provisions on royalties are also applicable to the gains from the alienation of property which gives rise to royalties.

E. Capital gains

In principle, the Agreement's provisions on capital gains follow those of the OECD Model. Thus, gains derived by a resident of one of the contracting states from the alienation of immovable property situated in the other contracting state may be taxed in that other country. Gains from the alienation of any other property are taxable only in the country of which the alienator is a resident. Besides the provisions of the OECD Model concerning capital gains, there are two special provisions in the Agreement:
- gains from the alienation of the shares of a company may be taxed in the company's country of residence if at least 25 per cent of the total shares issued are owned by the alienator and persons related to him and at least 5 per cent of the total shares issued were alienated by such persons in one taxable year. The Japanese treaties with the United Kingdom, Austria, Singapore and Denmark and the revised one with France[11] contain a similar provision; and
- gains from the alienation of the shares of a company whose property primarily consists of immovable property may be taxed in the country where such immovable property is situated. The Japanese treaties with the Philippines and Singapore and the revised one with France contain a similar provision.

F. Income from personal services

Dependent and Independent Services

Income from dependent personal services, such as salaries and wages of employees, and income from independent personal services, such as fees and remuneration of physicians and lawyers are not taxable in the country of source unless the length of the person's stay in that country exceeds in

9. The UN Model leaves the percentage to bilateral negotiations.
10. The UN Model leaves the percentage of the maximum rate of tax at source to bilateral negotiations.
11. The revised French treaty came into force on 24 March 1996.

aggregate 183 days in any 12 month period. However, income from independent personal services is taxable if the person has a fixed base, such as an office or clinic, regularly available to him in that country for the purpose of performing his activities. Directors' fees may be taxed in the company's country of residence regardless of where the services giving rise to the fees are preformed. By its nature, income derived by public entertainers, such as professional sportsmen and artistes, is subject to separate rules. Such income may be taxed in the country where the entertainer's activities are exercised. It is so taxed even if the entertainer exercises the activities for an enterprise which has neither a PE nor a fixed base in the source country. In all cases, tax exemption is granted under a special programme for cultural exchange agreed upon between both governments.

Like the OECD Model, the Agreement provides that pensions in consideration of past employment are taxable only in the country of the recipient.[12] Other provisions on personal services, including government services and students and business apprentices, follow those of the OECD Model. Like the OECD Model the Agreement does not provide for tax exemption for professors and researchers. In this regard the treaty is unusual for a Japanese treaty since Japanese treaties normally grant such exemption for a limited period of two years.

G. Elimination of double taxation

1. Credit method

The OECD Model sets forth two alternatives to relieve the international juridical double taxation (as distinguished from the economic double taxation) on income where the same income or capital is taxed in the hands of the same person by more than one state. These are the exemption method and the credit method. Under the former method, the income which may be taxed in one country is not taken into account at all by the other country for the purpose of its tax. Under the latter method, the country of residence calculates its tax on the basis of a taxpayer's total income including income from the country of source. Then it allows a deduction from its own tax for the tax paid in the other country.

Under the Agreement, both countries employ the credit method. Moreover, a Japanese corporation which owns not less than 25 per cent of the total shares of a Vietnamese corporation is entitled to an indirect foreign tax credit.

2. Tax sparing credit

The tax sparing credit was one of the most controversial issues when the draft UN Model was discussed. While all the developing nations were naturally anxious for the tax sparing credit clause, some developed nations were adamantly opposed to it. Japan's policy has been to accommodate developing countries by providing tax sparing credits under its tax treaties with a view to supporting their efforts for economic development. Vietnam is the 18th tax treaty partner to whom Japan has granted a tax sparing credit.

It is to be noted that the tax sparing credit under the Agreement is effective for 15 years and will not apply after 1 January 2011. By the same token, it may be remembered that the new tax treaty with Singapore which came into force on 28 April 1995 lets the tax sparing credit phase out gradually by the year 2000. The scope of the benefits accorded to taxpayers under the tax incentive measures to which the tax sparing credit is applicable is specified in the Exchange of Notes.

As mentioned earlier, the Law on Foreign Investment in Vietnam provides for a variety of tax incentive measures to promote economic development by attracting investment from abroad. Taking into consideration the various factors mentioned earlier, the SCCI decides on the favourable tax treatments. By virtue of the Agreement's tax sparing credit a Japanese business would be deemed to have paid profits tax at the standard rate of 25 per cent (and without refund) for the purposes of foreign tax credit in Japan, where in Vietnam:

- the business was liable to profits tax at a reduced rate of 15 per cent or 20 per cent;
- the amount of profits tax was reduced by up to 50 per cent for up to two years;
- to encourage foreign investment, the tax rate is reduced to 10 per cent; and
- a certain amount of tax paid will be refunded if profits are reinvested.

It should be noted that the tax sparing credit is not applicable to investments in hotels, banking, insurance, accountancy businesses, etc.

The tax sparing credit also applies to the tax on dividends and royalties for which the maximum rates are specified in the Agreement. To be more specific, even if the profit remittance tax on a dividend paid by a Vietnamese subsidiary to its Japanese parent company was less than 10 per cent, the Japanese company is entitled to the foreign tax credit as if the tax had been paid at the rate of 10 per cent.

H. Miscellaneous

1. Non-discrimination

The Agreement establishes the principle of non-discrimination in taxation with regards to nationality, PE, payees of income and capital. Paragraph 3 of the Protocol confirms that the non-discrimination clause does not prevent Vietnam from imposing tax on the exploitation of oil, gas and a number of other rare and precious natural resources, the remittance abroad of the profits of a PE situated in Vietnam, and profits from the agricultural production activities derived by a PE situated in Vietnam or by an enterprise wholly or partly owned by Japanese residents.

2. Other provisions

Like other tax treaties, the Agreement has articles on mutual agreement procedure and exchange of information. It also

12. This should be contrasted with the approach of the UN Model which provides that the other country may tax the pension in certain cases such as where payments are made under a public scheme or by a PE situated therein.

features an article on the mutual assistance for collection of taxes. Under the provisions of this article, both contracting states cooperate for the sake of the proper and fair enforcement of the Agreement. For this purpose, each of them should endeavour to collect the tax which any taxpayer in the other state evaded by claiming a tax reduction or exemption which he was not entitled to under the Agreement. This article is also included in the Japanese tax treaties with the United States, the Netherlands, the Republic of Korea, Norway, Finland, Luxembourg, Turkey and Singapore[13] although neither the OECD Model or UN Model has such a provision.

13. Most of these treaties are relatively new.

SINGAPORE

THE 1996 BUDGET

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I. INTRODUCTION

Singapore's Finance Minister, Dr Richard Hu presented his Budget Speech in parliament on 28 February 1996. The speech contained three parts: a review of the economy; the financial year 1996 Budget; and revenue and tax changes.

A. The economy

The Minister reported on the very satisfactory economic performance in 1995. Overall growth was 8.9 per cent, with strong growth in manufacturing, transport and communications and commerce. Indeed for the period 1990-95, Singapore's economic growth averaged 8.5 per cent p.a., better than the other Asian Newly Industrialized Economies and about the same as Malaysia and Thailand.

The Minister commented that Singapore had enjoyed faster growth than he had thought possible in 1986. In that year the Ministry of Trade and Industry had projected the long-term indigenous growth rate to be 4-6 per cent. In reality, growth had averaged 8.5 per cent in the last ten years.

On the economic prospect for 1996, the Minister observed that the outlook for the external environment would remain positive but sentiments in Europe and the United States had turned less optimistic. He expected the regional growth to be lower after the strong growth in recent years. The Ministry of Trade and Industry had therefore retained its earlier forecast of 7-8 per cent growth for 1996.

On meeting future challenges, the Minister pointed out that keeping the economy on course for about 7 per cent annual growth would be a challenge. The nature of global competition had changed with the entry of new and big players like China and India into the international economy. As ASEAN countries progressed, they would increasingly compete against Singapore for foreign investment. Therefore in order to continue to attract investment in the manufacturing and services sectors, Singapore needs to remain significantly more efficient than her competitors. This efficiency may in part be achieved by mobilizing and maximizing the national reserves to enable an effective response to be made to the exciting changes in the business world.

B. The finance year 1996 Budget

The Minister outlined Singapore's Expenditure Policy and the Reform of the Management and Control of Government Expenditure.

The government's budgetary policy is designed to ensure that all expenditures would be met from operating revenues. Income from investments would be retained in reserves to preserve their real value.

To achieve greater efficiency and accountability in public expenditure, the Minister disclosed that the Civil Service was in the process of introducing fundamental reforms to its management and control system. The Civil Service would be restructured so that the process Budgeting For Results (BFR) would be introduced. Under the BFR, all government units such as Ministries and Departments would be managed as Autonomous Agencies (AA) with considerable autonomy in financial and personnel management in exchange for greater accountability for the results to be achieved with the public funds allocated to them. BFR should enable Singapore to maintain and improve on her competitiveness.

C. Tax changes

The Minister announced the proposed tax changes. These changes affecting companies and individuals are outlined below.[1]

II. GOODS AND SERVICES TAX (GST)

The Minister said the GST of 3 per cent introduced in April 1994 had been implemented smoothly. It had broadened Singapore's tax base and the reform of her tax system could now proceed a stage further. As the growth outlook in 1996 remains buoyant, there is no pressing need to stimulate the economy with drastic tax cuts. But tax incentives will be fine-tuned to promote high value-added activities and encourage investments in equipment to conserve water and energy and to control pollution.

1. Unless otherwise stated, all tax changes are effective as from Year of Assessment 1997.

III. TAX CHANGES FOR COMPANIES

A. Corporate income tax rate

The corporate income tax rate will be reduced from 27 to 26 per cent. The one per cent reduction will help attract foreign investors and lighten the burden on local industries.

B. Development and expansion incentive

To encourage companies which engage in high value-added activities to operate in Singapore and continue to invest in high technology projects, and the major upgrading of equipment and operations, a new Development and Expansion Incentive will be introduced to replace the post-pioneer incentive.

Under the new scheme, income from qualifying activities will be assessed to tax at a concessionary rate of not less than 10 per cent. The initial period of the incentive will not exceed ten years. Extensions of the incentive after the initial period may be granted. Each extension will not exceed a period of five years and the total period for the incentive will not exceed 20 years.

C. Investment allowance incentive for water recycling plant

Under the old investment allowance incentive scheme, an investment allowance granted to a company on the capital expenditure incurred for an approved project could be set-off against the chargeable income generated by that project. As this income is already granted tax exemption, there was no real benefit from setting-off the allowances. To encourage water conservation, investment allowances granted to companies for water-recycling plants will be permitted under the new scheme to be set-off against chargeable income taxed at normal rates provided certain water consumption levels are achieved. This incentive applies to qualifying water-recycling plant expenditure incurred on or after 1.1.96.

D. Tax deduction for general provisions of finance companies

To encourage finance companies to build up their reserves, finance companies will be allowed to claim a tax deduction for general provisions made for loans and investments in securities. To qualify for this concession, finance companies must meet the statutory minimum capital funds requirements of SGD 50 million and minimum capital adequacy ratio of 12 per cent as prescribed under the Finance Companies (Amendment) Act.

As in the case of banks, the total amount of general provisions eligible for tax deduction will be limited to 2 per cent of each finance company's prescribed loans and investments. The amount deductible each year will be limited to 0.5 per cent of such loans and investments or 25 per cent of each finance company's qualifying profit, whichever is the lower.

E. First-year depreciation for highly efficient pollution control and energy-efficient equipment

To encourage the use of highly-efficient pollution-control and energy-efficient equipment, all expenditure on such equipment incurred from 1.1.96 will enjoy 100 per cent depreciation in the first year after purchase. If a company has insufficient profits to enjoy the full 100 per cent write-off, the balance will be available for deduction in subsequent years. This scheme will be administered by the Ministry of the Environment.

F. Reduction of withholding tax rates

Payments of royalties and interest to non-residents are currently subject to tax at 27 per cent. To facilitate the development of Singapore as a knowledge centre and a node for technology transfer, the rate of tax on royalties and rent from movable properties payable to non-residents will be reduced to 15 per cent of the gross amount with immediate effect. The rate of tax on interest payments to non-residents is similarly reduced from 27 per cent to 15 per cent of the gross amount with effect from 29.2.96.

The reduction in withholding tax will further facilitate the rationalization and expansion of overseas operations which will benefit from lower borrowing costs.

The reduced rate of withholding tax will not apply to interest, royalties or rent for immovable properties derived by non-residents through operations carried out in or from Singapore. Such interest, royalties and rent will continue to be subject to tax on the net amount at the normal corporate income tax rate.

IV. TAX CHANGES FOR INDIVIDUALS

A. Personal income tax

An across-the-board one-off tax rebate of 10 per cent on individual income tax will be granted in Year of Assessment 1996.

From the Year of Assessment 1997, the tax system will be simplified and the number of brackets in the personal income tax schedule will be reduced from 14 to 10. The top marginal income tax rate will also be lowered from 30 per cent to 28 per cent with appropriate reductions in the other rates. (See Appendix A for the new brackets and rates). The new structure of tax brackets has been especially designed to lighten the tax burden on the middle income group, with chargeable incomes between SGD 25,000 and SGD 100,000.

B. Tax relief for national servicemen

The tax relief for active National Servicemen (NSmen) will be doubled from SGD 1,000 to SGD 2,000.

Parents and wives of NSmen who are themselves Singaporean citizens will also qualify for tax relief. Each parent will receive a tax free allowance of SGD 500, (regardless of the number of children who have undergone national service). Wives of NSmen will also each receive a tax free allowance of SGD 500.

C. Net annual value of residential properties

The Net Annual Value (NAV) of an owner-occupied residential property is deemed to be profits arising from property and taxable unless specifically exempted. The tax exemption limit for the net annual value of an owner-occupied residential property will be increased from SGD 75,000 to SGD 150,000.

D. Estate duty

Formerly the value of the estate of a deceased individual was taxed as follows:

Exemption for:
- First SGD 3 million of all residential properties
- First SGD 500,000 of all movable assets including Central Provident Fund (CPF) balances

Chargeable estate:

First SGD 10 million	@ 5%
Over SGD 10 million	@ 10%

With effect from 29.2.96, the first SGD 10 million threshold is raised to SGD 12 million. In addition, the exemption limits for residential properties is raised from SGD 3 million to SGD 9 million.

The exemption limit for movable properties including CPF balances is also raised from SGD 500,000 to SGD 600,000. In a case where the deceased's CPF balances exceed SGD 600,000, there will be no exemption for movable assets but CPF balances in excess of SGD 600,000 will continue to be exempt.

E. Rebates on Housing Development Board (HDB) service and conservancy charges and rent

With effect from 1.7.96, the Government will give to Singaporean citizens living in HDB flats, rebates on service and conservancy charges and rent ranging from two to three months depending on the type of HDB flat in which they live.

F. Rebates on utilities bills

With effect from 1.7.96, the Government will grant rebates of SGD 100 to SGD 150 on the utilities bill of HDB citizen-households, depending on the type of flat in which they live.

G. CPF Medisave top-up scheme

On 1.10.96, the Government will pay SGD 200 into the Medisave account of every Singapore citizen aged 21 and above.

H. Pre-Medisave top-up scheme

In January 1997, the Government will pay the second instalment of the Pre-Medisave Top-Up Scheme. The first instalment was paid in January 1996 and the third instalment will be paid in January 1998. The top-up grant will be paid into the CPF Medisave Accounts of eligible Singaporeans who are 62 years of age or older on 1.4.96. Eligible recipients will have to make a co-payment of SGD 50 between 1.7.96 to 31.12.96 into their CPF Medisave Accounts. The Government will match this SGD 50 with a contribution of SGD 100 to SGD 350 depending on the age group.

I. CPF share ownership top-up scheme (SOTUS)

To help Singaporeans build up sufficient CPF savings to buy more Singapore Telecom shares and other approved shares, the Government will pay SGD 300 to SGD 500 into the ordinary accounts of Singaporean citizens. To qualify for this top-up scheme, CPF members must pay at least SGD 500 into their accounts during the period 1.3.96 to 28.2.97.

V. OTHER TAX CHANGES

A. Reduction in property tax

With effect from 1.7.96, the property tax rate for industrial, commercial and let out residential properties will be reduced from 13 per cent to 12 per cent.

The 4 per cent concessionary tax rate for owner-occupied residential properties will remain unchanged.

B. Stamp duty on property transfers

With effect from 29.2.96, the threshold values for stamp duty on property transfers are:

(a) 1 per cent for the first SGD 180,000
(b) 2 per cent for the next SGD 180,000
(c) 3 per cent thereafter on the value of the property.

C. Stamp duty on leases

With effect from 29.2.96, the stamp duty on leases was halved. The new rates range from 0.4 per cent of annual rental for leases with a lease period of less than one year, to 1.6 per cent for those with a lease period of more than three years. The new table is:

D. Rationalization of instruments subject to Stamp Duty

With effect from 29.2.96, stamp duty on the following 13 types of instruments has been abolished:-

Art. No.	Description
1	Affidavit, Statutory Declaration or Declaration in writing
4	Appointment of a Receiver under a mortgage
5	Appointment of a New Trustee and Appointment in Execution of a Power
6	Articles of Association of a Company
13	Bond on obtaining letters of administration
14	Charterparty
30	Memorandum of Association of a Company
32	Notarial Act
36	Power or Letter of Attorney
37	Promissory Note
39	Receipts
42	Revocation of Power or Letter of Attorney
43	Revocation of Trust

With effect from 29.2.96, the rates of stamp duties set out in Appendix B apply.

VI. CONCLUSION

To conclude, the Minister urged Singaporeans to upgrade their skills, technical know-how and the strength of their companies. To achieve this, Singapore must continue to maintain a fiscal environment conductive to business. Furthermore, Singapore's tax regime must support the next phase of economic development. The Asian and regional economies are growing strongly and in the coming years, international competition will become more intense. However, the Minister is confident that if Singapore perseveres in upgrading its human resource and domestic technical capabilities and capitalizes on the opportunities abroad, she will continue to progress and excel in the future.

From the post-budget reaction and debates in the Parliament, it is evident that every sector in commerce and industry welcomes the Budget as it provides rebates and new incentives to all. However, there are some small and medium enterprises who feel very strongly that more rebates and incentives could have been offered to them since they argue they need them to compete effectively and efficiently in the fast changing business environment. Nevertheless in general the 1996 Budget was well received by everybody and most people regarded it as being both generous and pragmatic in an election year.

Appendix "A"

REDUCTION IN PERSONAL INCOME TAX RATES WITH EFFECT FROM YEAR OF ASSESSMENT 1997

Chargeable Income Group (SGD)	YA96 Existing Rates (%)	YA97 Revised Rates (%)
1 - 5,000	2.50	2.00
5,001 - 7,500	5.00	2.00
7,501 - 10,000	6.00	5.00
10,001 - 15,000	7.00	5.00
15,001 - 20,000	8.00	5.00
20,001 - 25,000	11.00	8.00
25,001 - 35,000	13.00	8.00
35,001 - 50,000	15.00	12.00
50,001 - 75,000	19.00	16.00
75,001 - 100,000	22.00	20.00
100,001 - 150,000	24.00	22.00
150,001 - 200,000	25.00	23.00
200,001 - 400,000	28.00	26.00
> 400,000	30.00	28.00

Appendix "B"

Stamp Duties Retained and Streamlined

Article No.	Description of instrument	Current Duty	New Duty
11(a)(i)	Bond or other instruments being principal security for payment of money over a definite period	same as article 31(a) (i.e. 0.4%-0.5%)	as for article 31(a) (i.e. 0.4%)
11(a)(ii)	Bond or other instruments being principal security for payment of money over an indefinite period	2% [max SGD 500]	no change
11(b)(i)	Bond or other instruments being additional security to 11(a)(i)	SGD 10	SGD 10
11(b)(ii)	Bond or other instruments being additional security to 11(a)(ii)	0.5% [max SGD 500]	SGD 10
11(d)	Transfer, assignment or disposition of any instrument relating to a lease of any movable property by a lessor	same as article 31(d)	as for article 31(d)
12	Bond or other instrument by way of indemnity or security for the due execution of an office, or for the discharge of liabilities	SGD 4-SGD 5	SGD 10
16(a)	Conveyance assignment or transfer on sale of any property (except stock and marketable securities)	for the first SGD 30,000 - SGD 2 per 100 or part thereof for the next SGD 20,000 - SGD 2.5 per SGD 100 or part thereof thereafter for every SGD 100 or part thereof - SGD 3	No change
16(b)	On sale of any stock or shares	For every SGD 100 or part thereof 20 cents	No change
16(e)	Transfer to trustee	SGD 10	lesser of duty under article 16(a)/(b) or SGD 10
16(f)(i)	Transfer between trustees where beneficial interest passes	as article 16(a)/(b)	as article 16(a)/(b)
16(f)(ii)	Transfer between trustees where beneficial interest does not pass	SGD 5	lesser of duty under article 16(a)/(b) or SGD 10
16(g)	Transfer of any other kind	SGD 10	SGD 10
17	Duplicate	lesser of original duty or SGD 2	lesser of original duty or SGD 2
18	Any separate deed of covenant made on the sale or mortgage of any property	SGD 10	SGD 10
20	Declaration of Trust	SGD 10	SGD 10
21	Dissolution of Partnership	SGD 10	SGD 10
29(d)	Lease executed in pursuance of a duly stamped agreement	SGD 2	SGD 2
29(e)	Lease of any other kind	SGD 10	SGD 10
31(a)	Mortgages, Agreement for a mortgage, bond, covenant and debenture - being principal security for payment of money	for the first SGD 1000 - SGD 4; for every further sum of SGD 1000 or part thereof - SGD 5 [max SGD 500]	for every SGD 1000 or part thereof - SGD 4 [max SGD 500]

Stamp Duties Retained and Streamlined

31(c)	Mortgages, Agreement for a mortgage, bond, covenant and debenture - being an equitable mortgage	for the first SGD 1000 - SGD 2 for every further SGD 1000 or part thereof - SGD 2.5 [max. SGD 500]	for every SGD 1000 or part thereof - SGD 2 [max SGD 500]
31(d)	Transfer of mortgage or other instrument	for the first SGD 1000 - SGD 2 for subsequent SGD 1000 - SGD 2.5 [max SGD 500]	for every SGD 1000 - SGD 2 [max. SGD 500]
31(e)	Mortgage or other instruments pursuant to a duly stamped agreement	SGD 2	SGD 2
31(f)	Mortgage or other instruments of any other kind not covered by 31(a)-(e)	SGD 10	SGD 10
33	Partnership agreement	SGD 10	SGD 10
34	Partition	SGD 20	SGD 10
40	Reconveyance	SGD 1-SGD 10	SGD 10
44(a)	Settlement	same as article 16	same as article 16
44(b)	Settlement pursuant to agreement	SGD 2	lesser of duty on settlement or SGD 2
46	Surrender or lease	lesser of duty on lease or SGD 10	lesser of duty on lease or SGD 10

UNITED STATES

INTEREST ALLOCATION RULES FOR US BRANCHES

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I. INTRODUCTION

The Internal Revenue Service has issued final interest allocation regulations for foreign corporations that conduct business in the United States.[1] The regulations are issued pursuant to Section 882 of the Internal Revenue Code,[2] which authorizes the Secretary of the Treasury to promulgate regulations for the "proper apportionment and allocation" of deductions by foreign corporations engaged in business in the United States.[3] The regulations are modelled extensively on the current regulations and generally adopt the changes in the proposed regulations issued on 24 April 1992,[4] subject to several modifications.

The new regulations will be effective for taxable years that begin on or after 6 June 1996. The methods prescribed therein will be the exclusive means for determining the amount of interest that will be permitted to be deducted by a US branch in computing its income tax liability.[5] The Treasury Department states in the regulations that these methods must also be used under US tax treaties to compute business profits of foreign enterprises with US permanent establishments.[6]

The purpose of the new regulations is to update the current regulations[7] by taking into account legislative changes, most notably the enactment of the US branch profits tax in 1984[8] and the enactment of the Subpart J foreign currency rules in 1986.[9] An additional purpose is to address the impact of financial products, including notional principal contracts, on the mechanics of the interest allocation, although in this regard the regulations reserve in a number of places on the treatment of hedging transactions.

II. OVERVIEW OF THE FINAL REGULATIONS

The final regulations require foreign corporations to allocate interest expense to the United States using either:

(1) a general method that corresponds to the branch book/dollar pool method used in the current regulations, (although it is no longer referred to by this name); or
(2) a modified form of the separated currency pools method in the current regulations.[10]

The formulary methods are based on the principle that money is fungible and that the assets of the US branch are financed proportionately by the debt and equity of the foreign corporation taking into account its worldwide operations as a whole.

As an exception to the formulary methods, the regulations permit interest to be allocated directly to income from a specific asset if certain conditions are met, principally that the asset secures the liability on a non-recourse basis or is part of an integrated financial transaction, both as defined under the interest-source allocation rules of Section 861 of the IRC.[11]

The final regulations continue many of the basic rules in the current and proposed regulations for US branches of foreign corporations.[12] The most significant modifications are the removal of the 96 per cent cap for foreign banks in the "actual ratio" used to allocate liabilities to the United States, which was a key feature of the proposed regulations, and the continuation of the separate currency pools method, which had been withdrawn by the proposed regulations. Another significant modification is the streamlining of the rules in the final regulations for determining US branch assets to conform to the rules used for the branch profits tax (BPT).

The amount allocated to the US branch under either the general method or the separate currency pool method is determined using a three-step procedure. Both methods require determining the value of the assets used by the US branch and the proportionate amount of the liabilities of the foreign parent deemed to fund such assets. The difference between the methods is twofold: first, the general method requires that the allocation be made on the basis of the overall liabilities of the US branch, whereas the separate currency pools method allows a separate calculation for each currency in which the US branch has funded its assets; and second, the general method calculates the interest expense using separate interest rates for borrowings booked through the US branch and for liabilities booked outside the United States, whereas the sep-

1. T.D. 8658, 1996-14 I.R.B. (1 April 1996) at 13.
2. Hereinafter the IRC.
3. IRC § 882(c)(1)(A). Sec. 882 permits a foreign corporation engaged in business in the United States to claim deductions "only if and to the extent" such deductions are connected with income that is effectively connected with the US business.
4. INTL-309-88, 1992-1 C.B. 1157.
5. Treas. Reg. § 1.882-5(a)(1)(i).
6. See VI. G.
7. Treas. Reg. § 1.882-5 (adopted by T.D. 7749, 30 December 1980, 1981-1 C.B. 390, amended by T.D. 7939, 16 January 1984, 1984-1 C.B. 171).
8. IRC § 884.
9. IRC §§ 985-989.
10. Treas. Reg. § 1.882-5(a)(1)(i).
11. See V.
12. The new regulations apply to foreign corporations that are engaged in a trade or business in the United States. The term US branch is used herein as a short-hand expression.

arate currency pools method calculates the interest expense using the worldwide average interest rate for each foreign currency.

III. THE GENERAL ALLOCATION METHOD

The general allocation method uses the three-step procedure in the current regulations for the branch book/dollar pool method. This consists of (1) determining the total value of the US assets for the taxable year, (2) determining the total amount of US-connected liabilities for the taxable year, and (3) determining the amount of interest expense allocable to effectively connected income (ECI). The regulations incorporate many of the rules used in the branch profits tax (BPT) regulations for classifying US branch assets and liabilities.

While the three steps are governed by a number of special rules, the essence of the general method is to permit the US branch to deduct the actual interest paid or accrued on liabilities booked through the US branch, adjusted upwards or downwards by the hypothesized amount of US effectively connected liabilities, i.e. the amount of liabilities that would be allocated to the branch using the overall liabilities to assets ratio of the foreign corporation.

A. Step 1 – Determining the total value of US assets for the taxable year

1. Identifying US branch assets

The first step in the final regulations is to identify the assets of the foreign corporation that are attributable to the US branch.[13] Unlike the current regulations, which attribute assets to the US branch based on the ECI standard,[14] the final regulations incorporate the asset attribution rules of the BPT regulations. The BPT regulations use an ECI standard and also list assets by specific type and provide classification rules for each.[15] As a general rule, assets that solely produce ECI under the BPT regulations are treated as US assets, and assets that produce both ECI and non-ECI under the BPT regulations are treated as US assets in a proportionate amount, with the specific proportion depending on the type of asset.[16] Depreciable property, for example, is attributed to a US branch in the proportion that the depreciation deductions allowed in computing the ECI of the foreign corporation bear to the total depreciation claimed on the property. Specific rules are also provided for inventory, instalment obligations, receivables, bank deposits, debt instruments, securities, and partnership interests.[17]

The final regulations also clarify the circumstances under which real property will be treated as a US asset. Contrary to the recommendations of commentators, the Treasury Department decided to include US real property acquired by foreign banks as a result of foreclosure as US assets, and also real estate owned in the United States and used as offices by a foreign corporation, in both cases on the basis that the income from such assets would be treated as ECI. In addition, the real estate owned or foreclosed on will be treated as a US asset whether held directly by the foreign corporation or thought a US subsidiary.[18]

The final regulations also contain specific inclusion and exclusion rules for certain assets and classes of taxpayers.[19] The inclusions apply to assets held by industries and entities that are given special tax treatment under the IRC, for example certain assets held by a foreign sales corporation (FSC), certain captive insurance company assets, and certain assets of possession banks.[20]

The final regulations provide, as do the current regulations, that inter-branch transactions are to be disregarded and are not to be treated as creating US assets or liabilities.[21]

2. Determining the value of US branch assets

Assets attributed to the US branch are valued at their tax basis unless the taxpayer makes an affirmative election to make the valuation based on fair market value.[22] The election applies to all assets held by the branch, i.e. it cannot be made only with respect to particular assets. The method for determining the fair market value is the same as that used in the interest allocation and apportionment regulations applicable to US affiliated corporate groups.[23] If the taxpayer makes an election to use fair market value, it must be used for both Steps 1 and 2 and it must be continued to be used from year-to-year unless the Internal Revenue Service (IRS) consents to a change.[24]

The final regulations require that the value of an asset be computed "at the most frequent, regular intervals for which data are reasonably available."[25] This requirement contains a number of uncertainties, for example, the length or expense to which a taxpayer will be required to go to produce "reasonably available" data, and the use to be made of data which may be reliable but not regular, presumably the issue being not to cause a distortion to the average value determination.

13. Treas. Reg. § 1.882-5(b).
14. The formulation of the attribution rule in the current regulations is that the assets of the foreign corporation are attributed to the US branch if they have been used to generate (or could be expected to be used to generate) income, gain, or loss that is effectively connected with the US trade or business of the branch. See current Treas. Reg. § 1.882-5(b)(1).
15. Treas. Reg. § 1.884-1(d). The BPT regulations were amended concurrently with the issuance of the final regulations under Sec. 882. They differ in material respects from the proposed Sec. 884 regulations on which the proposed Sec. 882 regulations (issued in April 1992) were based. The ECI standard in the new BPT regulations applies to any income that would be treated as effectively connected to a US business under any provision of the IRC. See Treas. Reg. § 1.884-1(d)(1)(iii). In general, this means applying the asset use test and the business activities test of Sec. 864 of the IRC and the regulations thereunder.
16. Treas. Reg. § 1.884-1(d)(1)(ii) and -1(d)(2).
17. For the partnership rules see Treas. Reg. § 1.884-1(d)(3) and VI. B.
18. Treas. Reg. § 1.882-5(b)(1)(3)(A).
19. The specific exclusions apply to certain railroad rolling stock and communication satellite systems. Treas. Reg. § 1.882-5(b)(1)(ii) and IRC § 883(a)(3) and (b).
20. Treas. Reg. § 1.882-5(b)(1)(iii).
21. Treas. Reg. § 1.882-5(b)(1)(iv) and -5(c)(2)(viii).
22. Treas. Reg. § 1.882-5(b)(2).
23. Treas. Reg. § 1.861-9T(g)(1)(iii) and -9T(h). These regulations contain rules for valuing group assets, tangible property, and intangible property, and place the burden of proof on the taxpayer to establish fair market value to the satisfaction of the IRS.
24. See VI. D. for the rules governing elections under the final regulations.
25. Treas. Reg. § 1.882-5(b)(3).

As a minimum requirement, the regulations specify that large banks must make a valuation at least monthly and other taxpayers at least semi-annually.[26] In addition, banks are required to reduce the value of loans that qualify as US assets by the amount of the bad debt reserve for the loans under IRC Section 585.[27]

The preamble to the final regulations makes it clear that the average value determination is to be made on an asset-by-asset basis, and this is the way the test is formulated in the regulations. Since the frequency of valuation may vary from asset to asset, for example some assets may be susceptible to daily valuations and others no more than once annually, the progression is to first determine the average annual value of each asset and then add all such values obtained.[28]

The final regulations remove the special valuation rule in the proposed regulations for stock owned by a US branch, which was required to be adjusted by a percentage of the dividends received deduction permitted by the IRC.[29] This rule is no longer necessary in part because stock will not normally generate ECI under the general rules of Section 864(c) of the IRC except for US branches that hold the stock as part of their business activities or as part of a banking or finance business.[30]

B. STEP 2 – Determining the total amount of US-connected liabilities for the taxable year

The second step for calculating the interest deduction in the final regulations is to determine the total amount of the US-connected liabilities of the US branch.[31] As in the current regulations, this is determined by multiplying the total value of US assets determined in Step 1 by either the "actual ratio" or, at the election of the taxpayer, the "fixed ratio".

Although the title of Step 2 might imply determining US-connected liabilities on a tracing basis, the calculation used is actually a ratio of liabilities to assets for the foreign corporation as a whole, regardless of where the liabilities are incurred or booked (i.e. the US branch, home office, or third-country branch) or where the proceeds are expended. Liabilities can thus be attributed to the US branch in Step 2 even if the liabilities are incurred and booked abroad.[32]

1. The fixed ratio

The fixed ratio for all foreign corporations other than those conducting a banking business is 50 per cent of assets. For banks,[33] the final regulations change the fixed ratio to 93 per cent of assets (down from 95 per cent of assets in the current regulations).[34] The fixed ratios are intended by the regulations as safe harbours to save taxpayers the complexity of calculating the actual ratio. However, taxpayers remain free under the final regulations to compute and use the actual ratio as discussed below.

Once elected, the fixed ratio must be used by the taxpayer for all subsequent years unless the IRS consents to a change to the actual ratio. The regulations do not list the criteria under which the IRS will consent to such a change, but it is stated that the IRS will approve such change only in rare and unusual circumstances.[35]

2. The actual ratio

The actual ratio is defined in the final regulations, as in the current regulations, as the ratio of the average amount of the worldwide liabilities of the foreign corporation to the average total value of the corporation's worldwide assets, including in both cases the assets and liabilities of the US branch.[36] The final regulations abandon the special 96 per cent limitation on the actual ratio in the proposed regulations for foreign banks.[37] The preamble states that the actual ratio is the preferred ratio, and it is for that reason that the 96 per cent limitation was dropped. Banks with a low actual ratio may nevertheless elect to use the 93 per cent fixed ratio safe-harbour discussed above.

The final regulations relax the frequency with which the actual ratio must be computed from monthly in the proposed regulations to semi-annually in the case of large banks, and annually in the case of other taxpayers.[38]

3. Valuing assets and liabilities for the actual ratio

Assets are valued for the actual ratio using their tax basis unless the taxpayer makes an affirmative election to base the valuation on fair market value.[39] The same rules used to value assets in Step 1 apply generally in Step 2. The value of the assets and the amount of liabilities of the taxpayer must be determined consistently from year to year.

The final regulations provide that the classification of an item as an asset or liability must be made *strictly* in accordance with US tax principles.[40] However, the value of an asset or

26. Treas. Reg. § 1.882-5(b)(3). A bank is defined as a "large bank" if the average tax basis of its assets (or that of its parent-subsidiary controlled group) for the taxable year exceeds USD 500 million. IRC § 585(c)(2).
27. Treas. Reg. § 1.885-5(b)(2)(iii).
28. This is different from the valuation used for BPT purposes, which is required as of each "determination date" necessary to compute BPT liability. Since BPT liability is based in part on annual changes in the US net equity of the US branch, this is a year-end calculation. See Treas. Reg. § 1.884-1(c)(3).
29. Prop. Treas. Reg. § 1.882-5(b)(2)(iii)(B).
30. See Treas. Reg. § 1.864-4(c)(3) and -4(c)(5).
31. Treas. Reg. § 1.882-5(c).
32. The place where the liabilities are booked will, however, make a difference in calculating the interest deduction for the US branch in Step 3.
33. See note 53 below for the definition of a bank for this purpose.
34. Treas. Reg. § 1.882-5(c)(4). The 93 per cent ratio for banking branches is based on the US regulations that implement the Basle Agreement on bank capital standards. These regulations require a capital ratio of 8 per cent. The 93 per cent ratio includes a 1 per cent discount from capital for subordinated debt.
35. See VI. D.
36. Treas. Reg. § 1.882-5(c)(2)(i).
37. Prop. Treas. Reg. § 1.882-5(c)(2(i). The 96 per cent limitation in the proposed regulations was based on the 4 per cent "leverage ratio" of equity to assets that is generally required to be maintained by US banks. The Treasury Department was of the view that foreign banks should have at least 4 per cent net equity capital, but has withdrawn from this position.
38. Treas. Reg. § 1.882-5(c)(2)(i). See *supra* note 26 for the definition of a large bank. The provision in the proposed regulations that allowed banks to compute the actual ratio on the basis of a hypothetical tax year ending six months earlier was not included in the final regulations. See Prop. Treas. Reg. § 1.882-5(c)(2)(iv)(B) and -5(f) Example (2).
39. Treas. Reg. § 1.882-5(c)(2)(iv).
40. Treas. Reg. § 1.882-5(c)(2)(ii).

liability need only be determined *substantially* in accordance with US tax principles.[41] This is a change from the proposed regulations which required that the value be determined strictly in accordance with US principles.[42] The substantially requirement will be met if the amount of the liability or value of the asset does not differ from the amount that would be determined using US tax principles to such a degree that the difference materially affects the value of the taxpayer's worldwide liabilities or assets or the actual ratio.[43]

A weakness in the final regulations is that they do not quantify the standards applied in this area, i.e. substantially is defined in terms of materiality, but both terms are subjective without further defining criteria. A safe-harbour would have improved the usefulness of the test.

The final regulations illustrate the classification and valuation rules with the following examples:[44]

(1) The first example concerns the classification of a liability under debt/equity principles, and involves a perpetual subordinated debt instrument that would be treated as indebtedness under the foreign law involved but would not be so treated under US tax principles.[45] The foreign determination is thus not (strictly) in accordance with US principles, and the example concludes that the liability will be disregarded in computing the actual ratio.
(2) The second example concerns the calculation of a bank reserve in a manner that causes the value of assets to be understated in the financial statements relative to the value they would have been stated at had the reserve been computed using US tax principles. The example does not disclose the nature of the reserve. Since the difference is stated as having a material effect on the worldwide assets of the company, the value as computed under foreign law is disregarded, and the value of the assets is increased by the overstated reserve amount. The example does not quantify the degree of variation that will lead to a conclusion that the difference is material.
(3) The third example involves the use of a foreign depreciation method for non-US assets that is not available in the United States. The example does not disclose the difference in the amount of depreciation calculated, but stipulates that the difference did not materially affect the value of the bank's worldwide assets or its actual ratio, and thus concludes that the depreciation calculation was "substantially" in accordance with US tax principles.

The final regulations remove the special basis adjustment rule in the proposed regulations for subsidiaries in which the foreign corporation owned 20 per cent or more of the total combined voting power.[46] Under the proposed regulations, the basis of 20 per cent owned stock was required to be adjusted by the taxpayer's pro rata share of the earnings and profits (or deficit in earnings and profits) of the subsidiary that accumulated during the period the taxpayer held 20 per cent or more of the subsidiaries stock.

C. STEP 3 – Determining the interest expense allocable to ECI under the adjusted US booked liabilities method

The third step is the calculation of the amount of interest to be allocated to the US branch.[47] This is done by comparing the US-connected liabilities determined in Step 2 with the "branch book" liabilities, i.e. the liabilities properly accounted for through the US branch as reflected in its books. The interest deduction allowed under Section 882 is then the actual interest paid by the US branch on its booked liabilities, adjusted upwards or downwards to reflect the difference between the US branch book liabilities and the US-connected liabilities.

1. Determining liabilities booked in the US branch

The first part of Step 3 is to determine the booked liabilities of the US branch. The final regulations provide that a US booked liability is one "properly reflected" in the books of the US trade or business.[48] This is primarily a question of fact and of connecting the liabilities of the foreign corporation to the US branch. The final regulations contain different rules for making the connection for banks and non-banks. As a minimum requirement, the regulations specify that large banks must determine the amount of US booked liabilities at least monthly and other taxpayers at least semi-annually.[49]

In the case of partnership liabilities, the properly reflected standard is applied at the partnership level with respect to the books of the partnership's US business.[50]

(a) *Rules for non-banks*[51]

For non-banks, a liability is properly reflected in the books of the US branch if one of the following three conditions are satisfied:

(1) the liability is secured predominately by a US asset;
(2) the liability is recorded in the books of an activity that produces US ECI at a time "reasonably contemporaneous" with the time at which the liability is incurred; or
(3) the foreign corporation maintains books for an activity that produces US ECI and the District Director or Assistant Commissioner (International) determines that there is a direct connection between the activity and the liability.

41. Treas. Reg. § 1.882-5(c)(2)(iii) and (iv).
42. Prop. Treas. Reg. § 1.882-5(c)(2)(iii).
43. Treas. Reg. § 1.882-5(c)(2)(iii).
44. Treas. Reg. § 1.882-5(c)(5), Examples (1)-(3). The last example, involving a compensated loan by a US branch for the purpose of increasing US assets is discussed in VI. C.
45. Neither the IRS nor the US courts would recognize a perpetual loan obligation as indebtedness for income tax purposes.
46. Prop. Treas. Reg. § 1.882-5(c)(2)(iii)(C).
47. Treas. Reg. § 1.882-5(d).
48. Treas. Reg. § 1.882-5(d)(2).
49. Treas. Reg. § 1.882-5(d)(3). See *supra* note 26 for the definition of a large bank.
50. Treas. Reg. § 1.882-5(d)(2)(vii).
51. Treas. Reg. § 1.882-5(d)(2)(ii).

In normal usage, the predominately secured requirement of (1) would mean more than 50 per cent of the amount of the liability. For (2) and (3), there is no guidance given in the regulations other than that the direct connection in (3) is to be determined based on all the facts and circumstances. The "reasonably contemporaneous" requirement is also undefined, though clearly more liberal than the same-day rule for banks discussed below.

The final regulations provide that the identification rules used for the purposes of computing the branch level interest of the BPT do not apply under Section 882.[52]

(b) *Rules for banks*[53]

For banks, a liability is properly reflected in the books of the US branch if both of the following conditions are satisfied:

(1) the bank enters the liability in the books of an activity that produces US ECI before the close of the day on which the liability is incurred; and
(2) there is a direct connection between the activity and the liability.[54]

Relief from this rule is possible if the failure to record the liability in the US books before the close of the day is due to inadvertent error and the direct connection in (2) can be shown. The direct connection is to be determined based on all the facts and circumstances, although there is not a requirement as in the case of non-banks for approval of the District Director or Assistant Commissioner (International).

2. Calculating the interest deduction

Once the amount of the booked liabilities is determined, the interest deduction is computed by comparing the US booked liabilities to the US-connected liabilities determined in Step 2. The comparison may result in either the branch book liabilities being larger or the Step 2 liabilities being larger, and the interest deduction is then computed by increasing or decreasing the actual interest expense of the US branch on its booked liabilities.[55]

(a) *Branch book liabilities exceed US-connected liabilities*

If the branch book liabilities exceed the Step 2 liabilities, then the interest deduction of the US branch is the amount of the interest expense paid or accrued as shown in the books of the US branch, scaled back to the amount of interest on US booked liabilities equal in amount to the US connected liabilities.[56] A "scaling ratio" is used for this purpose, which is the ratio of the US-connected liabilities (Step 2) to the total amount of the branch book liabilities. The final US interest deduction is as follows:

$$\text{Branch interest deduction} = A \times \frac{B}{C}$$

where: A = Branch book interest expense
B = US-connected liabilities
C = US branch book liabilities

(b) *US-connected liabilities exceed branch book liabilities*

If the US-connected liabilities (Step 2) exceed the branch book liabilities, then the US branch is permitted to deduct interest both with respect to its branch book liabilities and with respect to the excess US-connected liabilities. The interest deduction for the excess Step 2 liabilities is equal to the amount of such excess liabilities multiplied times the average interest rate shown in the books of the foreign corporation for its non-US liabilities that are denominated in US dollars, i.e. the total interest expense paid or accrued on US dollar denominated liabilities of the foreign corporation that are booked through offices or branches of the foreign corporation located outside the United States divided by the total amount of such liabilities.[57]

The effect of this formula is to determine the average interest rate on the foreign corporation's external US dollar denominated debt, i.e. dollar debt that is not booked through the US branch. The final US interest deduction is as follows:

$$\text{Branch interest deduction} = A + \left(D \times \frac{E}{F}\right),$$

where: A = Branch book interest expense
D = Excess US-connected liabilities
E = Total interest expense on external US dollar denominated liabilities
F = Total amount of external US dollar denominated liabilities

The rule for excess US-connected liabilities in the final regulations is a liberalization of the proposed regulations, which had limited the interest rate on the excess amount to 90 per

52. Treas. Reg. § 1.882-5(d)(2)(ii)(B). The interest level rules of the BPT rules generally permit the identification to be made on or before the earlier of the first interest payment date for the liability or the due date of the tax return for the year, and have different limitations and requirements than those discussed above. See Treas. Reg. § 1.884-4(b)(1)(ii) and -4(b)(3). On the other hand, the BPT regulations incorporate the Sec. 882 regulations, with modifications, to determine US liabilities for purposes of the US net equity computation. See Treas. Reg. § 1.884-1(e).

53. Treas. Reg. § 1.882-5(d)(2)(iii). A bank is defined for this purpose by reference to Secs. 581 and 585(a)(2)(B) of the Code, which in general means an institution that accepts deposits and makes loans, or exercises fiduciary powers similar to those permitted to US national banks under the authority of the US Comptroller of the Currency, and that is subject to State or Federal supervision.

54. The rule in the proposed regulations that treats liabilities as US booked if so reported to a bank regulatory body (e.g., the Federal Reserve Board or Comptroller of the Currency) was not adopted in the final regulations. See Prop. Treas. Reg. § 1.882-5(d)(2))(C).

55. The concept is to permit a deduction for the amount of interest that is deemed to accrue on liabilities equal to the US-connected liabilities, but with particular rules for the rates of interest used, i.e. for US booked liabilities the actual rate, and for excess US-connected liabilities the external US dollar rate.

56. Treas. Reg. § 1.882-5(d)(4). The current regulations use a concept of the "average US-connected interest rate", which is equal to the total interest expense shown in the books of the US branch divided by the average total amount of the liabilities shown in the books of the US branch. Both the interest expense and the liabilities are stated in US dollars. The interest rate so determined is multiplied times the Step 2 liabilities and the result is the amount of interest expense deductible by the US branch for the taxable year. See current Treas. Reg. § 1.882-5(b)(3)(i)(A). The final regulations reject this method in favour of using the branch's actual interest expense for the US booked liabilities.

57. Treas. Reg. § 1.882-5(d)(5). The current regulations provide that if the actual interest rate for the dollar denominated non-US liabilities can not be determined, (referred to as "the non-US connected interest rate",) then such interest rate will be determined using any method that reasonably approximates to the actual rate, for example the London inter-bank offered rates (LIBOR) for 30-day deposits. The current regulations also provide that if the foreign corporation's dollar denominated non-US liabilities are *de minimis*, then the "average US-connected interest rate" (see *supra* note 56) will be applied to the total amount of the Step 2 liabilities. See current Treas. Reg. § 1.882-5(b)(3)(i)(B). The final regulations eliminate these rules.

cent of the LIBOR rate for US dollar demand deposits in the case of banks and 110 per cent of LIBOR in the case of non-banks.[58]

IV. THE SEPARATE CURRENCY POOLS METHOD

As an alternative to the general method discussed above, the final regulations permit the interest deduction of the US branch to be computed using the separate currency pools method. This method was restored from the current regulations, although in a form tied to US branch assets rather than liabilities.

The separate currency pools method uses the three-step procedure outlined above with the modification that the third step, determining the interest allocable to the US branch, is based on a separate calculation for each currency in which the US branch has financed its assets.[59] As with other elective alternatives contained in the final regulations, the separate currency pools method must be used for at least five taxable years before a change to the general method can be made.[60]

Step 1 of the separate currency pools method is computed as in the general method with the modification that the value of the US assets in each pool must be computed in the currency for that pool. The corporation can use the US dollar for any currency pool in which it holds less than 3 per cent of its US assets. The same valuation rules apply as in the general method.[61]

For Step 2, the US-connected liabilities are again computed separately for each currency pool. This is done by multiplying the value of the US assets in the currency pool, as determined in Step 1, by the actual or fixed ratio for the foreign corporation.[62]

Step 3 is computed as the multiplied product of the US-connected liabilities in Step 2 for each foreign currency pool and the "prescribed" interest rate for that currency. The prescribed interest rate is the average interest rate incurred by the foreign corporation for borrowings in that currency, i.e. the total amount of interest paid on that currency divided by the total amount of worldwide liabilities denominated in that currency.[63] The interest expense and liabilities must be stated in the foreign currency.

A separate calculation must be made for each currency in which the US branch has financed its assets, and the sum of the amounts so calculated is the interest deduction for the US branch under the separate currency pools method.

Like the general allocation method, the separate currency pools method allows the US branch to deduct interest based on the amount of the Step 2 allocated liabilities. The difference between the two methods is the interest rates used for the calculation. The interest rates for the separate currency pools method are the average worldwide rate for each currency, whereas the interest rates used for the general allocation method are the actual rates incurred by the US branch for US booked liabilities and, in the case of excess US connected liabilities, the external rate for US dollar denominated obligations.

To prevent distortions in the calculation, a special rule provides that the separate currency pools method may not be used if more than 10 per cent of the foreign corporation's US assets are denominated in a hyper-inflationary currency.[64]

The separate currency pools method in the final regulations differs from the method in the current regulations in that it treats each US asset as having been funded by the liabilities of the foreign corporation in that currency, whereas the method of the current regulations relied on the currency denomination of the US booked liabilities.[65]

V. DIRECT ALLOCATION OF SPECIFIC LIABILITIES

The final regulations permit interest on a liability to be directly allocated to income from a specific property or asset if the borrowing transaction satisfies the conditions set forth in the interest-source allocation rules of Section 861 of the IRC.[66] In such cases the interest deduction acts as an offset from the gross income derived from the asset to which the liability relates.

In general a direct allocation of interest expense is permitted under Section 861 in two cases. The first case applies to interest on qualified non-recourse indebtedness, where the liability is incurred to acquire an identified property and the property is the sole security and source of repayment for the liability. The second case applies to interest incurred on funds borrowed as part of an integrated financial transaction. There are a number of specific requirements that must be met for each case to apply.[67]

58. Prop. Treas. Reg. § 1.882-5(d)(4)(ii).
59. Treas. Reg. § 1.882-5(e).
60. See VI. D.
61. See III. A. 2.
62. The actual ratio is not separate currency dependent since it is based on the worldwide assets and liabilities of the foreign corporation and must be computed in either US dollars or the foreign currency of the home office. See Treas. Reg. § 1.882-5(c)(2)(ix) and VI. A.
63. Treas. Reg. § 1.882-5(e)(2).
64. Treas. Reg. § 1.882-5(e)(4). See note 71 below for the definition of hyper-inflationary currency.
65. The method for Step 3 in the current regulations is to compute the multiplied product of the following amounts for each foreign currency pool:
(1) The allocated liabilities from Step 2, stated in US dollars, divided by the total US branch book liabilities, stated either in US dollars or in the currency of the foreign country where the head office is located,
(2) The US branch book liabilities for the separate currency pool for which the allocation is being made, expressed in the same currency used in the denominator in paragraph (1) above, i.e. the US dollar or the head office currency, and
(3) The average worldwide interest rate incurred by the foreign corporation on liabilities denominated in the currency for the separate pool.
A separate computation is made for each currency and the sum of the amounts calculated is the interest deduction for the US branch under the separate currency pools method in the current regulations. See current Treas. Reg. § 1.882-5(b)(ii). As noted in the text, the current method is based on the US branch book liabilities whereas the new method is based on US branch assets.
66. Treas. Reg. § 1.882-5(a)(1)(ii).
67. See Treas. Reg § 1.861-10T(b) and (c).

If a direct allocation is made, the assets and liabilities of the foreign corporation must be adjusted so that the interest expense is not taken into account twice, i.e. once under Section 861 and again under Section 882. This means removing the particular asset, liability, and interest expense in all three steps of the Section 882 calculation, including the separate currency pools method.

A direct allocation can also be made with respect to the foreign corporation's share of interest on liabilities incurred through a partnership. See VI. B.

VI. RULES FOR APPLYING THE REGULATIONS

A. Foreign currency aspects

The regulations contain a number of rules for dealing with the foreign currency aspects of the allocation methods. As a general rule, the regulations require that values and amounts be translated into the relevant currency using either the spot exchange rate or the weighted average exchange rate for the currency, whichever method the taxpayer uses for financial accounting purposes.[68] The method chosen must be used consistently from year to year. The interest expense must be translated using the rules of Subpart J of the IRC. These rules generally apply based on the interest expense payment or accrual rules for the particular obligation, and use either the spot rate or average exchange rate accordingly.[69]

For purposes of computing the actual ratio in Step 2, the regulations require that assets and liabilities be stated in either US dollars or the functional currency of the country in which the head office of the foreign corporation is located.[70] An example is given of a taxpayer that determines the actual ratio annually and uses British pounds for financial reporting purposes, and is thus required to convert the US dollar value of the assets and liabilities of its US branch into British pounds at the spot rate on the last day of the taxable year.

For taxpayers whose functional currency is hyper-inflationary, the IRS can require that the US dollar be used to make the calculations under the regulations if a material distortion to the actual ratio or a distortion of another calculated amount would otherwise occur.[71]

B. Rules for partnership interests

The regulations contain specific rules to deal with assets and liabilities held through partnerships. For the purpose of Step 1, the BPT regulations provide that a partnership interest is treated as a US asset using either the asset method or the income method.[72] In brief, the asset method relies on determining the partner's share of the tax basis of each US asset in the partnership, which is the proportion in which the partner shares in the income, gain, loss or deduction that is generated by the asset, and then determining the portion that the sum of all such amounts bears to the partner's share of the tax basis of all assets held by the partnership. The income method treats the partnership interest as a US asset in the proportion that the partner's distributive share of ECI from the partnership bears to the partner's total distributive share of all income from the partnership. If a fair market value election is made, the final Section 882 regulations provide that the value shall be the fair market value of the partnership interest increased by the partner's share of the liabilities of the partnership determined under Step 2.[73]

For purposes of computing the actual ratio in Step 2, the regulations provide that the value of a partnership interest is equal to (i) the partner's adjusted tax basis for the partnership interest, reduced by (ii) the partner's share of partnership liabilities as determined under the partnership provisions of the IRC,[74] and increased by (iii) the partner's share of partnership liabilities determined under Step 2. Partnership liabilities are allocated among the partners for purposes of Step 2 in the same proportion as the expense for the liability is allocated among the partners for regular income tax purposes.[75]

As noted in Part V. above, a direct allocation may be made for liabilities incurred through a partnership. In this case the foreign corporation allocates its distributive share of the interest expense of the partnership with respect to the liability to the partner's distributive share of the income from the asset to which the liability relates.[76] The particular asset, liability, and interest expense must then be removed from the steps of the general allocation method, or the separate currency pools method if elected, to prevent double counting.

C. Anti-abuse rules

The final regulations contain anti-abuse rules that apply at each stage of the three step procedure. For Step 1, the anti-abuse rule prevents branch asset transfers designed to increase the total value of US assets.[77] The test for the rule is whether one of the principal purposes of the acquisition of the asset is to artificially increase the US assets of the foreign corporation on a determination date. A key aspect of the test is that it does not require that the artificial increase be the main purpose of the transfer, but only one of the purposes, and thus a substantial business reason for the transfer may not be sufficient to overcome the test. The regulations list several factors that the IRS will use to apply the test, including: (1) the period the asset is held in the US business, (2) whether the asset is acquired from a related person, and (3) whether the

68. Treas. Reg. § 1.882-5(a)(4).
69. See Treas. Reg. § 1.988-2(b).
70. Treas. Reg. § 1.882-5(c)(2)(ix). For the rules for determining the taxpayer's functional currency see IRC § 985 and the regulations thereunder.
71. A foreign currency is hyper-inflationary if it increases at a compounded rate of more than 100 per cent over a 36-month base period, determined by reference to the consumer price index for the country involved. See Treas. Reg. § 1.985-1(b)(2)(ii)(D).
72. Treas. Reg. § 1.884-1(d)(3).
73. Treas. Reg. § 1.882-5(b)(2)(ii)(B).
74. IRC § 752.
75. Treas. Reg. § 1.882-5(c)(2)(vi). See note 76 below.
76. Treas. Reg. § 1.882-5(a)(1)(ii)(B). This will normally depend on the allocation provisions contained in the partnership agreement, provided such provisions have substantial economic effect or are in accordance with the partner's interest in the partnership. See IRC § 704(b) and the regulations thereunder.
77. Treas. Reg. § 1.882-5(b)(1)(v).

total value of the US assets increased temporarily on or around the determination date.

The anti-abuse rule for liabilities in Step 2 is similar, and applies to liabilities "intentionally and artificially" designed to increase the actual ratio. The IRS is given express authority in the regulations to disregard related party loans if one of the principal purposes of the loan is to increase the actual ratio.[78]

The final regulations illustrate the anti-abuse rule with an example that involves a loan made by a US branch as part of an overall transaction in which a related party of the borrower maintained a compensating balance with the foreign corporation. The example concludes that the integrated loan made by the US branch will be disregarded as a US asset since one of the purposes of the loan was to artificially increase the actual ratio and the loan was arranged by the head office without the material participation of the US branch.[79]

For Step 3, the anti-abuse rule applies to US branch booked liabilities if one of the principal purposes of incurring or holding the liability is to artificially increase the interest expense of the US branch on its booked liabilities.[80] This test is made on a facts and circumstances basis. The final regulations list two factors that will be taken into account: first, whether the interest expense on the particular liability is excessive when compared to other liabilities of the foreign corporation denominated in the same currency, and second, whether the currency denominations of the US branch liabilities substantially match the currency denominations of the US branch assets.

D. Elections

The final regulations contain general rules that apply to all instances in the regulations where the taxpayer is permitted to make an affirmative election to use an alternative means or method to calculate the interest deduction, for example the election to use the fixed ratio in lieu of the actual ratio or the election to value assets at fair market value rather than tax basis. The regulations provide that the taxpayer can change a currently existing method in the income tax return for the first taxable year beginning on or after the effective date of the regulations, i.e. 6 June 1996. An amended return cannot be used for this purpose.

An election is made by calculating the interest deduction on the tax return in accordance with the method or choice elected. Once an election is made, it must be used for a minimum period of 5 years, and can only be changed thereafter with the consent of the IRS. The regulations do not indicate the guidelines that will be used by the IRS to decide whether to approve a change, but do state that consent to change will only be given in "rare and unusual circumstances."[81] If a taxpayer fails to make an election under the regulations, the IRS may make the election on the taxpayer's behalf, and the taxpayer will be bound by the IRS's determination.

E. Overall limitation on interest deduction

The final regulations provide that the total amount of interest expense calculated cannot exceed the total amount of interest paid or accrued by the foreign corporation during the taxable year.[82] The total interest expense for this purpose is translated into US dollars using the weighted average exchange rate for each foreign currency as prescribed under the rules for Subpart J of the IRC.[83]

For example, a foreign corporation that uses the 50 per cent fixed ratio to determine its US-connected liabilities will not be entitled to claim an interest deduction in excess of the actual amount of interest paid or accrued even if the use of the 50 per cent ratio produces a higher amount.[84]

F. Application of other interest limitations

The final regulations provide that interest must first be allocated to the ECI of the US branch using the rules of the Section 882 regulations before the other rules of the IRC that deal with the deferral, disallowance, or capitalization of interest are applied.[85] The rules referred to in the final regulations include the following:
- the deferred deduction of original issue discount (OID) owed to related foreign persons until such OID is paid;[86]
- the matching requirement of the deduction from income where the interest payment is made to foreign persons;[87]
- the earnings stripping provisions;[88]
- the requirement that interest be capitalized if incurred for inventory or the acquisition of capital assets;[89] and
- the disallowance of interest incurred to acquire tax-exempt obligations.[90]

The disallowance of interest on liabilities incurred to acquire tax-exempt obligations includes obligations that pay tax-exempt interest under domestic US law[91] and also obligations that are subject to a reduced rate of withholding under US tax treaties.

The final regulations illustrate the disallowance rule for tax-exempt treaty income with an example of a US branch that holds assets that produce US-source taxable income and additional assets that produce tax-exempt foreign source income (via a tax treaty under which the foreign corporation can claim benefits). The tax-exempt income producing assets

78. Treas. Reg. § 1.882-5(c)(3).
79. Treas. Reg. § 1.882-5(c)(5), Example (5).
80. Treas. Reg. § 1.882-5(d)(2)(v).
81. Treas. Reg. § 1.882-5(a)(7).
82. Treas. Reg. § 1.882-5(a)(3).
83. See Treas. Reg. § 1.989(b)-1 for the computation of the weighted average exchange rate.
84. See Treas. Reg. § 1.882-5(a)(8), Example 2.
85. Treas. Reg. § 1.882-5(a)(5).
86. IRC § 163(e)(3).
87. IRC § 267(a)(3).
88. IRC § 163(j).
89. IRC § 263A.
90. IRC § 265.
91. IRC § 103, providing for exempt interest on obligations of US states and municipalities.

comprise 10 per cent (by tax basis) of the total assets of the US branch. Accordingly, the interest expense deduction under Section 882 is reduced by 10 per cent.[92]

G. Application to tax treaties

The final regulations provide that the methods described in the regulations are the exclusive methods for determining the interest expense attributable to a permanent establishment under US tax treaties.[93] The preamble to the regulations states that the Treasury Department believes that this is a reasonable interpretation of the business profits articles of US treaties since such articles do not require the use of any particular method.

92. Treas. Reg. § 1.882-5(a)(8), Example (4).
93. Treas. Reg. § 1.882-5(a)(2). See also Revenue Ruling 89-115, 1989-2 C.B. 130 (Art. 7(3) of the US–UK Income tax Treaty); Revenue Ruling 85-7, 1985-1 C.B. 188 (Art. 8(3) of the US–Japan Income Tax Treaty), holding that the allocation method of the current Sec. 1.882-5 regulations applied for treaty purposes.

NEW ZEALAND

INTERNATIONAL TAX REFORM

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I. INTRODUCTION

On 12 December 1995, three important reforms to New Zealand's international tax regime came into effect:[1] an extended foreign investor tax credit ("FITC") regime,[2] a comprehensive transfer pricing regime[3] and a new thin-capitalization regime.[4]

These three reforms will affect foreign investors in different ways. The extended FITC regime is intended to encourage foreign direct investment into New Zealand by ensuring that non-resident investors pay the same effective rate of New Zealand tax as resident investors. Previously, non-resident investors faced an effective New Zealand tax rate of up to 53 per cent, compared to 33 per cent for resident investors. The transfer pricing and thin-capitalization regimes, on the other hand, are base strengthening measures. These reforms focus on minimizing the tax planning opportunities open to non-resident investors who employ abusive capital structures and transfer pricing practices. As a package, the reforms attempt to create "a level playing field" for foreign investors.

This article analyses the new FITC, transfer pricing and thin-capitalization regimes. Part II of this article traces the development of the international tax reforms from the proposal stage through to the enacted legislation. Parts III, IV and V examine the FITC regime, transfer pricing regime and thin-capitalization regime respectively. Part VI evaluates the reform package as a whole.

II. DEVELOPMENT OF INTERNATIONAL TAX REFORMS

The new international tax reforms were first proposed in the international tax discussion document issued in February 1995.[5] After considering submissions on both the international tax policy framework and the substance of the proposed reforms, the New Zealand Government introduced the Taxation (International Tax) Bill into Parliament in August 1995. The Minister of Revenue emphasized that the Government's objective was not to reduce the total tax take from non-resident investors, but rather to spread the New Zealand tax burden evenly across all non-resident investors.[6] In other words, the Government expected to raise the revenue needed to fund the extension to the FITC regime (currently estimated at NZD 140 million per year) through the enforcement of the thin-capitalization and transfer pricing regimes.

The Taxation (International Tax) Bill broadly followed the proposals set out in the Discussion Document, but with several notable exceptions. Perhaps the most important development concerned the decision to proceed with a thin-capitalization regime. The Discussion Document considered the possibility of introducing a thin-capitalization regime, but did not reach a conclusion on the matter.[7] The Bill included a robust thin-capitalization regime designed to prevent non-residents from minimizing New Zealand taxation by employing abusive capital structures.

The public was invited to make submissions on the Taxation (International Tax) Bill. The Finance and Expenditure Select Committee ("the Select Committee") received and considered a total of 24 submissions. Although these submissions did not result in any major changes to the new legislation, the detail of the specific reforms has clearly been influenced by the careful consideration of submissions.

The remainder of this article focuses on the key changes to the FITC, transfer pricing and thin-capitalization regimes resulting from consideration of submissions on the Discussion Document and the Taxation (International Tax) Bill.[8]

III. FOREIGN INVESTOR TAX CREDIT REGIME

A. Overview of the FITC regime

The FITC regime was enacted to provide relief from double taxation resulting from New Zealand's classical system of

1. The Income Tax Act 1994 Amendment Act (No.3) 1995 (referred to as "the new legislation" in this article).
2. Id., Sec. 17 (inserting subpart LE into the Income Tax Act 1994).
3. Id., Sec. 12 (inserting Sec. GD 13 into the Income Tax Act 1994).
4. Id., Sec. 9 (inserting subpart FG into the Income Tax Act 1994).
5. New Zealand Government, "International Tax – A Discussion Document", Government Printer, Wellington, 28 February 1995 (referred to as "the Discussion Document" in this article).
6. Introductory Ministerial Speech to Parliament on the Taxation (International Tax) Bill and the Taxation (Miscellaneous Issues) Bill.
7. Op. cit. note 5, at 59.
8. For an overview of the original proposals contained in the Discussion Document, see Sawyer, A.J., "International Taxation: A Complete Approach at Last?", 49 *Bulletin for International Fiscal Documentation* 10, (1995), at 472.

taxing corporate profits. Under the classical taxation system, two distinct layers of tax are imposed on corporate earnings distributed to shareholders:

- the company is subject to taxation on its net taxable income; and
- shareholders are taxed on dividends paid by the company.

In the case of dividends paid to non-resident shareholders, non-resident withholding tax ("NRWT") was withheld at the rate of 30 per cent of the gross dividend (or 15 per cent in the case of dividends paid to residents of most treaty countries). Income tax paid at the level of the company was not creditable against either the income tax liability of the resident shareholders or the NRWT withheld from dividends paid to the non-resident shareholders.

A dividend imputation regime was introduced in 1988 to provide relief from double taxation for resident shareholders.[9] However, the benefits of imputation were not extended to non-resident shareholders and the NRWT provisions continued to apply. As a result, non-resident investors incurred a much higher overall tax burden than resident investors.

Limited relief for non-resident investors was granted in September 1993 when the Government enacted the Foreign Investor Tax Credit Regime for non-resident portfolio investors (investors holding less than a 10 per cent interest in the company).[10] Instead of exempting fully imputed dividends from NRWT (the Australian approach), relief came in the form of a foreign investor tax credit to be passed onto non-resident portfolio investors as a supplementary dividend. The effect of this supplementary dividend was to reduce New Zealand taxation on earnings distributed to non-resident portfolio investors to 33 per cent (in the case of dividends distributed to non-resident portfolio investors resident in a treaty country).

The new legislation extends this relief to all non-resident shareholders. However, instead of simply repealing the restriction applying to non-resident portfolio investors (as suggested in the Discussion Document),[11] the original FITC regime has been repealed and a new FITC regime enacted in its place.

The new legislation also reduces the rate of NRWT withheld from dividends paid to non-resident investors from 30 per cent to 15 per cent, to the extent that the dividends are fully imputed. This is of particular significance to investors resident in non-treaty countries. Under the original FITC regime, the supplementary dividend was insufficient to completely offset the NRWT liability of these investors. As a result, investors resident in non-treaty countries faced a higher effective rate of New Zealand taxation than other investors.

The extended FITC regime applies to dividends paid on or after 12 December 1995. The following sections provide an analysis of some of the more important issues arising from the enactment of the new legislation.

B. Preference for the FITC regime over the NRWT exemption approach

The new legislation extends the original FITC regime to all non-resident shareholders. The alternative, which was considered but rejected by the Select Committee, was to exempt dividends paid to non-resident direct investors (investors holding a 10 per cent or greater interest in the New Zealand company) from NRWT to the extent that the dividends are fully imputed (the Australian approach).

The Select Committee noted that the choice between the two mechanisms involved a trade-off between a number of competing considerations, including:[12]

- reducing taxes on non-resident investors in the most efficient manner (that is, in a manner that produces the greatest economic benefit to New Zealand at the least revenue cost); and
- minimizing compliance costs.

The Select Committee received a total of 11 submissions on whether an extended FITC regime or the NRWT exemption alternative should be adopted. Five submissions contained an express preference for the FITC mechanism. Four submissions stated a preference for the NRWT exemption alternative, although two of those submissions expressed a weak preference only. The remaining two submissions suggested a hybrid approach, with the NRWT exemption mechanism applying only to companies 100 per cent owned by a single non-resident shareholder.

The Select Committee's preference for the extended FITC regime was influenced by the Government's decision to retain the FITC mechanism for non-resident portfolio investors. The Select Committee considered that applying the FITC mechanism to non-resident portfolio investors and an exemption from NRWT to non-resident direct investors would result in an increase in compliance costs, because a new boundary would be introduced into the Act.[13]

C. Calculation and application of foreign investor tax credits

Under the FITC regime, the foreign investor tax credit is calculated in accordance with the following formula:[14]

$$FITC = IC * 67/120$$

where "IC" is the imputation credit (if any) attached to the dividend.

This formula is difficult to apply because in determining the imputation credit to be attached to dividends paid to non-resident investors under the FITC regime, supplementary divi-

9. See subpart ME of the Income Tax Act 1994.
10. See Sec. 308A of the Income Tax Act 1976.
11. Op. cit. note 5, at 42.
12. Officials' Report to the Finance and Expenditure Select Committee on Submissions Received on the Taxation (International Tax) Bill, 23 November 1995, at 6.
13. Id., at 7.
14. The original legislation used 0.5583 as a multiplier instead of 67 ÷ 120. The decimal approximation was replaced in the new legislation as it was not sufficiently accurate to deal with large dividend payments.

dends are ignored and the foreign investor tax credit is itself deemed to be an imputation credit attached to the dividend. Thus, the amount of the foreign investor tax credit must be determined before calculating the imputation credit to be attached to the dividend. Unfortunately, calculation of the foreign investor tax credit is itself dependent on the imputation credit attached to the dividend. It is however, possible to derive a mathematical solution to this rather circular problem. The formula below can be used for calculating the amount of imputation credit which will result in a dividend paid to a non-resident investor being fully imputed:

$$IC_{nr} = Div_{nr} * 3960/12529$$

where "Div_{nr}" is the net dividend paid to the non-resident investor.

Furthermore, the following formula can be used to calculate the amount of imputation credit which will result in a dividend paid to a non-resident investor being imputed to the same level as a dividend of the same amount paid to a resident investor:

$$IC_{nr} = IC_{r} * 120/187$$

where "IC_r" is the imputation credit attached to the dividend paid to the resident investor.

Non-resident investors should also be aware of limitations imposed on the application of foreign investor tax credits. In essence, the amount of the foreign investor tax credit is limited to the income tax liability of the company paying the dividend (and other companies in the same wholly owned group). This can affect the ability of a company to repatriate accumulated profit at an effective marginal New Zealand tax rate of 33 per cent, notwithstanding that the legislation permits a company to apply the foreign investor tax credit against income tax payable over the last four years (commencing from 1993/1994). The Select Committee recognized this problem and agreed that there was a need to create a more flexible mechanism for the application of foreign investor tax credits.[15] The Select Committee's solution was to allow unused foreign investor tax credits to be carried forward, subject to shareholder continuity rules.[16]

IV. TRANSFER PRICING

A. Overview of the transfer pricing regime

In the international context, the term transfer pricing is used to refer to the manipulation of prices charged for goods or services between related parties resident in different tax jurisdictions so that profits are generated in the country with the lowest tax rate. Taken to extremes, aggressive transfer pricing arrangements can ensure that no tax is paid in the high tax jurisdiction.

New Zealand's new transfer pricing regime is based on OECD guidelines. The focus of the regime is cross-border arrangements between associated parties which deplete New Zealand's tax base. However, specific anti-avoidance provisions ensure that certain other non-arm's length transactions which have the purpose or effect of defeating the intent and application of the transfer pricing regime fall within the scope of the anti-avoidance provisions.

Taxpayers must use one of the prescribed pricing methodologies to calculate the arm's-length transfer price for arrangements subject to the transfer pricing regime. Taxpayers must apply the "best method", which is the method that provides the most reliable measure of the arm's-length price, having regard to a number of factors. If the Commissioner of the Inland Revenue ("the Commissioner") chooses to dispute the arm's-length price determined by the taxpayer, the Commissioner bears the onus of proving that another price provides a more reliable measure.

The new transfer pricing regime applies from the beginning of the 1996/1997 income year. Many of the important changes to the new regime arose from favourable consideration of submissions on the proposals contained in the Discussion Document. The following sections consider a number of the key changes.

B. Application of the transfer pricing regime

The transfer pricing regime proposed in the Discussion Document placed transactions between both associated and unrelated parties within the ambit of the regime. Submissions indicated that the ambit of the proposed regime was too wide, even though a presumption that transactions between unrelated parties would be at arm's-length was included in order to reduce administrative and compliance costs. In response to these submissions, the focus of the transfer pricing regime has been narrowed to cross-border transactions between associated parties. To ensure that the regime is effective, anti-avoidance provisions extend the regime to:[17]

- domestic transactions that are part of a broader agreement involving non-residents that have a character similar to that of cross-border transactions; and
- transactions between unrelated parties acting in concert to avoid tax through manipulative cross-border transfer pricing.

Associated parties are only obliged to report cross-border transactions at arm's length prices to the extent that the transaction depletes the New Zealand tax base.

This change in focus is to be welcomed as it brings New Zealand into line with the OECD's guidelines on transfer pricing and reduces taxpayer compliance costs.

C. Determination of the "best method"

The new legislation prescribes five different methods which a taxpayer can apply to calculate the arm's-length price. These methods are the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable

15. Op. cit. note 12, at 12.
16. Id., at 13.
17. *Supra* note 1, Sec. 10 (replacing Sec. GC 1 of the Income Tax Act 1994).

profits method and the profit split method.[18] The Government originally proposed to elevate the comparable uncontrolled price method as a "safe-harbour". In other words, the Commissioner would not impose a different method for calculating the arm's-length price where the taxpayer had used the comparable uncontrolled price method.

International experience indicates that calculating the comparable uncontrolled price (which involves identifying prices for similar transactions between unrelated parties) is virtually impossible in a number of cases. It is even more difficult to identify the comparable uncontrolled price in a small economy such as New Zealand where a number of unique factors, including geographical isolation, make comparison between similar transactions difficult. In response to these concerns, the new legislation does not elevate the comparable uncontrolled method as a "safe-harbour". Rather, taxpayers are required to apply the "best method" in calculating the arm's-length price. The "best method" is determined by taking into account the following four factors:[19]

- the similarity between the transaction undertaken by the taxpayer and the unrelated transactions used for comparison;
- the completeness and accuracy of data relied upon;
- the reliability of assumptions used; and
- the sensitivity of the calculation to possible deficiencies in the data and assumptions.

The arm's-length price calculated by the taxpayer will apply unless the Commissioner is able to prove that a more reliable estimate of the arm's-length price exists. Thus, the onus of proof rests with the Commissioner (unless the taxpayer fails to cooperate with the Commissioner's requests for information).

D. Documentation requirements

The new legislation does not explicitly require taxpayers to document the process by which the arm's-length price is calculated. However, failure to provide the Commissioner with information justifying the choice and application of the "best method" could result in the taxpayer bearing the burden of proving that his estimate of arm's-length price is the most reliable estimate. If the taxpayer is unable to discharge this burden of proof, the Commissioner will be at liberty to determine the arm's-length price. Thus, there is an implicit requirement to document the process by which the arm's-length price is calculated. Given the impending legislative strengthening of penalties for non-compliance, this implicit requirement must be a strong one.

V. THIN-CAPITALIZATION

A. Overview of the thin-capitalization regime

Non-resident investors are subject to a significantly lower level of taxation on their New Zealand investments where income takes the form of interest rather than dividends. This is because interest payments are generally deductible for tax purposes while dividend payments are not.[20] The lower effective rate of New Zealand taxation on debt investment compared to equity investment provides an incentive for non-resident investors to finance their New Zealand operations by debt rather than equity. When a company is financed predominantly by debt, it is said to be "thinly-capitalized". This leads to erosion of the New Zealand tax base and a lack of foreign equity investment.

The Discussion Document invited submissions on whether the introduction of a thin-capitalization regime was both necessary and feasible for New Zealand. After considering these submissions the Government decided to proceed with a thin-capitalization regime. The Commentary to the Taxation (International Tax) Bill outlines the reasons why the Government believes that a thin-capitalization regime is necessary:[21]

- to limit the extent to which non-resident investors can finance their New Zealand operations with excessive debt to reduce their New Zealand tax liabilities; and
- to act as a backstop to the transfer pricing regime, as thin-capitalization is an alternative means by which non-residents can reduce their New Zealand tax liabilities.

The thin-capitalization regime does not apply to all New Zealand entities with non-resident shareholders; only those entities controlled by a single non-resident are affected. For the purposes of the thin-capitalization regime, control means a 50 per cent or greater interest, determined on a "tier-by-tier" basis.[22]

Entities controlled by a single non-resident are subject to complicated interest apportionment rules. The effect of these rules is to restrict interest deductions where more than 75 per cent of the entity's assets are financed by debt, and the entity is clearly more highly geared than its worldwide group. Special rules determine what constitutes debt and how it is to be measured for the purpose of the regime.

The thin-capitalization regime applies from the 1996/1997 income year. Several aspects of the regime are considered in the following sections.

B. Application of the control test

The thin-capitalization regime applies to entities controlled by a single non-resident. For the purposes of the thin-capitalization regime, control means a 50 per cent or greater interest, as determined on a "tier-by-tier" basis. In other words, control over a lower tier company is determined by whether the first-tier company controls the second-tier company, the ability of that second-tier company to control third-tier companies, and so on. Control over lower tier companies is not

18. For a description of these methods see *supra* note 8 at 477.
19. See Sec. GD 13(8) of the Income Tax Act 1994.
20. For a discussion of the difference in effective tax rates, see *supra* note 8, at 474.
21. New Zealand Government, "Taxation (International Tax) Bill; Commentary on the Bill", Government Printer, Wellington, August 1995, at 3.
22. An explanation of the "tier-by-tier" basis is provided in Section V. part B. "Application of the control test" below.

calculated by the simple multiplication of control interests down the chain of companies.

This differs from the approach taken in the Taxation (International Tax) Bill, which employed a control test based on the simple multiplication of ownership interests. Under the approach taken in the Bill, if Company "A" holds a 70 per cent voting interest in Company "B" and Company "B" holds a 70 per cent voting interest in Company "C", then Company "A" would only have a 49 per cent interest in Company "C", which would not constitute a control interest. This was not the way in which the legislation was intended to be applied. Furthermore, it was not clear whether the "catch-all" control provision would resolve the problem. Accordingly, the Select Committee recommended that the control test be redrafted to explicitly reflect the tier-by-tier approach to calculating control interests.[23]

C. Inclusion of third party debt

The New Zealand thin-capitalization regime is unusual in that both related and third-party debt are included in the debt percentage calculation. A number of other countries (for example Australia) only include related party debt in the calculation. The inclusion of third-party debt in the debt percentage calculation was fiercely contested in a number of submissions made to the Select Committee. Reasons for excluding third-party debt from the thin-capitalization regime included:[24]

- taxpayers borrow from third parties for genuine commercial reasons;
- restricting interest deductions for commercial arrangements involving third parties may place highly-geared non-resident investors at a competitive disadvantage to New Zealand firms;
- abusive use of third-party debt could be countered by specific anti-avoidance rules; and
- the thin-capitalization regime, as proposed, may conflict with New Zealand's double tax agreements.

However, the Select Committee rejected these submissions and concluded that the inclusion of both related and third-party debt was fundamental to the effective operation of the thin-capitalization regime.[25] One has to sympathize with the Select Committee's view. Australia, which operates a thin-capitalization regime directed solely at related party debt, has experienced difficulties in enforcing specific anti-avoidance rules designed to counter abusive forms of third-party debt such as back-to-back loans and third-party loans backed by parent company guarantees.[26] Clearly, a thin-capitalization regime which can easily be circumvented will not be effective.

D. Formula for calculating interest apportionment

The formula for calculating interest apportionment[27] differs substantially from the formula initially proposed in the Discussion Document.[28] To assist in explaining the differences between the two formulae, the formula adopted in the new legislation (along with a simple description of the variables) is reproduced below:[29]

$$NDIE = (I\text{-}GI\text{-}IFD) * \frac{TNZD\text{-}NZDA}{TNZD} * \frac{NZDP\text{-}TDP}{NZDP}$$

Where:

NDIE	=	Non-deductible interest expense;
I	=	Total interest expense;
GI	=	Intra-group interest expense;
IFD	=	Interest excluded from the thin-capitalization regime;
TNZD	=	Total debt for the taxpayer's New Zealand group;
NZDA	=	Money on-lent;
NZDP	=	The taxpayer's New Zealand group debt percentage; and
TDP	=	The threshold debt percentage, which is the greater of: (a) 75 per cent; and (b) the taxpayer's worldwide group debt percentage multiplied by 1.1.

The key differences between the two formulae are:

- the enacted formula contains a more precise definition of the interest expense that is subject to the thin-capitalization regime. In particular the enacted formula excludes intra-group interest and interest arising from borrowings that do not provide the taxpayer with funds;
- rather than apply different safe-harbour ratios for particular industries (such as financial institutions), the new formula provides a concession for on-lending. The effect of this concession is to exclude on-lending operations of financial institutions from the ambit of the thin-capitalization regime;
- the new formula uses debt percentages rather than safe-harbour debt:equity ratios. As a result, no more than 25 per cent of the taxpayer's interest expense will ever be non-deductible under the interest apportionment formula. If the Discussion Document formula was applied, potentially all of the taxpayer's interest expense could be non-deductible.

The last point demonstrates that the thin-capitalization regime is less severe on highly leveraged structures than originally feared. Perhaps this was a concession designed to alleviate the effect of including both related and third-party debt in the debt calculation.

23. Op. cit. note 12, at 60.
24. Id., at 68.
25. Ibid.
26. See Smith, A.M.C., *Tax Avoidance and Non-Resident Investors: The Case of Thin Capitalization*, (Institute of Policy Studies, Wellington, 1992) at 68.
27. See Sec. FG 8 of the Income Tax Act 1994.
28. Op. cit. note 5, at 59.
29. For the formula proposed in the Discussion Document see *supra* note 8, at 479.

VI. CONCLUSION

International tax reform is notoriously difficult to implement effectively. The New Zealand Government will no doubt be pleased that the current round of international tax reform, which has spanned the last seven years, is finally complete. The successful implementation of this instalment of the reform programme has no doubt been influenced by the extensive consultation undertaken at all stages of the legislative process. Most commentators agree that the reform package, taken as a whole, is a positive step forward. Not only will the reforms act as a catalyst for encouraging foreign investment, but they go some way in ensuring that all taxpayers, resident and non-resident, pay their fair share of taxes.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

JUNE 1996

International Taxation of Permanent Establishments, Amsterdam, 10-11 June 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

JULY 1996

Offshore Tax Planning in a Radical New Environment, Dorchester Hotel, London, 9 July 1996 (English):

Juliet Neckar or Sarah Avian, IBC Group plc, Gilmoora House, 57-61 Mortimer Street, London, WIN 8JX, Tel.: 44-171-453 2070, Fax: 44-171-436 2450.

Fundamentals of Corporate Taxation in Singapore, Singapore, 15-17 July 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

AUGUST 1996

Summer Course on Principles of International Taxation, Amsterdam, the Netherlands, 19-30 August 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Indonesian Tax and Foreign Investment Seminar, Singapore, 23 August 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

SEPTEMBER 1996

International Tax Avoidance and Anti-Avoidance, Amsterdam, 25-26 September 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1996

International Commissionary Arrangements, Amsterdam, 4 October 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Aspects of VAT, Amsterdam, 23-24 October 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

GHANA

TAX INCENTIVES

by Seth E. Terkper

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I. INTRODUCTION

The comprehensive Structural Adjustment Programme (SAP)[1] which Ghana embarked on in 1983 is regarded by many fiscal experts as a successful case study in Sub-Saharan African economic recovery.[2] This view appears to hold despite increasing signs since 1992 that the country may have started experiencing some reverses due mainly to adjustment fatigue and growing impatience with the slow positive social impact of the programme.[3] The reforms were initiated in 1984 and during the period of recovery, GDP grew on average 5 per cent a year (or 2 per cent in real terms). This growth is directly attributable to the various measures implemented to stem the decline in economic performance experienced during the 1970s and the early 1980s.

The primary step taken to facilitate the recovery was the realignment of relative prices. The programme was implemented to eliminate many years of pervasive trade, investment, price and foreign exchange control regimes. Other measures included the restoration of fiscal and monetary discipline and the rehabilitation of basic physical infrastructure. To a large extent, these measures were made possible by the injection into the economy of foreign aid and loans negotiated under the auspices of the IMF and the World Bank. Another major contributor to the improvement in economic conditions was the boost in foreign exchange earnings which resulted from the revitalization of the export sector.[4]

II. TAXATION INVESTMENT STRATEGY

The country's tax reform programme under the SAP has played a very important role in reducing the high level of budget deficits which had caused difficulties for the country in the past. The programme concentrated on achieving a given number of specific objectives, including:[5]

a) improvement in economic efficiency through the elimination of numerous distortions which had become manifest in the tax system;
b) the reorganization of the revenue agencies to improve administrative efficiency;
c) a widening of the tax base and rationalization of the regime of direct and indirect taxes.[6]

There is no doubt that the improvements in revenue performance due to these changes did anchor the initial (i.e. stabilization) phase of the recovery programme. In particular, it made the achievement of fiscal stability possible during the 1980s without resorting to very high increases in tax rates.[7] However, the successes enumerated above are tainted by some disappointing aspects of the reform effort. Apart from the perception that the programme may have adversely affected economically and socially vulnerable groups, perhaps the major disappointment with the reforms to date is the lack of any appreciable increase in both domestic and foreign investment.

The domestic savings and investment rates in Ghana have always been very low.[8] The increase in the savings rate from 5 to 8 per cent of GDP between 1981 and 1991 merely restored the performance of this index to levels which were previously recorded in the 1960s. Indeed the rate falls well below the peak of 14 per cent recorded in the early 1970s. The current 8 per cent rate compares very unfavourably with the Sub-Saharan African (SSA) average of 13 per cent and 28 per cent for the Asian sub-region. Ghana's investment indicators, though bolstered by inflows of official aid and direct foreign investment, are equally low. Currently, the official foreign assistance to GDP is only 10 per cent compared with an SSA average of 20 – 30 per cent. In comparison, the level of private investment to GDP is estimated to be only 8 per cent. Therefore, notwithstanding the apparent low rate of foreign assistance and direct private investment in the country, together they have both contributed significantly to maintaining the investment to GDP ratio at the current average of 16 per cent.[9]

1. The Structural Adjustment Programme (SAP) is also referred to as the Economic Recovery Programme (ERP) in Ghana.
2. See for example; Ishan Kapur, "Ghana – Adjustment and Growth, 1983 – 91", IMF 1991; Chad Leechor, "Ghana: Front runner in Adjustment" (Adjustment in Africa – Lessons from Country Case Studies, the World Bank, Washington, 1994.
3. See Michael Holman, "Ghana: A Slow Recovery in Danger of Relapse", Financial Times Survey, 4 August 1995.
4. See *supra* note 2.
5. For a detailed discussion of tax reforms in Ghana, see Seth Terkper, "Ghana: Trends in Tax Reform (1985–93)", 8 *Tax Notes Int'l* 19, 9 May 1994 and "GHANA: Tax Administration Reforms (1985–93)", 8 *Tax Notes Int'l* 21, 23 May 1994.
6. One of the country's recent reversals was the inability to carry through a planned introduction of Value Added Tax (VAT) in 1995. The tax was meant to further expand the tax base and consolidate domestic indirect tax administration in the country (see Seth Terkper forthcoming, VAT in Ghana: Why It Failed, Tax Notes Int'l).
7. See *supra* note 2.
8. See *supra* note 2, (Leechor).
9. Id.

The stated aim of Ghana's economic policy is to transform the experience of economic recovery and stabilization into a formula which imitates the experiences of the fast-growing economies of South-East Asia.[10] The achievement of an appreciable local and foreign investment ratio is central to achieving this economic goal. It is to this end that the tax incentives available to investors have been undergoing critical review in recent years. Thus, the current phase of the adjustment process places renewed emphasis on encouraging the private sector to propel the desired growth in economic performance. The need to increase foreign investment in particular accounts for the recent increase in the number of foreign trips made by the country's President and ministers to certain European, American and Asian-tiger states.[11]

III. THE RELEVANCE OF TAX INCENTIVES

Ghana has maintained a liberal tax incentive regime for almost three decades. The regime was ushered in as part of the state-led industrialization programme introduced in the 1960s after the attainment of political independence from Britain in 1957. The professed aim of these incentives is to encourage savings and attract domestic as well as foreign investment into the economy. Nevertheless, some ambivalence has been expressed in the past about the viability of using liberal tax concessions to increase investments. For example, the report of a Tax Review Commission,[12] established by the Government as far back as 1977 stated that:

> Experience has clearly shown that attempts to *actively promote* economic growth through tax measures, particularly tax incentives and especially income tax exemptions and tax holidays are of *limited potential*. In addition, tax favours can normally have only a marginal impact upon a firm's location, production and investment decisions, given the over-riding importance of such other factors as availability of resources, presence of physical infrastructure (such as roads, power etc.), skilled labour and political stability (emphasis added).

It is also true that the trend in a number of developed and developing economies which have implemented comprehensive tax reforms appears to favour phasing out excessive incentives and replacing them with a simplified and liberal general tax structure.[13] The purpose of this paper is not to exhaustively discuss the merits or otherwise of tax incentives in Ghana or developing countries for that matter. However, it may be useful to summarize the factors which are usually considered in the debate.

It has been suggested that it may be possible for a well rationalized set of incentives to minimize corporate tax distortions, attract foreign investment, create employment, promote risk sharing and increase information. Even this argument appears to favour elimination of extreme differences in the incentive structure. This is because where liberal tax incentives are not well managed, they tend to complicate tax administration, undermine compliance and erode the tax base. Above all, they may have very little impact on investment decisions as already suggested. Tax incentives, like most economic policies, tend to reflect the political structure and the benefits conferred on interest groups which patronize the system in many countries. It is also true that incentives may sometimes result in negative resource flows from developing to developed countries.[14]

Recent developments seem to suggest that Ghana may have decided to set aside any reservations regarding incentives. Instead, it has chosen to enhance the attractiveness of the existing investment incentives. The renewed emphasis on tax incentives aims to achieve rapid economic growth through an enhanced investments promotion strategy. In September 1994, Parliament enacted a new investment code, the Ghana Investment Promotion Centre Act, 1994 (Act 478 referred to hereafter as "the Code") to replace the old code, the Investment Code, 1985 (PNDC Law 116), which was passed in 1985. In September 1995, the House passed a Free Zones law, The Free Zone Act, 1995 (Act 504), thus adding to the incentives available under the Code and the Income Tax Decree, 1975 (SMC Decree 5). Other customs and indirect tax incentives may be found in the Customs, Excise and Preventive Service Law, 1993 (PNDC Law 330). The incentives under the laws enumerated in this paragraph do not, however, apply to the mining and petroleum sectors.[15] The incentives available to these sectors are regulated by a separate law, the Minerals and Mining Law, 1986 (PNDC Law 153).

IV. THE ADMINISTRATION OF TAX INCENTIVES

One effect of enacting the Code is to change the traditional role assigned to the Ghana Investment Centre (GIC), renamed the Ghana Investments Promotion Centre (GIPC) under the new law. As its new name suggests, the Centre has now been transformed into an institution devoted to promoting investments.

A. Changes in the administration of tax incentives

The law assigns the administration of tax incentives to the country's two existing revenue institutions. These are the Internal Revenue Service (IRS) and Customs, Excise and Preventive Service (CEPS) for direct and indirect taxes respectively. To give practical meaning to this objective, the references to specific tax incentives in the previous code (PNDC Law 116, 1985) have been removed from the new

10. World Bank, "Ghana 2000 and Beyond – Setting the Stage for Accelerated Growth and Poverty Reduction", February 1993.
11. It is significant to note that the President, Flt Lt. J.J. Rawlings recently embarked on various tours to Europe, America and South East Asia to draw attention to the favourable investment climate in Ghana. See *supra* notes 3 and 2 (Leechor).
12. Republic of Ghana: Report of the Tax Review Commission, Parts 1, 2 & 3, Accra, Oct. 1977.
13. Commonwealth Association of Tax Administrators (CATA): "Tax Incentives and Economic Growth", *Newsletter*, March 1993.
14. Javad Khalilzadeh-Shirazi and Anwar Shah, "Tax Policy Issues for the 1990s", Vol. 5 *The World Bank Economic Review*, (Sept. 1991) No. 3. See also *supra* note 13 and Shah, S.M.S and Toye, J.F.J, "Fiscal Incentives for Firms in Some Developing Countries: Survey and Critique" *Bird & Oldman: Taxation in Developing Countries*, 4 ed., The John Hopkins University Press, 1990.
15. Act 478, Sec. 17.

Code. The Code simply states that enterprises shall be entitled to such benefits and incentives as are applicable to such enterprise under SMC Decree 5, PNDC Law 330 and any other law for the time being in force.[16] This provision puts the principal tax laws at the centre of the incentive structure since they include certain provisions which previously could only be found in the old code, PNDC Law 116.[17]

Despite the powers given to the IRS and CEPS to administer the incentives under PNDC Law 330 and SMC Decree 5, the Centre is vested with powers to negotiate specific incentive packages under conditions specified in the Code.[18] However, the specific concessions granted by the Centre may be given only in consultation with appropriate state agencies which the Board of the Centre may determine to be important to the process. Also, once the terms of the specific conditions are agreed, the tax institutions and not the Centre will be responsible for their actual implementation. In all cases, the additional incentives must be approved by the President of the Republic.[19] It is expected that this provision will enable the Centre to actively identify and promote what the Code refers to as "strategic or major investments". It is worth emphasizing that the specific incentives may be granted in addition to the general incentives provided under Section 23 of the Code.

B. Transitional provisions

It is important to note that the new Code has elaborate transitional provisions[20] meant to protect agreements executed under PNDC Law 116, 1985. It states, *inter alia*, that notwithstanding the repeal of any provision in PNDC Law 116, the terms of any agreements entered into under this law shall continue to remain in force until they expire.[21] Moreover, any application submitted for consideration whilst the previous law was still in force shall, on approval, be deemed to operate under that law.[22]

The benefits of the transitional provisions extend to other guarantees provided in PNDC Law 116, including the clauses which regulate minimum equity requirements, employment quotas and technology transfers.[23] The principal effect of the transitional provisions is to protect investors who may have benefited from reliefs contained in the old legislation.[24] As such, the sections which could be of continuous interest to investors are highlighted as footnotes in this paper even though, in general, they may stand repealed under the new Code.

C. Functions of the GIPC

As stated earlier, the Ghana Investment Promotion Centre (GIPC) is principally charged with identifying new investments and monitoring the performance of existing investment contracts in the country. As noted in the preceding paragraph, it may also grant special concessions under certain limited conditions.[25] The major activities of the Centre are as follows:[26]

a) promoting investment within and outside the country and in doing so initiating measures which will enhance the nation's investment climate;
b) collecting, collating, analysing and disseminating information about investment opportunities in Ghana;
c) identifying projects and inviting investors to participate in their establishment;
d) providing supporting services for existing and new investors.

An important function of the Centre is to maintain a liaison between investors and the relevant agencies concerned with investment. It is in pursuance of this function that a permanent working relationship is expected to evolve with the country's revenue institutions. As noted in the preceding section, the latter are charged with implementing the tax incentives which the Centre is established to promote. It is pertinent to note that the operations of the GIPC and the tax institutions (i.e. the IRS and CEPS) have become autonomous from the Civil Service. Each of these organizations is under the control of its own board of directors. The members of these boards are appointed in accordance with the laws governing the organizations.[27] The reform of the administration of investment promotion and direct and indirect taxes is aimed at enhancing operational efficiency by facilitating the decision-making process for investment purposes.

V. THE STRUCTURE OF TAX INCENTIVES

The main feature of tax incentives in the past was the emphasis placed on investment in particular sectors of the economy. Indeed, Part II of the previous code defined the priority sectors of the economy to include tourism, agriculture, manufacturing, construction and building (i.e. real estate).[28]

Also there were situations where the incentives granted to a particular firm depended on the geographical location of its operations. The revision of the old investment code (PNDC Law 116) was meant to minimize the distortions created by these wide variations in the treatment of sectors and geographical regions. Nevertheless, many aspects of the diversified structure of the old incentives appear to have been retained in the new Code.

16. Act 478, Sec. 23.
17. PNDC Law 116, Part II (Priority Areas).
18. Act 478, Sec. 25.
19. Id.
20. Act 478, Sec. 37.
21. Act 478, Sec. 37(1).
22. Act 478, Sec. 37(2).
23. Act 478, Secs. 37(4), (5)&(6).
24. The GIPC issued a Guideline, "Procedures for Establishment of Investment Projects and Clearance of Capital Goods" which restricted the processing of pipeline applications under PNDC Law 116 to 31 December 1994.
25. Act 478, Secs. 2 and 25.
26. Act 478, Sec. 3.
27. See *supra* note 5.
28. PNDC Law 116, Part II, Sec. 12.

A. Tax holidays

The Income Tax Decree, 1975 (SMC Decree 5) provides that firms operating in the following sectors may be exempted from tax for the periods specified below. The objective of the incentive is to assist in overcoming some perceived difficulties associated with the initial operations of enterprises in these sectors.

1. Agriculture and agro-industries

The tax holidays or exemptions from tax for the agricultural sector depend on the cultivation period for a variety of products. The waiver of tax may benefit farming enterprises engaged in the production or processing of crops, fish or livestock in Ghana. Prior to 1989, this form of relief was given for a uniform period of five years for all agricultural produce, apart from cocoa. The specific periods of holiday are now as follows:[29]

a) tree crops such as coffee, oil palm, shea-butter, rubber and coconut – ten years following the date of first harvest;
b) cash crops such as maize, rice, pineapple, cassava and yam – five years following the date of commencement of the enterprise;
c) livestock (excluding cattle and poultry) – five years following the date of commencement of the enterprise;
d) Cattle – ten years commencing from the date of start-up of the enterprise;
e) Fish Farming and Poultry – five years commencing from the date of start-up of the enterprise.

2. Real Estate

The basic law, SMCD 5 was amended in 1988 to provide exemption from tax for the rental income[30] of any residential or commercial premises during the first five years after completion of the construction of such premises.[31] Also, income accruing to a company engaged in the construction for sale or letting of residential premises during the first five years following the commencement of the operations of that company shall be exempt from tax.[32]

There are certain important points to note about these two provisions. There appear to be no restrictions on the type of business entity which may benefit from the waiver of tax for rental income – (SMC Decree 5, Section 3{1}t). On the other hand, the waiver of tax on the general income accruing from construction only applies to companies (SMC Decree 5, Section 3{1}tt). Moreover, this latter sub-section is further restricted to the construction of residential premises for outright sale or letting. It excludes the construction of commercial premises for sale or rental. It would also appear from the emphasis placed on construction that the mere acquisition (as opposed to construction) of completed residential or commercial premises for rental purposes may not benefit from this latter clause. Both restrictions may be seen to reflect the importance attached to increasing the personal housing, as opposed to commercial, stock in the country.

3. Profits of rural banks

The income of rural banks for the period of ten years following the date their operations first commence shall be exempt from tax.[33] Rural Banks in Ghana are community-based banks owned partially by the people in a given locality. They are established as avenues for mobilizing financial resources and channelling them to low-income, mainly farming communities. The banks are subject to strict financial supervision by the Central Bank.

4. Manufacturing

It is proposed that any manufacturing company which processes agricultural products under an investment-oriented scheme being planned by the government shall be exempt from income tax for a three year period.[34] However, a business may benefit from this incentive only when the raw materials it uses are produced in Ghana and not imported. This clause is clearly aimed at encouraging firms to add value to inputs produced locally. The primary inputs include cotton, cocoa, timber and wood. At the moment, most of these are exported in their raw state for processing by the industrialized economies. Given the heavy reliance of Ghana's import-substitution industries on the importation of raw materials, this incentive may ultimately be of very limited application.

B. Exemption from direct taxes

There are certain categories of income which are completely exempt from tax under SMCD 5, 1975 (as amended). The major categories are set out below.

1. Cocoa farms[35]

The income of cocoa farmers, peasant or commercial, is completely exempt from income tax. This may be due to the fact that the export of cocoa is currently the only activity which attracts export duty. This duty may be regarded as a levy imposed in lieu of income tax. However, given the practical difficulty experienced by the IRS in collecting income tax from most farmers and the generous incentives placed at their disposal the imposition of the export duty may put the cocoa farmer at a disadvantage regardless of the income tax exemption. First, there is no provision to waive the export tax during any of the periods specified above for tax holidays.[36] Second, the export tax is a flat levy which does not consider the progressiveness built into the income tax schedule for low income earners. As such, the tax may be falling on the income of a large number of peasant farmers with net incomes below the personal income tax exemption.

29. SMCD 5, Sec. 3(1)f {i-iv}.
30. The separate (i.e. schedular) tax regime for income from rent was abolished in 1987. Rent income is now added to other sources of income for tax purposes.
31. SMCD 5, Sec. 3(1)t.
32. SMCD 5, Sec. 3(1)tt.
33. SMCD 5, Sec. 3(1)k.
34. Budget Statement and Economic Policy, 1996.
35. SMCD 5, Sec. 3(1)u.
36. See V. A.

2. Facilities for employees in certain sectors

The employees of any business engaged in mining, timber, building, construction or farming are entitled to a waiver of income tax relating to the benefit of furnished accommodation provided by the employer on site.[37]

3. Shipping and aircraft

The gains or profits from the business of operating ships or aircraft carried on by a person not resident in Ghana may be exempted from tax.[38] This provision is, however, a reciprocal exemption clause. It is subject to the Commissioner of Income Tax obtaining satisfactory evidence that an equivalent exemption is granted by the country in which such person is resident to persons resident in Ghana.

4. Transfer of shares of listed companies

The Stock Exchange in Ghana was established about six years ago to improve resource mobilization and further enhance dealings in financial instruments in the country. The law provided for gains realized from the transfer of shares of companies listed on the Exchange to be exempt from tax for the first five years of the Exchange's life. This provision expired in 1995 but legislation is being processed to extend the exemption for a further ten years to 30 November 2005.[39]

5. Other exemptions

(a) *Minimum chargeable income*

The general rule is that the income chargeable to tax for businesses in Ghana shall not be less than 5 per cent of the turnover declared, irrespective of the actual profits of the business, whether corporate or non-corporate.[40] However, this rule does not apply for the first five years following commencement of the enterprises operations. In addition, the exemption may be granted for a ten year period to persons operating in mining, farming and individuals who maintain adequate books of accounts (to the satisfaction of the Commissioner).

(b) *Income of non-profit organizations*

The income of certain organizations which are social or development oriented, in so far as they are not derived from trade or business, are usually exempt from income tax.[41] These institutions or bodies include the income of a local authority; ecclesiastical, educational or charitable institutions of a public character; sporting and social amenities; statutory or registered building and friendly societies; pension and provident funds;[42] trade unions, mutual and unit trusts; institutions established for scientific research and cooperative societies.

(c) *Interest on bonds*

The interest paid on bonds is exempted from income tax provided the bonds are held by non-resident persons and are issued by the government, a cooperative society or a statutory corporation.[43] Interest on savings accounts and other interest or discounts earned by individuals is also exempt from income tax.

C. Tax rebates

Tax rebates refer to reductions of income tax assessed or payable subject to the taxpayer meeting certain specific provisions of the law.[44]

1. Regional incentives

Part X of the Fifth Schedule to SMCD 5, 1975 provides that the following rebates of income tax may be granted to enterprises which are located in particular areas of the country.[45]

a) Companies engaged in manufacturing that are located in regional capitals other than Accra and Tema[46] shall pay tax at the rate of 75 per cent of the normal rate for such companies. Given a standard rate of 35 per cent, the reduced rate would be on average, 26.25 per cent.

b) All other manufacturing companies located elsewhere shall pay tax at a rate of 50 per cent of the normal rate for such companies. In these instances the reduced rate is 17.5 per cent.

2. Withholding taxes

Generally, tax is withheld by companies, corporations, institutions, partnerships, cooperatives and other bodies corporate

37. Rent (income) is imputed on the value of accommodation provided by employers as follows: Soft-furnished accommodation – 15%; Hard-furnished accommodation – 10%; Accommodation or Soft-furnishing only – 7.5% and Hard-furnishing only – 5% (all percentages of salary). SMCD 5, Sec. 13 (1).
38. SMCD 5, Sec. 3(1)m.
39. Budget Statement (1996).
40. SMCD 5, Secs. 13 (2 and 3).
41. SMCD 5, Sec. 3(1).
42. The deduction from employee remuneration and payment of the capital sum to beneficiaries is also exempt from tax (ref. SMCD 5, Sec. 3{1}g and Sec. 14).
43. SMCD 5, Sec. 3(1)1.
44. Some of the tax rebates which disappeared with the repeal of PNDC Law 116 and portions of SMC Decree 5 include:
i) Utilization of Ghanaian labour in preference to imported machinery: employing 20 or more persons in agriculture a sum equal to the social security contribution for each employee in excess of 20 employees; employing 100 or more in manufacturing a sum equal to the social security contribution for each employee in excess of 100 employees; employing 75 or more in construction and building a sum equal to the social security contribution for each employee in excess of 75 employees – Section 13(4);
ii) Export tax rebates: Under the original SMC Decree 5, the following rebates were made to enterprises in manufacturing and exporters of agricultural produce:

Percent Exported %	Agriculture Rebate %	Manufacturing Rebate %
5 – 15	40	30
16 – 25	60	50
Above 25	75	75

The rebate for agriculture was related to the share of profits accruing from exports only.
45. Sec. 13(2), PNDC Law 116 had three separate regimes relating to the reduction of corporate income tax, namely, Kumasi and Sekondi-Takoradi Metropolitan areas (15 %); regional capitals other than Accra-Tema, Kumasi, Sekondi-Takoradi and Wa (25 %); the rest of the country, including Wa (40 %).
46. There are ten regions in Ghana, each with a capital. Accra is the capital city and adjoins Tema which apart from Takoradi (capital of the Western Region) is the main port city.

at the rate of 30 or 15 per cent on fixed incomes such as fees and commissions paid to their beneficiaries. "Beneficiaries" include shareholders, directors, board members, part-time teachers and insurance, sales or canvassing agents.[47] These general withholding tax rates are reduced for the following categories of income: dividends and interest (10 per cent);[48] royalties, management and technology transfer fees (15 per cent) and interest (10 per cent). It is important to note that the withholding tax on dividends, royalties, management and technical fees is deemed to be a final tax and therefore the relevant income is not included in taxable income in the recipient's annual tax return.[49]

Since Ghana does not aggregate[50] other income with these categories of income for tax purposes, the impact of the tax on individuals will depend on how the marginal rate of income tax compares with the average of these withholding taxes. If the marginal rate is less than the average of the withholding taxes the tax payable is likely to be higher than that which would have been due under a global income tax system. The converse applies to individuals with a higher marginal rate than the average of the withholding tax rates. It is important to note that the top marginal rate of tax in Ghana is 35 per cent for income above GHC 16 million [51].

3. Non-traditional exports

Companies which export non-traditional products are subject to corporate tax at a reduced rate of 8 per cent.[52] Non-traditional exports under SMCD 5, 1975 means exports other than cocoa beans, coffee beans, timber and logs, electricity, unprocessed gold or any other mineral in its natural state.[53]

4. Hotel industry

Part IX of the Fifth Schedule of SMCD 5 provides that the corporate tax rate for the hotel industry shall be 25 per cent. This compares favourably with the standard rate of 35 per cent.

5. Standard deduction for construction

The Income Tax Decree allows a standard deduction of 30 per cent of aggregate rental income for firms which earn income from rent. This deduction is additional to any sum paid as local rates to a local, urban, city or district assembly in respect of residential or commercial premises and mortgage interest on money borrowed for the construction. It is important to emphasize that these provisions would not prevent the company from duly deducting all allowable expenses in excess of the standard allowance as legitimate expenditure to be written-off against the income earned.[54]

D. Loss carry-over provisions

Under a new Section 4(A) of SMCD 5 every enterprise established in Ghana is entitled to deduct any loss incurred from the assessable income of the five years immediately following the year in which the loss was incurred.[55] However, under Section 6 of the same Decree, the period for carrying over losses for insurance companies still remains unlimited.

E. Accelerated allowances

The separate schedules of capital allowances under SMC Decree 5 and the previous Investment code (PNDC Law 116) are now harmonized under a common regime. The new allowances which are now located in SMCD 5, Section 13 (Third Schedule) are accelerated for certain categories of businesses.[56]

1. Accelerated depreciation allowances[57]

These allowances may apply to all sectors except banking, finance, commerce, insurance, mining and petroleum.[58]

a) Qualifying plant expenditure – depreciation rate of 50 per cent per annum for two years;
b) Qualifying building expenditure – depreciation rate of 20 per cent per annum for five years.

2. Depreciation allowances

These allowances are available to the banking/finance, commerce, insurance, mining and petroleum sectors.[59] Allowances may be claimed by the enterprise only once in the year in which the asset is first utilized by the owner.

a) Qualifying plant expenditure – depreciation allowance of 20 per cent.
b) Qualifying building expenditure – depreciation allowance of 10 per cent.
c) Qualifying mining expenditure – depreciation allowance of 25 per cent.
d) Plantations – depreciation allowance of 10 per cent.

3. Annual depreciation allowances[60]

The annual allowances may accrue to firms in banking, finance, commerce and insurance in addition to the once-only allowances specified above. Thus it excludes all sectors which may benefit from the accelerated depreciation allowance specified in paragraph E(1). It also excludes the mining and petroleum sectors (but see paragraph F(1) for special incentives accruing to the mining sector). The major categories of annual allowance rates are machinery (10 per

47. SMCD 5, Sec. 55(2).
48. SMCD 5, Sec. 55(5). However, the interest earned by *individuals* and persons providing proof of waiver from payment of income tax may not be subject to withholding or any tax.
49. SMCD 5, Secs. 55C and 55D respectively.
50. The main argument advanced for integration is to ensure neutral tax treatment between debt and equity investors.
51. The exchange rate for the *cedi* or local currency is currently about GHC 1500 to USD 1.00.
52. SMCD 5, Part VIII of the Fifth Sch.
53. SMCD 5, Sec. 76.
54. SMCD 5, Sec. 4(cc).
55. The periods for loss carry-over under the old laws (SMC Decree 5 or PNDC Law 116), were varied e.g. companies engaged in construction or real estate – two years; insurance – unlimited; agriculture – five years; and manufacturing – two years.
56. The different schedule of allowances for priority sectors under the previous law, PNDC Law 116, Sec. 12 (Part II) has now been repealed.
57. SMCD 5, Third Sch., Sec. 5.
58. SMCD 5, Third Sch., Sec. 5(5).
59. SMCD 5, Third Sch., Secs. 6(1)&(2).
60. SMCD 5, Third Sch., Sec. 7.

cent); plant (7.5 per cent); furniture, fixtures and fittings (7.5 per cent); buildings, excluding residential property (5 per cent for mining and timber and 3 per cent for other sectors; ships, trawlers, ferry boats, lighters and tug boats, barges, dredges and pontoons (5 per cent); airplanes (10 per cent); helicopters (7.5 per cent); and timber and mining expenditure (15 per cent).

4. Research and development expenditure

The IRS may allow a deduction for any expense incurred by a manufacturing company on research and development undertaken for the purpose of improving its products.[61] This clause is subject to a certificate being issued by the Minister responsible for Industry in support of the research programme. Also, the Commissioner is empowered to allow full deduction or determine the limit of expenditure which may be deducted for any given year of assessment.

F. Tax incentives for the mining industry

As noted earlier, the mining sector in Ghana is regulated under a separate law, the Minerals and Mining Law, PNDC Law 153, 1986. The most significant incentives under this law relate to capital allowances.

1. Capital allowances

Capital allowances are granted at the rate of 75 per cent of capital expenditure in the year of investment and 50 per cent in subsequent years. The amount can be taken in full or deferred over a reasonable period of time by the investor. In addition, an investment allowance is granted once at the rate of 5 per cent on all qualifying expenditure. The cumulative effect of these allowances is that for tax purposes the costs of the investment are written off over a two to three year period. This makes the present value of investments very attractive in the mining sector.

2. Loss carry-over

Losses incurred in mining operations can be carried forward. The loss carried forward may be restricted to an amount not exceeding the total of capital allowances claimed in the year in which the loss was incurred.

3. Tax rate

The concessionary corporate rate of 45 per cent granted under the PNDC Law 153 appears to have been superseded by the lowering of the general corporate rate to 35 per cent under the Income Tax Decree. At the time of enactment of the former law, the general corporate rate was 55 per cent.

4. Exemption from customs duties

The law allows the holder of a mineral right to be exempted from payment of customs import duties in respect of plant, machinery, equipment and accessories imported specifically and exclusively for the commencement of the mineral operations. Further relief may be provided from customs and excise duties after establishment of the mineral operations.[62] The company may be exempted from the payment of registration and stamp duties for a period of up to five years.

5. Personal income tax relief

As mentioned above, employees of mining companies may be exempted from payment of income tax relating to furnished accommodation provided at the mining site.

VI. OTHER TAX INCENTIVES

There are other significant tax and non-tax incentives contained in both the Income Tax Decree and the Investment Code. Some of these incentives are general in application, whilst others only apply to specific sectors or industries.

A. Capital gains

The treatment of capital gains is similar to dividends, management fees and royalties. The 5 per cent tax rate is a final tax and therefore the taxpayer is not required to add the capital gain to his other income when filing his tax return at the end of the year. The policies on dividends and capital gains were adopted as compromise measures in 1991 to substantially reduce the double taxation of equity capital in the case of dividends and to minimize the inflationary impact of taxing nominal capital gains.

B. Free zone incentives

The Free Zone Act, 1995 (Act 504) has the following specific provisions on tax incentives.

1. Tax holiday

Free zone developers and enterprises operating under Act 504 are exempted from the payment of income tax on profits for the period of ten years from the date of commencement of operations.[63]

2. Tax rebate

The income tax rate after the initial ten year period mentioned above shall not exceed 8 per cent.[64]

3. Tax exemption

A shareholder shall be exempted from the payment of withholding taxes on dividends arising out of free zone investments.[65] Foreign employees are totally exempt from payment of income tax on income earned in the free zone during the

61. SMCD 5, Sec. 4 (dd).
62. There is an approved Mining List for the purpose of implementing this provision of the law.
63. Act 504, Sec. 28(1).
64. Act 504, Sec. 28(2).
65. Act 504, Sec. 28(3).

period of that work. However, this provision shall be subject to any double taxation agreement between Ghana and the country of origin of the foreign employee.[66]

4. Export tax incentives

The sale of goods and services by domestic enterprises operating from within the national customs territory to enterprises in the free zone areas are considered to be exports. Consequently, such enterprises are eligible to benefit from the prevailing export incentives available to national exporters.[67]

C. Insurance

Firms in the insurance industry can carry forward losses without time limit subject to the approval of the Commissioner of the IRS.[68]

D. Indirect tax incentives

The indirect tax incentives are included under Section 23 of the Code. This section states that enterprises shall be entitled to such benefits and incentives as are applicable to such enterprises under SMCD 5 and the CEPS Management Law, PNDC Law 330, 1993. The indirect tax incentives are identified as specific headings of Chapters 82, 84, 85 and 98 of the Customs Harmonized Commodity and Tariff Code which is a schedule to PNDC Law 330. The incentives may take the form of exemptions or concessionary import duty rates. These Chapters of the Tariff deal with:

a) Chapter 82 – tools and implements;
b) Chapter 84 – nuclear reactors, boilers, machinery and mechanical appliances and parts thereof;
c) Chapter 85 – electrical machinery and equipment and parts thereof, sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles.
d) Chapter 98 – goods admissible at concessionary duty rates when imported by enterprises under the GIPC Act (Act 478). They include items specified for the hotel, restaurant, film production and electronic media sectors. They are subject to certificates issued by the appropriate authority, usually the supervising Ministry.

Section 24 of the Code anticipates that certain firms may not find it easy to avail themselves of the list provided in the HS Code Chapters specified above. It states that where a firm's plant, machinery, equipment or parts are not zero-rated under the Customs Harmonized Commodity and Tariff Code, it may submit an application for exemption from import duties, sales tax and excise duties on the relevant items. It is also important to note that the CEPS Management Law, PNDC Law 330 makes provision for firms paying import duty and sales tax on raw materials to file for these taxes to be refunded provided proof of export is provided to the customs administration.

E. Stamp duties

Currently, citizens are exempted from the payment of stamp duty on the transfer or sale of shares in companies. The 1996 Budget proposes to make this concession neutral by extending the exemption to non-resident shareholders.[69] The aim of the proposal is to add to the measures designed to attract foreign investment.[70]

VII. CONCLUSION

The comprehensiveness of Ghana's tax incentive regime is very striking. Individual measures are not couched in terms of being granted to investors as alternative schemes. Thus, it is possible for losses incurred during a tax holiday to be carried forward and offset against future profits under the loss carry over provisions.[71] The new law therefore has enhanced the attractiveness of the incentives bringing the regime into line with most tax regimes in developing countries.[72] Notwithstanding the generosity of the incentive regime, the political environment in which they are granted is observed to be crucial in attracting investments into the country.

There are many factors apart from taxation which could contribute to promoting a dynamic investment climate in any country. These include a conducive political climate, competition among regional blocs for international finance capital and the pressure exerted by large multinational firms in influencing global financial and investment decision.[73] In most developing countries therefore, major investment decisions are affected by the degree of political and economic stability prevailing in the country.[74]

The relevant portions of Parts II & III of the Investment Code, contain elaborate guarantees for investors seeking to invest in the country. This may be a direct response to the turbulent political history of the country, which on occasions has been cited[75] as the single factor disturbing the conducive climate for inward investment. The guarantees include:[76]

a) transfer of funds:[77] an enterprise registered under Act 478 is guaranteed unconditional transferability, through any authorized dealer bank[78] in freely convertible currency in

66. Act 504, Sec. 34 (4).
67. Act 504, Secs. 24(1)&(2). The most important of these tax incentives may be the rebates granted to non-traditional exporters.
68. SMCD 5, Sec. 6(3).
69. Budget Statement 1996.
70. PNDC Law 116, Section 13(1) gave powers to the Ghana Investment Centre to defer the payment of stamp duty for a period not exceeding five years.
71. It is even likely that these losses could be increased by the accelerated depreciation provisions.
72. See *supra* note 15 (Shah, S.M.S. and Toye).
73. Id.
74. Ghana has had its share of political instability since gaining independence over 30 years ago. This included the overthrow of civilian administrations by the military and nationalization of private firms in some instances during these takeover periods.
75. See *supra* note 3.
76. There are similar provisions under the Minerals and Mining Law, PNDC Law 153, 1986 and the Free Zones Act, 1995, Act 504.
77. Act 478, Sec. 27.
78. The previous law, PNOC Law 116, specified the Central Bank.

respect of dividends, loan servicing (where a foreign loan was obtained), remittance of proceeds and fees and charges;

b) expropriation and ceding of interest: the law debars the Government from expropriating or compelling an investor to cede any interest in an enterprise under the law. Where this occurs in the "national interest for a public purpose", the State shall pay fair compensation and the investor shall have access to the judiciary and arbitration for review;[79]

c) arbitration: there are elaborate provisions for the amicable settlement of disputes either locally or through international arbitration.[80]

It is possible that the appropriateness or otherwise of the incentive regime in Ghana will continue to be debated. The trend of this debate is likely to focus on the observation that lower tax rates, coupled with a broader, fairer and simplified tax basis, are better options for attracting investment than differentiated tax incentives which distort economic activity and complicate tax administration and compliance.[81] After all, the country's Tax Commission Report stated in 1977 that "the wiser strategy in designing tax policy favourable to growth is that of concentrating upon the removal of those elements of the tax structure that operate to penalize growth and stifle operating efficiency".[82]

79. Act 478, Sec. 28.
80. Act 478, Sec. 29.
81. CATA *Newsletter*, 1993 (Canadian Government: White Paper on Tax Reform, 1987).
82. Report of the Tax Commission (1977).

SOUTH AFRICA

BUDGET 1996 – SUMMARY AND COMMENTARY

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I. INTRODUCTION

The following is a summary of salient taxation points of the 1996 Budget Speech tabled by Finance Minister Chris Liebenberg on 13 March 1996. Please note that, at this stage, these are merely proposals. The related legislation is likely to be enacted in June or July 1996.

II. VAT

The VAT rate remains unchanged at 14 per cent, following trade union pressure on government not to increase the rate. In light of the government's compliance with union demands there has been considerable disquiet expressed by economists as to the influence of labour unions on the development of fiscal policy. Against this, it must be acknowledged that the formulation of the 1996 Budget has been the most open in South Africa's history, with extensive open consultation with business, labour and others, and these consultations have all influenced the make up of the budget.

Furthermore, the reluctance to increase the VAT rate must be seen in the context of the relatively inadequate poverty safety net in South Africa. When poverty relief measures become more effective, government will have more flexibility when considering a VAT increase.

The banking industry. Most fee-based financial services rendered by the banking industry (and which were previously exempted from VAT) will now be subject to VAT. These services will consequently be exempt from the financial services levy (which was previously charged in lieu of VAT). The effective date of this change will be 1 October 1996.

III. CORPORATE TAX

The basic corporate tax rate remains unaltered at 35 per cent.

The Secondary Tax on Companies (STC) rate is reduced to 12.5 per cent on dividends declared after 13 March 1996. The combined rate on distributed earnings thus drops from 48 per cent to 42.22 per cent. The calculation of this rate is illustrated in the following example:

Taxable income	100,000
Company tax at 35%	(35,000)
Earnings after tax	65,000
Dividend	57,778
STC at 12.5% of dividend	7,222
Gross distribution	65,000
Total taxation:	
Normal company tax	35,000
STC	7,222
Total tax	42,222
Tax rate	42.22%

The reduction in STC follows the recommendations (to which this author contributed) of the Katz Commission in their third interim report (December 1995). This reform goes a considerable way to reducing the corporate tax rate on distributed earnings to the 40 per cent median which prevails internationally.

Gold mines. There is a corresponding change to the tax rates applicable to gold mines which opted to remain outside the STC system.[1] The gold tax formula becomes: $y = 51-(255/x)$. A rate of 42 per cent applies to any non-gold mining income (typically interest income).

The gold mining tax formula (see above) is derived as follows: $y = (a-ab/x)$. In this formula, "y" is the tax rate to be determined. "X" is the ratio of the mining company's gold taxable income to its total gold revenue, and "a" and "b" are variables set by the Income Tax Act. Following the Marais Commission on Mining Tax,[2] it was accepted that the "b" factor (which governs the so-called "tax tunnel") should be set at 5, and that the "a" factor should be kept at approximately 120 per cent of the corporate tax rate (on distributed earnings). Consequently, when the rate dropped from 48 per cent to 42.22 per cent, the "a" factor dropped from 58 to 51.

Branch profits. A branch profits tax will be introduced, amounting to 40 per cent on South African source income, to apply to branches of foreign companies and other foreign entities, where the place of effective management of such

1. To the author's knowledge, almost all South African gold mines have opted to remain outside the STC system – the exceptions are: Blyvoor, Durban Deep, ERPM and Harmony.
2. The author served on this commission.

branches is outside South Africa. The change applies to assessment years ending on or after 1 April 1996. As a consequence, foreign companies with such South African branches will no longer be subject to STC on dividends derived from a South African source. Until recently, from the point of view of foreign investors, there has been an anomaly in the South African tax system. This was because, although local subsidiaries and local branches of foreign companies were both legally subject to STC, for various technical reasons the tax authorities did not enforce STC on branches. Government has accepted the validity of these technical reasons, and will now formally exempt these branches from STC. However, to prevent branches from having a disproportionate advantage over subsidiaries, their normal tax rate will rise from 35 per cent to 40 per cent.

Tax avoidance. The current anti-tax avoidance provisions are to be amended to provide for a "trade purposes test".

IV. PERSONAL TAX

The maximum marginal tax rate remains unchanged at 45 per cent. The tax brackets have been reduced from 10 to 8, and have also been widened. The maximum tax rate is thus now only reached at a taxable income of ZAR 100,000 (previously ZAR 80,000).

The new table is as follows:

Taxable income (ZAR)	Tax Payable
00,000 to 15,000	17%
15,000 to 20,000	2,550, plus 19% of the excess
20,000 to 30,000	3,500, plus 21% of the excess
30,000 to 40,000	5,600, plus 30% of the excess
40,000 to 60,000	8,600, plus 41% of the excess
60,000 to 80,000	16,800, plus 43% of the excess
80,000 to 100,000	25,400, plus 44% of the excess
100,000 and over	34,200, plus 45% of the excess

- The primary rebate has been increased from ZAR 2,625 to ZAR 2,660.
- The temporary transition levy has not been renewed.
- For individuals over the age of 65 the provisional tax threshold has been increased to ZAR 50,000 (from ZAR 35,000).

V. OTHER MATTERS

Excise duties. Excise duties on alcohol and tobacco products have been increased considerably.

Marketable securities. With effect from 1 April 1996, the marketable securities tax is to be reduced to 0.5 per cent (was 1 per cent). This tax will be further reduced, or abolished, if there is a corresponding move in the London financial markets.

Retirement Funds. Retirement funds (including government and semi-government funds) are to be taxed at 17 per cent on their gross interest and net rental income. This is a highly controversial move, following the recommendations of the Katz Commission in their third interim report, which favoured a 30 per cent rate of tax on interest and rental income. There are a number of concerns about this tax, including:

- the fear that this may be "the thin edge of the wedge", with significant tax rate increases in future years;
- the cost to employers of making up the shortfall to ensure that pension pay outs are not reduced, especially in the case of "defined benefit" pension schemes.
- the cost to taxpayers of making up the shortfall in government and semi-government funds, to ensure that pension pay outs are not reduced, since all of these funds are "defined benefit" funds.

Fuel levy. The fuel levy is to be increased by 3 cents per litre, for both leaded and unleaded petrol.

Estate duty and donations tax. Estate duty and donations tax rates are increased to 25 per cent (previously 15 per cent) from 14 March 1996. The personal donations tax threshold has been increased to ZAR 25,000 (was ZAR 20,000).

Donations. Donations to the Bible Society will, from 1 October 1996, no longer be tax-deductible. This leaves the only statutory tax-deductible donations as donations to recognized educational funds.

National lottery. The envisaged national lottery will be subject to special income tax rules, (these rules have yet to be devised).

Tax administration. Regarding tax administration, in October 1995 the Cabinet approved the restructuring of the Inland Revenue and Customs and Excise and the formation of an autonomous revenue collection service, the South African Revenue Service (SARS). It is envisaged that SARS will be launched in April 1996, although full implementation will of necessity have to be a phased process. A business plan for SARS as well as concomitant reforms in areas such as technology modernization, communications, financial management, human resources development, corporate image, business management and the interface with the Department of Finance are being finalized.

Interest. Regarding the accrual of interest on financial instruments, last year's budget introduced the accrual basis for taxing interest on financial instruments. As was envisaged then this measure will now be extended to encompass those instruments issued on or before 15 March 1995 which are not as yet within the scope of the accrual basis.

Stamp duty. Stamp duty payable on certain debit entries was last increased in 1992 and it is proposed that this be increased from 15 cents to 20 cents per entry from 1 June 1996. Equity considerations and the escalation in the use of private and in-house retail cards make it necessary to bring debit entries posted to such accounts within the ambit of the Stamp Duties Act. The Inland Revenue will consult with the issuers of such cards on how to bring this about. To allow sufficient time, 1 August 1996 is proposed as the implementation date. A revised scale for stamp duties on instalment credit agreements is also proposed to take effect on 1 June 1996.

Taxpayer rights. A statement of taxpayer rights is on the cards. The government has accepted the proposal of the Katz Commission and the Joint Standing Committee on Finance that basic rights of taxpayers should be articulated in a clear public statement of Taxpayers' Rights. This would include, among others, principles such as expeditious tax administration, as well as the fair, impartial and consistent application of the law. A statement in this regard will be issued soon.

VI. OUTSTANDING MATTERS

Katz Commission. The Katz Commission of Inquiry (which has submitted three interim reports to date) will submit its report on the holistic review of the tax system in October 1996.

Group Taxation. The Minister stated that the introduction of group taxation will impose a severe strain on the tax administration. Thus its introduction will be held in abeyance until the new South African Revenue Service is fully operational.

Small business units. The Katz Commission recommended certain criteria of qualification to be met for the proposed cash flow basis of taxation of small business units. There is a concern that the envisaged criteria may not be appropriate and the tax authorities have been requested to consult further with interested parties and organizations with the view to making further recommendations.

Regional Services Councils levies. The Katz Commission registered various difficulties with the concept and administration of Regional Services Councils Levies and recommended that the Financial and Fiscal Commission investigates these matters further. The government supports this.

Land tax. The Katz Commission recommended that a land tax should not be implemented at national level, but the introduction at local level should be investigated. The local land tax issue will be investigated in more detail in close cooperation with the Ministry of Land Affairs in the near future.

Capital gains tax. The government does not propose considering capital gains tax further until a tax administration is in place which will be capable of dealing with the complex application of such a tax.

Retirement Funds. The government accepts that the following principles should be reflected in a new system of retirement fund taxation:

- consistent treatment of private and public sector funds;
- neutrality between the different forms of retirement provision;
- minimization of opportunities for tax arbitrage;
- an incentive in favour of lifetime annuities; and
- taxation of income as it arises, rather than when paid out.

The government has acknowledged the complexity of these issues and the need for further consultation, which will be led by the Department of Finance and the South African Revenue Service. In view of the importance of early clarification of the reform to be adopted, a process has been agreed on between government and, respectively, business (the pension industry) and labour, to finalize the eventual dispensation for announcement during the coming year and implementation in the next fiscal year.

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CHINA

TRANSFER OF TECHNOLOGY TO CHINA: A TAX ANALYSIS*

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I. INTRODUCTION

Foreign companies wishing to transfer technology to China have a variety of options. They may choose to sell the technology outright, license it with or without the sale or lease of equipment, provide it as part of a compensation trade or contracted projects arrangement, or contribute the technology as an investment in a joint venture or a wholly foreign-owned enterprise. Each form of technology transfer attracts different tax liabilities in China. This article discusses the tax implications and policy rationale for the different treatments. It begins with a general introduction to China's legal framework governing the transfer of technology to China. Parts II and III provide an overview of China's tax laws and tax treaty policy. The last part of this article provides a transactional analysis of the Chinese tax implications which attach to various forms of technology transfers.

II. CHINA'S GENERAL LEGAL FRAMEWORK FOR THE TRANSFER OF TECHNOLOGY

China needs foreign technology to "modernize" its economy. The kind of technology needed in China is that "suitable to Chinese conditions," which may or may not be the most advanced technology in the world. Technology transferred to China can be found in different forms, ranging from patents, trademarks and copyrights to proprietary technology (such as know-how, concepts, formulas, models, designs, data bases, and industrial or commercial information).

Since the late 1970s, China has introduced legislation concerning the protection of intellectual property and the import of technology. Such legislation includes the Equity Joint Venture Law (EJV Law),[1] the Cooperative Joint Venture Law (CJV Law),[2] the Wholly Foreign-owned Enterprise Law (WFOE Law),[3] Patent Law,[4] Trademark Law,[5] Copyright Law,[6] and technology transfer regulations.[7] In addition, China has also signed some multilateral conventions.[8] On 26 February 1995, the United States and China signed an intellectual property accord which set out specific intellectual property rights protection and enforcement mechanisms.[9]

* The author wishes to thank her research assistant, Thomas Wall, for his assistance with the drafts of this article.

1. Law of the People's Republic of China (PRC) Concerning Joint Ventures Using Chinese and Foreign Investment, adopted by the National People's Congress (NPC) on 1 July 1979, and amended on 4 April 1990 (hereafter the "EJV Law"); Detailed Rules and Regulations for the Implementation of the EJV Law, issued by the State Council on 20 September 1983.
2. Law of the PRC Concerning Chinese-Foreign Cooperative Joint Ventures, passed by the NPC on 13 April 1988 (hereafter the "CJV Law"); implementing regulations for the CJV Law were issued by the Ministry of Foreign Trade and Economic Co-operation on 5 September 1995.
3. Law of the PRC Concerning Enterprises Operated Exclusively with Foreign Capital, passed by the NPC on 12 April 1986 (hereafter "WFOE Law"); Detailed Rules for the Implementation of the WFOE Law, issued by the State Council on 12 September 1990.
4. Patent Law of the PRC, promulgated by the NPC on 12 March 1984, amended on 4 September 1992. The implementing regulations for the Patent Law were promulgated by the China Patent Bureau on 25 January 1985. See also Regulations for the Administrative Protection of Pharmaceuticals and the Administrative Protection of Agrochemical Products, promulgated by the State Pharmaceutical Administration and the Ministry of the Chemical Industry respectively on 19 December 1992.
5. Trademark Law of the PRC, promulgated on 23 August 1982 by the NPC and amended on 22 February 1993. The implementing regulations for the Trademark Law were promulgated on 10 March 1983, amended on 13 January 1988 and 28 July 1993 by the State Administration of Industry and Commerce. For trademark protection, it is essential that the trademark be registered in China.
6. Copyright Law of the PRC, promulgated by the NPC on 7 September 1990. The implementing regulations for the Copyright Law were introduced by the State Council on 1 June 1991. See also Computer Software Protection Regulations introduced by the State Council on 4 June 1991.
7. Law of the PRC on Technology Importation Contracts, promulgated by the 21st session of the 6th National People's Congress on 21 March 1987 (the Technology Import Regulations); implementing regulations for this law were issued by the State Science and Technology Commission on 15 March 1989.
8. China is a party to the Universal Copyright Convention, the Berne Convention for the Protection of Literary and Artistic Works, the Convention for the Protection of Phonogram, the Madrid Agreement concerning the Registration of Trademarks, and the GATT Intellectual Property Rights Agreement.
9. The accord affirms steps China has recently taken to combat intellectual property rights infringements, such as the establishment of specialized intellectual property courts, a prohibition of infringing products, and a copyright verification system consisting of unique identifiers on compact discs, CD-ROMs and laser discs to identify the source and licence number of such products. The agreement also contains a series of new commitments by China, including: (a) US entities can enter into exclusive licence agreements with Chinese publishers; Chinese–US joint ventures in the computer software sector will be allowed to produce and sell software and software products in China; revenue sharing arrangements between Chinese and foreign companies through exploiting foreign companies catalogues may continue; and China will publish all laws, rules, regulations, administrative guidance, and other official documents concerning any limitation on, regulation of, or permission required to engage in all of the activities identified above prior to 1 October 1995. The United States made a number of commitments to provide training of intellectual property personnel and advice on the setting up of systems and procedures.
In recent months in the light of continuing reports of intellectual property piracy, the United States has expressed dissatisfaction with the enforcement of laws penalizing infringements.

A. Protection of intellectual property

Intellectual property is protected under specific legislation or under contracts. Patents, trademarks, copyrights and computer software are protected under specific legislation; know-how and other forms of proprietary technology are not.

1. Patents

Under the Chinese Patent Law, inventions, utility models and exterior designs may be patented. The Patent Law prohibits the granting of patents for scientific discoveries, rules and methods for mental activities, methods for the diagnosis of, or for the treatment of diseases and substances obtained by means of nuclear transformation. Food, beverages, flavourings and pharmaceutical and chemical products were unpatentable until the Patent Law was amended in 1992. Chinese and foreign persons (individuals and companies) may apply for a patent. Patent applications are governed by the first-to-file principle.[10] A foreign applicant must appoint one of the patent agents that are officially authorized to handle the application.[11] An invention or utility model for which a patent application is made must possess novelty, inventiveness and practical applicability. Any invention that violates the law, social morality or the public interest is not patentable. The duration for a patent is 20 years for invention patents and ten years for utility model and design patents. Patentees have the right to prevent parallel imports of their patented products.

2. Trademarks

China's first-to-file trademark registration system protects only registered trademarks. Under the Trademark Law, a registration is valid for ten years and may be renewed. As in the case of patents, applications for trademark registration must be made through one of the officially designated trademark agents authorized to deal with Chinese trademark applications.

Trademark registration is currently granted for both goods and service marks. Trademarks and service marks can be registered if they are distinctive. No registration is granted if the mark uses words and symbols which:
- are identical to or similar to the state name, national flag, national emblem, military flags or decorations of China, foreign countries or international organizations;
- relate to generic names or symbols of the goods in respect of which the trademark is used;
- directly refer to the quality, main raw materials, function, use, weight, quantity, or other features of the goods in respect of which the trademark is used;
- discriminate against any ethnic group;
- advertise goods in an exaggerated or deceitful manner; or
- are detrimental to socialist morals or customs or have other unhealthy influences.

To address problems caused by the inconsistent translation of the names of foreign applicants, a foreign applicant's name must be consistent with the Chinese name registered in China. Where a trademark or service mark is assigned, the assignor must apply for the assignment for the mark together with other identical or similar trademarks registered for the same or similar goods or services that the registrant also holds. In addition, a licence contract must be concluded and a copy of the contract sent to the competent government agency for the record. Trademark holders are responsible for the quality control of goods or services bearing their trademarks or service marks. Failure in this regard can result in cancellation of a trademark registration.

3. Copyrights

Copyright protection is governed by the Copyright Law, which is modified by international copyright treaties signed by China (such as the Berne Convention on Copyrights and the Universal Copyright).[12] Works that are protected under the Copyright Law include literary and oral works, various types of performance works, audio and video recordings and computer software. Adaptations, translations, annotations and collations of pre-existing works are also protected. With respect to work produced by foreign persons, the work is protected under the Copyright Law where it is published first in China, or under bilateral or multilateral agreements in other cases.

The duration of copyright protection is:
- generally, the life of the author, plus 50 years;
- in the case of copyrights originally vesting in a legal person and in the cases of copyrights in sound recording and video recording, the duration of protection is generally 50 years from the date of first publication;
- perpetual protection for moral rights of attribution, the right to revise a work and the right to protect the integrity of a work.

4. Computer software

"Computer software"[13] is protected under separate regulations.[14] According to these regulations, protection is extended to foreign works which are "first published" in China or which are created by citizens of countries which have concluded bilateral or multilateral agreements to which China is a party. Unpublished foreign works may receive protection under international agreements to which China is a party.

10. Since China is a member of the Paris Convention, the priority date for an application for an invention or utility model patent filed in another member country within 12 months prior to the filing of an application in China, will be deemed to be the prior filing date in that other country. For design patents the prior application must be made within six months of the application in China.
11. The Regulations on Patent Agencies effective as of 1 April 1991, (which replaced the Provisional Regulations on Patent Agencies promulgated on 12 September 1985) provide that other patent agencies may be established with the permission of the State Council or the China Patent Bureau.
12. According to the Regulations for the Implementation of International Copyright Treaties which were promulgated by the State Council on 25 September 1992, international copyright conventions are defined as the Berne Convention and bilateral copyright agreements.
13. Computer software may not include programmes incorporated in semiconductor chips. It does not include ideas, concepts, discoveries, principles, algorithms, processing methods and operation methods used in the development of the software.
14. Computer Software Protection Rules, adopted by the State Council on 24 May 1991; Measures for Computer Software Copyright Registration, issued by the Ministry of Engineering and Electronics on 6 April 1992.

Registration of computer software is a precondition to the filing of infringement actions with either the courts or with administration agencies. Registration is described as providing prima facie evidence that a software copyright is effective. Copyright in software includes the economic rights to copy, reveal, distribute, alter, translate, annotate, etc. on the condition that the public interest is not harmed. The right also includes the right to license and assign works, as well as the personal or moral rights of attribution and the right of publication. The initial term of protection is 25 years from the date of first publication. The duration of licensing contracts for software is limited to ten years. The licensee must record the licence within three months after the execution of the contract.

5. Infringement

The Chinese government has taken steps to combat the rampant infringement of intellectual property rights in China. For example, China has concluded accords with the United States, established a specialized intellectual property court and introduced regulations imposing penalties on infringers.[15] The criminal sanctions against infringers of the Copyright Law include prison terms of up to seven years.

Where an infringement occurs there are two possible courses of action: the owner of the intellectual property right may either bring a suit in the People's Court or request administrative action by the competent government agency. Civil and criminal sanctions may both be imposed where an infringement has taken place.

B. Technology import regulations

The transfer or licence of technology to China either alone or together with the sale of equipment or as part of a compensation trade is governed by several specific laws and regulations at both the national and local level. [16]At the national level, these laws include the Regulations on the Administration of Technology Import Contracts (Technology Import Regulations) and the Examination Measures for the Examination and Approval of Technology Import Contracts.[17] Local governments in Shenzhen Special Economic Zone, Guangdong province, Xiamen and other places have introduced similar regulations.[18]

According to these regulations, a transfer of technology to China requires approval from various Chinese government agencies and all imported technology must be "advanced and appropriate" and capable of:

- developing and producing new products;
- raising the quality and performance of products, lowering production costs and conserving energy or materials;
- furthering the full utilization of China's natural resources;
- expanding product exports and increasing foreign exchange earnings;
- furthering environmental protection;
- furthering safety in production;
- improving management and administration; or
- assisting in raising the level of science and technology.[19]

Naturally, not all of these criteria can be met simultaneously in any single transaction. Whether or not the technology transfer contract can be approved by the Chinese government may depend on administrative practice and China's industrial policy. In light of China's desire to generate foreign exchange earnings, technologies that ultimately would increase China's exports or reduce China's imports are likely to be favoured.

A technology import contract must be in writing and submitted to the designated Chinese examination and approval authority. It must comply with the provisions of the Foreign Economic Contract Law.[20] Various terms must be stipulated in the contract (such as a detailed description of the contents, scope and essential specification of the technology to be transferred, an exhaustive list of any patents and trademarks involved, the technological objectives to be achieved and the relevant measures and time limit for the achievement of such ends, and the amount and method of payment). The transferor must guarantee that the technology is "complete, free of error, effective and can achieve the objectives stipulated in the contract".[21] The transferee must maintain the confidentiality of the technology.

The term of a technology import contract is generally ten years; a longer term may be obtained, but only with the special approval of the government. Chinese government policy strongly favours a relatively short duration, after which the transferee will become the owner of the technology. A principal exception to this rule applies to technology that is contributed or licensed to a Chinese-foreign joint venture. As discussed below, when the duration of the joint venture is more than ten years, as it often is, the duration for the relevant trans-

15. For example, the National People's Congress' Standing Committee's Decisions on Penalties for Infringement upon Copyrights, issued on 5 July 1994 and Administration of Audio and Video Products Regulations, issued on 25 August 1995.

16. Transfers of technology among Chinese entities, including joint ventures and wholly foreign-owned enterprises established in China, are governed under the Law of the PRC Concerning Technology Contracts, promulgated by the 21st Session of the 6th National People's Congress on 23 June 1987 (the Technology Contracts Law); its implementing regulations were promulgated by the State Science and Technology Commission on 15 February 1989.

17. The Technology Import Regulations were promulgated by the State Council on 24 May 1985. Implementing Rules for Technology Import Regulations were issued on 20 January 1988. Examination Measures were approved by the State Council on 26 August 1985 and published by the Ministry of Foreign Economic Relations and Trade on 18 September 1985.

18. Provisional Regulations of the Shenzhen Special Economic Zone Concerning the Import of Technology, promulgated on 11 January 1984; the Regulations on Technology Imports to the Xiamen Special Economic Zone, adopted on 14 July 1984.

19. Technology Import Regulations, *supra* note 17, Art. 3.

20. Law of the PRC Concerning Contracts with Foreign Elements, promulgated by the 10th Session of the 6th National People's Congress on 21 March 1985.

21. Implementing Rules for the Technology Import Regulations, *supra* note 17, Art. 9. Additional obligations on the transferor include a requirement that prices of raw materials, spare parts, or equipment which the recipient imports from the transferor for use with the transferred technology must not be higher than those of similar products in the international market (see Arts. 10 and 11).

fer of technology to the joint venture will be coterminous with the duration of the joint venture.[22]

Royalties for the transfer of technology are generally paid at a fixed rate in instalments. In some cases, the amount may be determined on the basis of the actual number of units produced or sold, and on occasion, a fixed lump sum is used. The Chinese generally prefer to tie royalties to net profits or to actual sales, thereby requiring the transferor to share the commercial risks, whereas the transferor will be more interested in ensuring a minimum return, regardless of production or sales.

C. Contribution of technology to foreign investment enterprises

Under the EJV Law, CJV Law and the WFOE Law, contributions to the registered capital of an equity joint venture, cooperative joint venture or wholly foreign-owned enterprise (collectively referred to as "foreign investment enterprises" or FIEs) can be made in cash or in kind (including tangible and intangible property). An in-kind capital contribution generally includes the transfer of technology to a FIE, this method has been a common form of technology transfer to China. This form of technology transfer, and in particular, transfers to joint ventures, has been encouraged by the Chinese government. From the Chinese perspective, the foreign company's contribution of technology to a joint venture obviates the need for the Chinese party to pay royalties in foreign exchange. In addition, the direct involvement of the foreign company in an ongoing enterprise ensures that the technology is effectively transferred. From the foreign company's perspective, a contribution of technology to the capital of a joint venture may help the company in keeping the technology transfer within the scope of the joint venture and reduce the amount of cash investment in the joint venture.

Although China encourages technology transfer through capitalization of technology, the Chinese government has become increasingly concerned about the under-financing of ventures launched with largely intangible assets. Efforts have been made to discourage over-capitalization in technology. In the case of joint ventures, there is no published regulation limiting the percentage of the foreign partner's contribution which may be constituted by technology. In practice, however, high percentages of capital contributions in technology are usually discouraged.[23] For example, the WFOE regulations specify that the percentage of capitalization of technology cannot exceed 20 per cent of the total registered capital.[24] Because of these limitations, the foreign partner may be forced to contribute a portion of its technology as a capital investment and license the remainder of its technology to the joint venture for a royalty. Since valuation of technology is often difficult, such an arrangement may be viewed by the Chinese as an attempt to double count the value of the technology.

III. OVERVIEW OF THE CHINESE DOMESTIC INCOME TAX SYSTEM

Chinese taxes applicable to foreign companies that transfer technology to China are mainly the Income Tax on Foreign Investment Enterprises and Foreign Enterprises (the "FIE Tax")[25] and the Individual Income Tax (the "IIT").[26] The FIE Tax is applicable to FIEs and foreign companies that earn business profits or receive royalties from China. The IIT may apply to individuals who are sent by the foreign company to provide technical or other services to the Chinese licensee in connection with the technology transfer. In addition, China has concluded more than 40 tax treaties. These treaties are based on the OECD Model Treaty[27] and the United Nations Model Treaty;[28] they apply to both the IIT and FIE Tax.

A. FIE Tax

The FIE Tax legislation was introduced in 1991. It does not, however, represent the total of China's tax regime applicable to foreign business and investment. As mentioned below, many specific regulations that govern issues such as the transfer of technology, lending, leasing and tax incentives remain in force.

1. Tax liability of FIEs and foreign enterprises

The FIE Tax applies to "foreign investment enterprises" and foreign enterprises doing business in China or earning income from China. FIEs are subject to tax on their world-

22. Ibid., Art. 4. However, even in such cases, the period for payment of royalties is generally limited to ten years.
23. In Shenzhen SEZ and Guuangzhou Economic and Technological Development Zone (ETDZ) the percentage is set to be 20 per cent of the registered capital in most cases. A higher percentage is allowed in the case of FIEs that qualify as "technologically advanced enterprises".
24. WFOE Regulations, *supra* note 3, Art. 28.
25. The Income Tax Law of the PRC Concerning Foreign Investment Enterprises and Foreign Enterprises, adopted by the NPC on 9 April 1991 (hereafter "FIE Tax Law"); Detailed Regulations for the Implementation of the FIE Tax Law, promulgated by the State Council on 30 June 1991 (hereafter "FIE Tax Regulations"). For further, see Stephen Nelson, "New Unified Tax Law Governing Foreign Investment Enterprises and Foreign Companies, "*Tax Notes Int'l* (June 1991) at 605 and "Detailed Rules for China's Unified Tax Law (three parts), *Tax Notes Int'l* (October 1991, December 1991 and February 1992); T. A. Gelatt, "China's New Tax Law for Foreign Business: a Rational System Emerges," *East Asian Executive Reports* (15 May 1991) at 13 ; Jinyan Li, "People's Republic of China: The Implementing Regulations for the New Consolidated Income Tax on Foreign Investment," 46 *Bulletin for International Fiscal Documentation* 4 (1992) at 170.
26. The Individual Income Tax Law of the PRC, promulgated by the National People's Congress on 10 September 1980 and amended 31 October 1993 and effective on 1 January 1994 (hereafter the IIT Law); Implementing Regulations for the IIT Law, issued by the State Council on 29 January 1994 (hereafter the IIT Regulations). See T. A. Gelatt, "China's New Individual Tax Law: Implications for Foreign Business," *East Asian Executive Reports* (10 November 1993) at 15 ; Jinyan Li, "The Impact on Foreigners of China's New Individual Income Tax Law," 7 *Tax Notes Int'l* (13 December 1993) at 1495 ; and "The Impact on Foreigners of China's Implementing Regulations for the New Individual Income Tax Law," 8 *Tax Notes Int'l* (4 April 1994) at 939.
27. OECD Model Double Taxation Convention on Income and on Capital, Paris, 1977, revised in 1992.
28. United Nations Model Double Taxation Convention between Developed and Developing Countries, UN, ST/ESA/102 (1980).

wide income, whereas foreign enterprises are taxable only on their Chinese-source income.

Foreign investment enterprises: FIEs pay tax on their worldwide income if they maintain a head office in China[29] and have the status of a legal person. Equity joint ventures and wholly foreign-owned enterprises are legal persons under Chinese law.[30] A cooperative joint venture may or may not be incorporated as a legal person.[31] If a cooperative joint venture takes the form of a contractual arrangement or partnership, the venture is not a separate taxpayer. Rather, the parties to the venture pay tax separately, and the venture is deemed to be an establishment of the foreign party. With the approval of the tax authorities, however, some ventures may elect to have the venture taxed as a separate entity.[32] If a cooperative joint venture is a legal person, or the parties elect to treat the venture as one entity, the venture is the taxpayer.

Foreign enterprises with an establishment in China: Chinese taxation of a foreign company that transfers technology to China or carries on business in China depends on whether the foreign company has an "establishment" in China. Where a foreign company has an establishment in China, any profits derived through the establishment are taxable on the net income basis at 33 per cent. Foreign companies without establishments in China are taxable only on Chinese-source investment income and capital gains at 20 per cent of the gross income. The significant difference in tax treatment between a tax on net income and a tax on gross income makes it critical for a foreign company to determine whether it has an "establishment". The word is defined under the FIE Tax to include a "management office, business site, office, factory, place of extraction of natural resources, site for contracted projects such as construction, installation, assembly or exploration projects, site for the furnishing of services, and a business agent.[33] A business agent is deemed to be an establishment of a foreign company if the agent habitually negotiates and concludes purchase or sales contracts in the name of the company, or habitually stores the company's goods and makes deliveries to third parties on behalf of the company.[34] The concept of "establishment" is modified by the definition of "permanent establishment" under tax treaties. The definition of a "permanent establishment" has a narrower meaning than "establishment". For example, treaties distinguish between dependent and independent agents, whereas the FIE Tax does not. Under most of China's treaties, a dependent agent in China is deemed to be a permanent establishment of a foreign company, but an independent agent is not, unless the agent is an exclusive agent and habitually exercises the power to conclude contracts for the foreign company.[35] Similarly, a service project may be deemed to be an "establishment" for the purposes of the FIE Tax regardless of the duration of the project, but the project is not a "permanent establishment" under the treaty unless it lasts more than six months.[36]

Foreign enterprises without establishments in China: These enterprises are subject to withholding tax on Chinese-source income, including royalties. If, however, the earning of such income is "actually related" to a foreign company's establishment in China, the income is taxable as part of the establishment's profit, regardless of whether it is derived from inside or outside China. The meaning of "actually related" is unclear. For example, where a Canadian company has a representative office in Beijing and the Beijing representative is also responsible for the company's other East Asian business, and the representative, while on a business trip to Tokyo, negotiates and signs a licensing agreement with a Japanese firm and the royalties are payable to the company in Canada, should the royalties from this Japanese contract be considered related to the Beijing office? The answer to this question is unclear and the Chinese tax authorities have not yet indicated whether they will attempt to assess the representative office on the royalties.

2. Computation of business profits

FIEs and foreign companies with establishments[37] in China pay tax on their "taxable income". "Taxable income" is the gross income net of costs, expenses and losses.[38] The rules with respect to calculating income largely follow internationally-accepted accounting principles. Income is computed annually[39] and is generally recognized on an accrual basis. Where parties to a cooperative joint venture share products instead of cash profits, each party is deemed to have realized income when products are received.

Income of FIEs or foreign enterprises with establishments in China includes:

- income from production or business including income from manufacturing, farming, transportation, construction trading, financing and services, and other trades;
- investment income, i.e. dividends (other than inter-corporate dividends[40]), interest, rent, and royalties (income from the provision or assignment of the right to use patents, proprietary technology, trademarks, copyrights);

29. A "head office" refers to a central organization set up in China by an FIE to be responsible for the operations, management and control of the enterprise. FIE Tax Regulations, *supra* note 25, Art. 5.
30. An enterprise is a legal person if it is established in accordance with Chinese laws, possesses the necessary property or funds, has its own name, organizational structure and premises, and is able to assume civil obligations independently. See General Provisions of the Civil Law of the PRC, adopted by the NPC on 12 April 1986, Art. 4.
31. CJV Law, *supra* note 2, Art. 2.
32. FIE Tax Regulations, *supra* note 25, Art 7; State Tax Bureau Notice on Operational Problems in the Thorough Implementation of the Foreign Related Enterprise Income Tax Law, [1991] *Guo Shui Fa* No. 165 of 15 October 1991, Art. 4.
33. FIE Tax Regulations, *supra* note 25, Art. 3.
34. FIE Tax Regulations, *supra* note 25, Art. 4.
35. Canada–China treaty, Art. 5(6).
36. The Chinese tax administration's posture suggests that "establishment" is not interpreted as broadly as the regulations might seem to allow, but rather in a manner akin to the concept of a "permanent establishment" within the meaning of the treaty.
37. Where a foreign enterprise has two or more establishments in China, it may, subject to approval by the tax authorities, designate one of the establishments to file returns and pay income tax on a consolidated basis; FIE Tax Regulations, *supra* note 25, Art. 92.
38. FIE Tax Law, *supra* note 25, Art. 4.
39. A "taxation year" is normally the calendar year. In special cases, taxpayers may use their own 12-month fiscal period with the approval of the tax authorities. A short taxation year is allowed where the taxpayer commences or terminates its business during the year or where there is a reorganization of the enterprise.
40. FIE Tax Regulations, *supra* note 25, Art. 2.

- non-operating income;[41] and
- capital gains from the disposition of capital property and gains from the liquidation of a business.[42]

Royalty payments and other costs of doing business are generally deductible by taxpayers in computing income.[43] Where royalties are paid to a taxpayer's head office, however, the royalties are not deductible.[44] This prohibition is presumably intended to prevent foreign companies from shifting income outside China in the form of royalty payments. Payments to the head office for overhead and administrative expenses are deductible, provided that these payments are properly documented and approved by the local tax authorities.[45] It is difficult for the Chinese tax authorities to monitor these fees; in many cases foreign enterprises could substitute administrative fees for royalty payments as a means of reducing taxable income in China.[46]

Interest expenses are deductible if the amount of the interest is reasonable.[47] An interest payment is considered reasonable where the amount is computed according to a rate no higher than the rate for ordinary commercial loans. Interest expenses incurred in respect of the acquisition of fixed assets or intangible assets are not deductible before the assets are put into use, but may be added to the cost of the assets and amortized. The FIE Tax legislation contains no rules on the debt/equity ratio of FIEs. In practice, when the debt/equity ratio of a FIE exceeds the ratio specified under other regulations, the Chinese tax authorities may deny the deduction of interest on any excessive debt.[48]

The cost of acquiring fixed assets, equipment and intangible assets may be depreciated or amortized according to detailed statutory rules.[49] Depreciation is based on the "original cost"[50] of the assets less residual value[51] and is computed according to the straight-line method over the prescribed useful life of the assets.[52] Useful life is prescribed to be ten years for machines and other production equipment, and five years for electronic equipment and transportation equipment. The tax authorities may approve accelerated depreciation in certain cases.[53] Taxpayers may amortize the cost of acquiring intangible assets,[54] such as know-how, patents, trademarks, and the right to use a site. The amortization period is the remainder of the useful life as provided under the technology transfer contract[55] or ten years in other cases.

3. Deemed profit and transfer pricing rules

Deemed profit: Where taxpayers are unable to submit complete and accurate evidence of their costs and expenses, their taxable income may be assessed according to a deemed profit rate. In addition, income earned from certain activities may also be computed under the deemed profit method. For example, 5 per cent for technical services and 10 per cent for services in connection with contracted projects.[56]

Transfer pricing rules: Under Article 13 of the FIE Tax, the tax authorities are authorized to adjust an enterprise's income when the income of the enterprise has been decreased as a result of the prices charged, or received, for transactions with its associated enterprises which took place at levels different from those that unrelated enterprises in similar circumstances would have agreed to. In such cases, the income of the Chinese enterprise will be increased.

The term "associated enterprise" is defined under Article 52 of the FIE Tax Regulations to mean an enterprise that has any of the following relationships with another enterprise: (a) direct or indirect ownership of, or control over, such matters

41. FIE Tax Law, *supra* note 25, Art. 1.
42. This is the net asset value of the remaining property; FIE Tax Law, *supra* note 25, Art. 18; FIE Tax Regulations, *supra* note 25, Art. 29.
43. For example, the cost of goods sold, sales taxes, and marketing and administration fees. Art. 19 of the FIE Tax Regulations prohibits the deduction of certain expenses, such as capital expenditures, income tax payments, fines and penalties, and expenses unrelated to production and business operations.
44. FIE Tax Regulations, *supra* note 25, Art. 19(9).
45. FIE Tax Regulations, *supra* note 25, Art. 20. An FIE may apportion to its branches the management fees relating to the business of such branches; FIE Tax Regulations, *supra* note 25, Art. 58.
46. FIE Tax Regulations, *supra* note 25, Art. 20. Payments are deductible if they are reasonably related to the business of the establishment of the foreign enterprise, supported by a document issued by the enterprise's head office specifying the management services, total amount and basis for allocation to the Chinese establishment. These documents must be verified by a Chinese chartered accountant.
47. FIE Tax Regulations, *supra* note 25, Art. 21. The deduction is subject to approval by the local tax authorities, to whom information concerning the loan and payment of interest must be provided.
48. This is based on an interview of the author with a Chinese tax official on 14 July 1994. The following debt/equity ratios are specified to prevent under-capitalization:
- where the total investment (including both debt and equity) of an FIE is less than USD 3 million, the equity must be at least 70 per cent of the total investment;
- where the total investment is between USD 3 million and USD 10 million, the equity must be at least 50 per cent of the total investment, but not less than USD 2.1 million;
- where the total investment is between USD 10 million and USD 30 million, the equity must be at least 40 per cent of the total investment, but not less than USD 5 million; and
- where the total investment is over USD 30 million, the equity must be at least 33.3 per cent of the total investment, but not less than USD 12 million.

49. FIE Tax Regulations, *supra* note 25, Part III.
50. FIE Tax Regulations, *supra* note 25, Arts. 31 and 46. The original cost is determined as follows: for purchased assets, the purchase price plus freight, insurance, installation expenses and other related expenses incurred before they are put into use; (b) for fixed assets manufactured by the taxpayer, the cost of production; (c) for assets contributed as an investment in a FIE, the reasonable value of the assets plus relevant expenses incurred before they are put into use; and (d) for fixed assets acquired as a gift, the reasonable appraised price.
51. Residual value must not be less than 10 per cent of original cost. If a taxpayer wishes to have a lower or no residual value, approval from the local tax authorities must be obtained. See FIE Tax Regulations, *supra* note 25, Art. 33.
52. FIE Tax Regulations, *supra* note 25, Arts. 33 and 34. Other methods of depreciation may be used by a taxpayer provided they are approved by the local tax authorities.
53. FIE Tax Regulations, *supra* note 25, Art. 40. For example, these may include machinery and equipment exposed to highly corrosive materials, buildings in a state of vibration throughout the year, machinery and equipment in operation 24 hours a day throughout the year, assets of a joint venture with an operation term shorter than the prescribed useful life of the assets. Similarly, where the Chinese party to a cooperative joint venture takes title to the assets upon the termination of the joint venture contract, the useful life can be shorter.
54. The acquisition cost is deemed to be the reasonable purchase price. The cost of self-developed intangibles is deemed to be the expenditure on research and development. The cost of assets contributed as an investment in FIEs is deemed to be the reasonable price set out in the investment contract. See FIE Tax Regulations, *supra* note 25, Art. 46.
55. For example, where intangible assets are contributed as an equity investment to a FIE or are otherwise obtained by the taxpayer and the useful life is set forth in the relevant contract, the amortization period is the prescribed useful life under the contract. FIE Tax Regulations, *supra* note 25, Art. 47.
56. This may be determined by reference to the profit rate of other enterprises in the same or similar industries. FIE Tax Regulations, *supra* note 25, Art. 16.

as finances, business operations, or purchases and sales; (b) direct or indirect ownership or control of both entities by a third party; or (c) any other relationship arising from mutual interests.[57] For the purposes of Chinese transfer pricing rules, the meaning of "control" seems very broad. It refers to both direct or indirect de jure control and de facto control of one enterprise by another in the areas of financing, supply of raw materials and technology, sales of products, management, etc. According to the de jure control test the following two companies are associated with the foreign investor company, a Chinese-foreign joint venture in which the foreign party owns at least 25 per cent of the equity (minimum required under Chinese law) and a wholly foreign-owned enterprise (WFOE). According to the de facto control test, an FIE may be "associated" with a bank that provides a loan in an amount constituting 50 per cent or more of the FIE's total capital or another company that guarantees the FIE's loan. Similarly, an FIE is "associated" with a foreign company if that company licenses technology that is key to the FIE's operations, supplies raw materials to the FIE, or markets the FIE's products. In practice, foreign companies that provide financing, technology, raw materials, or handle a FIE's sales at non-arm's length prices are companies that invest in the FIE (the FIE's parent company) or are associated with the company investing in the FIE (the FIE's sister companies).

The arm's length price is determined according to internationally accepted methods, such as the comparable uncontrolled price, resale price, and cost plus methods. With respect to lending and financing transactions, the arm's length price is deemed to be the "normal interest rate," which is presumably the market rate or the rate that would be used in the absence of the affiliation. For services, the arm's length price is deemed to be the "normal charge rates for similar services"; and for the transfer of property or licensing and leasing transactions, the arm's length price is deemed to be the amount that would be agreed upon in the absence of the affiliation.

4. Tax rates and tax incentives

FIEs or foreign enterprises with establishments in China pay tax at a combined rate of 33 per cent, of which 30 per cent is national tax and 3 per cent is local tax. Local tax is currently waived by many local governments under local tax incentive regulations.

To encourage foreign investment in China, China provides various tax incentives to FIEs and foreign companies. Some tax incentives apply to all FIEs and others are confined to certain areas or certain industries. General tax incentives include tax reductions and exemptions available to all FIEs that are engaged in productive activities with an operating period of ten years or more. The standard period of tax holiday is five years, which includes a tax exemption for the first two profit-making years[58] and a half-rate reduction for the subsequent three years.[59] "Productive activities" include manufacturing, processing, construction and agricultural projects.[60]

FIEs operating in certain special areas are taxed at the reduced rates of 15 per cent or 24 per cent. The 15 per cent rate applies to: (a) FIEs and establishments of foreign enterprises that carry on productive activities in the special economic zones (SEZs)[61] and economic and technological development zones (ETDZs); (b) FIEs that operate in projects that are technology-intensive or knowledge-intensive, that have a long-term foreign investment of USD 30 million or more and are located in the "old city area" of cities where the SEZs[62] or ETDZs are located; (c) FIEs that operate in energy, transportation, or port construction projects in the Open Coastal Economic Zones (OCEZs);[63] (d) FIEs in the Shanghai Pudong New Area engaged in production or construction projects in the fields of energy, transportation and communications;[64] and e) FIEs operating in the State High and New-Technology Industry Development Zones.[65] The 24 per cent

57. These tests are interpreted by the State Tax Bureau in its Implementing Rules for the Administration of Transactions Between Associated Enterprises, 29 October 1992 (Transfer Pricing Notice). According to this notice, an enterprise is associated with another enterprise (the "taxpayer") where:
- the enterprise directly or indirectly owns 25 per cent or more of the shares of the taxpayer;
- a third party directly or indirectly owns at least 25 per cent of the shares of both the enterprise and the taxpayer;
- the taxpayer's debt to the enterprise accounts for 50 per cent of the taxpayer's total capital, or 10 per cent of the taxpayer's debt is guaranteed by the enterprise;
- more than half of the directors or high-level managers of the taxpayer are appointed by the company;
- the taxpayer's business operations depend on the use of the enterprise's proprietary technology;
- the enterprise controls the taxpayer's supply of raw materials and spare parts and the sale of products; or
- the enterprise controls the taxpayer's business operations in other ways (for instance, the owners or managers of the enterprise and the taxpayer are related).

58. The term of a tax holiday commences with a taxpayer's "first profit-making year," which is the year in which a taxpayer begins to make a profit after taking into account any loss carry-overs. The duration of the tax holiday is calculated without any interruption.

59. FIE Tax Law, *supra* note 25, Art. 8. FIEs operating in farming, forestry, or animal husbandry or in remote, economically underdeveloped areas may receive a further reduction of 15 per cent to 30 per cent for another ten years following the end of the five-year period.

60. Other productive activities include activities in the following areas:
- energy (excluding the exploitation of petroleum and natural gas);
- metallurgical, chemical and building materials, light industries, textiles and packaging;
- medical apparatus and pharmaceutical industries;
- agriculture, forestry, animal husbandry, fisheries and water conservation;
- construction;
- communications and transportation (other than passenger transport);
- scientific and technological development;
- geological surveying and industrial information consultancy that directly serve the purposes of production; and
- maintenance services for production equipment and precision instruments.

See FIE Tax Regulations, *supra* note 25, Art. 72; State Tax Bureau Notice on the Explanation and Determination of Productive Activities of Foreign Investment Enterprises in Other Industries, [1992] *Guo Shui Fa* No. 109 of 29 April 1992.

61. The Special Economic Zones (SEZs) are Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan Province.

62. FIE Tax Regulations, *supra* note 25, Art. 73(1). See also SEZ Tax Regulations, Part III, Art. 1, note 64 below; and OCEZ Regulations, Art. 1, note 63 below. The FIE Tax Regulations do not define some key concepts, such as "technology-intensive or knowledge-intensive," and "long payback period".

63. FIE Tax Regulations, Art. 70, *supra* note 25; Interim Provisions of the State Council on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for Open Coastal Economic Zones, issued on 15 June 1988 (hereafter the OCEZ Regulations). Cities in the Liaodong Pennisalar, Shandong Pennisalar, Changjiang Triangle, Zhoujiang Triangle and Minnan Triangle were designated as OCEZs.

rate applies to FIEs carrying on productive activities in the OCEZs and in the "old city area" of cities where the SEZs and the ETDZs are located.

Further incentives are available to FIEs engaged in certain projects in the special areas. For example, a ten-year tax holiday (five-year tax exemption and five-year half-rate reduction) applies to FIEs with a scheduled operation term of 15 years or more if they are engaged in port and pier construction projects, infrastructure projects or in agricultural development in Hainan SEZ, or engaged in construction projects in energy and transportation in Shanghai Pudong New Area.

Technologically advanced enterprises and export-oriented enterprises receive additional tax concessions, irrespective of where they are located. "Technologically advanced enterprises" are FIEs that possess advanced technology and are engaged in developing new products or upgrading products to earn foreign exchange from exports or from import substitution.[66] "Export-oriented enterprises" are FIEs that export more than 70 per cent of their products as assessed annually by the local tax authorities.[67] By obtaining export-oriented or technologically-advanced status, FIEs receive a 50 per cent reduction in the national tax rate after the regular tax holidays expire. For FIEs that are already taxed at 15 per cent, the reduced rate is limited to 10 per cent. The rate reduction is applicable for three years for technologically advanced FIEs; it is available indefinitely for export-oriented FIEs provided they maintain export-oriented status.

5. Non-resident withholding taxes

Royalties and other payments received by foreign companies without establishments in China are subject to a 20 per cent withholding tax.[68] This rate is reduced under the FIE Tax legislation and tax treaties.[69] An amount that is deemed to be earned through the establishment of a foreign enterprise in China is taxable on a net basis as business profits under the above-described rules and rates.

Royalties (fees for the use of proprietary rights): The word "royalties" is not used in the FIE Tax legislation. Instead the phrase "fees for the use of proprietary rights" is used. In Chinese, this phrase is *texuquan shiyongfei*. It can be translated as "royalties," but the term "royalties" is too narrow and fails to capture the intended scope of the Chinese term. The precise Chinese term for "royalties" in the Western sense of that term is *tichengfei*. For ease of reference, however, the English word "royalties" is frequently used by translators and commentators.

Fees for the use of proprietary rights refer to fees for the use in China of trademarks, copyrights, patents; and fees for the use of other proprietary rights, which include fees for technical training, technical services, technical documentation and other relevant information provided by foreign companies in relation to the transfer of proprietary rights to a Chinese entity.[70] For the purpose of the meaning of "royalties", technical services and training generally refer to such services as consultation with Chinese enterprises on management methods and assistance in performing feasibility studies, conducting technical seminars, the design of construction sites and the technical training of Chinese personnel. Payments made in respect of the transfer of computer software are treated as royalties where there is a restriction on the use of the software by the Chinese transferee. In other words, if the transfer constitutes a sale of computer software, the payments are not treated as royalties.[71]

The rate of withholding tax may be reduced to 10 per cent or waived where the technology is "advanced," offered on "preferential" terms,[72] and the technology is related to scientific research, the development of energy resources, transportation, communications, and production in agriculture, forestry, animal husbandry and fishing.[73] In determining whether technology is "advanced", the importing Chinese entity must evaluate which of the available technologies is most effective, and transmit its findings to the tax authorities for a decision. In determining whether the technology is offered on "preferential terms," the tax authorities will consider such factors as whether: the cost is low relative to comparable technology, free training is included, payment may be made in kind rather than in cash, or whether the Chinese transferee may continue to use the technology free of charge after the termination of the contract.

64. FIE Tax Regulations, *supra* note 25, Art. 75(1)-(3). See Provisional Regulations on Reduction and Exemption of Enterprise Income Tax and the Consolidated Industrial and Commercial Tax for the Special Economic Zones and the 14 Coastal Cities, promulgated by the State Council on 15 November 1984 (hereafter the SEZs Tax Regulations); Regulations Concerning the Encouragement of Investment and Development of Hainan Island, issued by the State Council on 4 May 1988 (hereafter the Hainan Regulations); and Regulations Concerning the Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax in the Pudong New Zone in order to Encourage Foreign Investment, approved by the State Council on 7 September 1990 and issued by the Ministry of Finance on 11 September 1990 (hereafter the Shanghai Pudong Regulations).

65. State Tax Bureau Notice on Matters Relevant to Foreign Income Tax with Respect to Implementing the State Council Policy Concerning Taxation of State New and High Technology Development Zones, *Guo Shui Han Fa* No. 663 of 16 September 1991.

66. The specific criteria for "technologically-advanced" are not specified in the FIE Tax Regulations, and may be subject to standards set out by the State Science and Technology Commission. See State Tax Bureau Notice No. 663 of 16 September 1991, Art. 4, *supra* note 65.

67. Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment, adopted 11 October 1986; Measures of the Ministry of Finance for the Implementation of Preferential Tax Terms, adopted on 30 January 1987, Art. 5; and Implementing Measures of the Ministry of Foreign Economic Relations and Trade on the Confirmation and Examination of Export-Oriented Enterprises and Technologically Advanced Enterprises with Foreign Investment, issued on 27 January 1987, Art. 5. FIEs do not automatically qualify as "technologically advanced" or "export-oriented" simply because they use advanced technology in production or because they export most of their products; they must apply to the local tax authorities for the special status.

68. FIE Tax Law, Art. 19 and FIE Tax Regulations, *supra* note 25, Part V. Withholding tax is levied when a payment of the Chinese-source income is made to a foreign enterprise.

69. The withholding tax is reduced under the treaty to 10 per cent or 15 per cent.

70. FIE Tax Regulations, *supra* note 25, Art. 59; State Tax Bureau Notice (82) Cai *Shui Wai Zi* No. 143 of 14 October 1982; Provisional Regulations of the Ministry of Finance Regarding the Reduction of and Exemption from Income Tax on Fees for the Use of Proprietary Technology, (82) *Cai Shui Zi* No. 326 of 13 December 1982 (hereafter "Proprietary Technology Provisions").

71. State Tax Bureau, Notice Concerning the Taxation of Fees Paid to Foreign Companies for the Right to Use Computer Software, *Guo Shui Han Fa* [1994] No. 304, 10 June 1994 (the "Computer Software Notice").

72. FIE Tax Law, *supra* note 25, Art. 19(4); FIE Tax Regulations, *supra* note 25, Art. 66; Proprietary Technology Provisions, Art. 1, *supra* note 70.

73. FIE Tax Law, *supra* note 25, Art. 19.

Article 66 of the FIE Tax Regulations further specify that the following payments are eligible for the reduction or exemption:

(1) fees for the use of, or the right to use proprietary technology in respect of production relating to agriculture, forestry, animal husbandry and fishery, which include:

- technology for the improvement of soil and grassland, the development of barren hills and the full utilization of natural resources;
- technology for the cultivation of new animal breeds and plant varieties and the production of high-efficiency, low-toxicity agrochemicals;
- technology for scientific management and production, preserving the ecological balance and enhancing resistance against natural disasters in agriculture, forestry, animal husbandry and fishery;

(2) fees paid by scientific academies, institutes of higher learning and other scientific research institutes for the use of proprietary technology for conducting or cooperating in conducting scientific research and scientific experiments;

(3) fees for the use of proprietary technology for the exploitation of energy resources and the development of communications and transportation;

(4) fees for the use of proprietary technology for energy conservation and the prevention and control of environmental pollution;

(5) fees for the use of proprietary technology for the development of science and technology in respect of:

- manufacturing electro-mechanical equipment;
- nuclear energy;
- production of large integrated circuits;
- production of optical integration, microwave semiconductors, microwave integrated circuits and microwave tubes;
- manufacturing ultra-fast computers and microprocessors;
- optical telecommunications;
- remote, ultra-high voltage, direct current power transmission; and
- liquefaction, gasification and integrated utilization of coal.[74]

Fees for the use of proprietary technology in other areas may also be subject to the reduction or exemption in accordance with provisions approved by the State Council.[75] For example, tax is waived on fees payable to foreign companies for services such as consultation with Chinese enterprises on management methods, assistance in performing feasibility studies, technical training, and the design of construction sites and equipment.[76] Similarly, withholding tax on royalties derived by foreign enterprises from the SEZs, ETDZs and OCEZs may be taxed at the reduced rate of 10 per cent if such income is not otherwise exempt from tax under the above rules and regulations.[77]

Other payments: "Dividends"[78] (after-tax profit distributions) are considered to be from Chinese sources if they are paid by enterprises (FIEs and other enterprises) in China.[79] Dividends paid by FIEs are currently exempt from withholding tax. Interest on deposits, loans, bonds, advances, and deferred payments is considered to be derived from a Chinese source if it is paid by a person resident in China. Such interest is subject to the 20 per cent withholding tax. There may be an exemption for interest on loans extended to the Chinese Government or China's state banks by international financial organizations, or for interest on loans given at a preferential rate by foreign banks to China's state banks. "Rent" or lease payments are derived from a Chinese source if they are paid for the use of property situated in China.[80]

Capital gains from the disposition of property[81] in China are also subject to the withholding tax at 20 per cent of the net gain.[82] Tax is withheld by the purchaser of the property. The FIE Tax legislation is unclear as to whether "technology" is considered to be "property" for capital gains purposes. In practice, where foreign companies sell technology to China, the profits are generally treated as business profits, rather than capital gains.

B. The individual income tax

Foreign individuals who provide technical services to the Chinese licensee of technology may be liable to tax under the IIT. The IIT was first introduced in 1980 and amended in 1993.[83] It is a schedular tax in that different types of income attract different tax liabilities. There is no aggregation of income earned from different sources. Thus, losses from one source cannot be used to offset profits from other sources.

74. FIE Tax Regulations, *supra* note 25, Art. 66.
75. FIE Tax Law, *supra* note 25, Art. 19, last paragraph.
76. Proprietary Technology Provisions, Art. 2, *supra* note 70; Ministry of Finance Notice Concerning the Levy of Income Tax on Income Derived From Patents and Proprietary Rights, (82) *Cai Shui Zi* No. 109 of 8 May 1982.
77. Hainan Regulations, Art. 13, *supra* note 64; SEZ Tax Regulations, *supra* note 64, Part I, Art. 1(4) and Part II, Art. 1(4); Pudong Regulations, *supra* note 25, Art. 10.
78. The FIE Tax legislation uses the word "profits" (lirun) rather than "dividends". "Profits received from another enterprise" refers to "income derived by virtue of an investment ratio, share rights, stock or other non-creditor's right to a share of profit". See FIE Tax Law, *supra* note 25, Art. 19 and FIT Regulations, *supra* note 25, Art. 60.
79. FIT Regulations, *supra* note 25, Art. 63.
80. State Tax Bureau Notice on the Question of Exempting Tax on a Temporary Basis for Rentals for the Use of Foreign Containers in International Shipping, (1993) *Guo Shui Fa* No. 049 of 11 March 1993.
81. "Property" refers to buildings, structures, facilities ancillary to such buildings and structures and land-use rights; FIE Tax Regulation, *supra* note 25, Art. 6(2).
82. Net gain is the proceeds of disposition less the original cost of the property; FIE Tax Regulations, *supra* note 25, Art. 61.
83. The new IIT consolidated three existing taxes: the IIT of 1980 applicable mostly to foreigners; the Individual Income Regulatory Tax of 1986 applicable to Chinese citizens; and a Household Income Tax of 1986 applicable to business income earned by individuals and households.

1. Tax liability of foreign individuals

Under the IIT, individuals are liable to tax if they are domiciled in China,[84] reside in China, or derive income from Chinese sources. Foreigners who reside in China for one year or more are liable to the IIT on their worldwide income; individuals who never visit China or who stay in China for less than one year are liable to the IIT only on their Chinese source income (the "one-year rule"). Individuals are considered to have resided in China for one year if they have stayed in China for 365 days in a tax year.[85] In calculating the period of stay, no subtraction is allowed for temporary absences from China (i.e. absences not exceeding 30 days at any one time, or in the aggregate not exceeding 90 days in a taxation year).[86]

Exemptions are provided to foreign individuals in two cases. First, where an individual stays in China for one year or more, but not more than five years, in this situation the individual is exempt from tax on his or her foreign-source income paid by non-residents of China. Therefore, foreigners are subject to worldwide taxation in China only if they stay in China for more than five years.[87] Second, where individuals reside in China for an aggregate of 90 days or less during the year (the 90-day rule), they are exempt from the IIT on wage or salary income received from foreign enterprises for services performed in China, provided that the payment is not borne by an employer's establishment in China.[88]

Non-residents (individuals who do not visit China or who stay in China for less than a year) are subject to the IIT only on income earned from Chinese sources. Chinese-source income is considered to have been earned in China regardless of whether actual payments are made in China or abroad. Chinese-source income includes:

- employment income from services rendered in China,
- rent for the use of property in China,
- gains from the transfer of property in China,
- royalties for the use of proprietary rights in China,
- interest from individuals, companies and other economic organizations in China, and
- dividends from companies in China.

2. Wages and salaries

"Wages and salaries" include bonuses, year-end extras,[89] benefits, allowances, and other income earned by an individual from an employment or office. "Benefits" and "allowances" are undefined. The meaning of these concepts is left to be clarified by the tax administration. Over the years, the Chinese tax authorities have developed guidelines on the taxability of various fringe benefits and allowances received by foreigners working in China from their employers. These guidelines cover the provision of 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. For example, certain expenses paid directly by the employer or paid by the employee and reimbursed by the employer are normally not treated as benefits taxable on the employee. Such expenses include costs of housing or accommodation,[90] travelling costs to return home on leave, relocation or moving costs, local transportation, housekeeping expenses, and meals.[91] Similarly, contributions made by employers to pension plans, dental plans or insurance plans on behalf of employees are not considered to be taxable benefits.[92] In contrast, where an employee receives a cash "allowance" on a per diem or monthly basis, the allowance is normally deemed to be part of salary. For example, overseas allowances or family allowances to cover the employees' expenses on home visits while working in China are clearly taxable. Because the IIT Law does not permit any deductions from wages and salaries, other than a standard deduction (see below), few employers pay taxable allowances to their employees. Instead, the employer either pays such expenses directly or reimburses the employee for expenses actually incurred as supported by vouchers. Furthermore, the payment of income tax by an employer on behalf of an employee is regarded as taxable remuneration; the employee is consequently taxed on the grossed-up amount.[93]

Income from wages or salary is taxed at progressive rates ranging from 5 per cent to 45 per cent (45 per cent applies to a monthly taxable income of CNY 100,000).[94] The tax liability on employment income is computed monthly. In calculating taxable income, taxpayers may deduct a monthly sum of

84. Individuals domiciled in China are liable to tax on their worldwide income. Individuals are deemed to be domiciled in China if they habitually live in China because of household registration, family, or economic interests. These individuals include Chinese citizens with their household registration in China and foreigners who make China their permanent home instead of a place of work or temporary stay. Very few foreigners receive permanent resident status in China; most are issued a visa or residence permit to visit or stay temporarily in China.

85. A taxation year is defined as a calendar year; IIT Regulations, *supra* note 26, Arts. 3 and 44.

86. IIT Regulations, *supra* note 26, Art. 3.

87. Unlike the earlier legislation, this rule applies irrespective of the reason for the long-term residency. Under the previous IIT, foreign-source income was exempt from tax if the foreigners' presence was attributable to their employment with FIEs, and if the individual had no general intention to take up long-term residency in China. 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.

88. IIT Regulations, *supra* note 26 above, Art. 7.

89. Because wages and salaries are taxed on a monthly basis at progressive rates, the inclusion of bonuses in the definition of "wages and salaries" can 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, a form of income averaging is allowed in practice. Ministry of Finance (81) *Shui Wai Bian Zi* No. 65 of 17 July 1981.

90. As 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.

91. The employer must submit "proof" to be verified by the local tax authorities. This "proof" must establish that the payments were for "company expenses" and not for food, laundry, or other personal expenses of the employee, and were not part of the employee's salary.

92. Where part of an employee's salary is used to buy stocks in the employer company, 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.

93. Ministry of Finance Notice (86) *Cai Shui Wai Zi* No. 034 of 18 February 1986.

94. When the IIT Law was introduced in December 1993, the official exchange rate was USD 1 = CNY 5.8, while the market rate was about USD 1 = CNY 8.8. On 1 January 1994, China implemented a single controlled foreign exchange floating rate in line with the long-standing swap market rate.

CNY 800. This deduction was intended to be an allowance for the "cost of living" [95]Because of inflation and the devaluation of the Chinese currency, the cost of living for expatriates has been increasing; to provide some relief, the IIT Regulations allow expatriates an additional deduction of CNY 3200.[96]

3. Income from independent services

Independent personal services include services provided by accountants, lawyers, medical doctors, engineers, architects, entertainers and other professionals.[97] Unlike income from employment, income from remuneration for personal services is taxable at a flat rate of 20 per cent on a single payment basis. Where the taxable income from a particular payment exceeds CNY 20,000, a surtax is imposed so that the combined rate is 30 per cent on the amount between CNY 20,000 and CNY 50,000 and 40 per cent on any amount exceeding CNY 50,000.[98]

A single payment means income from a lump-sum payment for personal services, payments from performing a single piece of work, or payments received within a month for work of a continuing nature. In computing the sum taxable in respect of each payment, taxpayers may deduct the lesser of CNY 800 or 20 per cent of the payment.[99]

Under the IIT, remuneration for personal services in China is taxable irrespective of the place of payment. Foreign individuals who provide services to Chinese enterprises in China normally receive payments directly from the Chinese enterprise. In some cases, they may be paid indirectly by a company outside China. For example, a foreign company that sells machinery to a Chinese enterprise may agree to provide installation and maintenance services, or training for the Chinese operators, and send a self-employed technician from Germany to provide those services. In such cases the Chinese tax authorities generally treat the fee as the technician's Chinese-source income and tax it accordingly.[100]

4. Other income

Other types of income, such as rent,[101] royalties,[102] interest, dividends, net capital gains[103] and incidental income,[104] are taxable under the IIT at a flat rate of 20 per cent.[105] Tax is computed on a single-payment basis.[106] In the case of income from rent and royalties the taxpayer is entitled to a statutory deduction of the lesser of CNY 800 or 20 per cent of each payment.

IV. TAX TREATIES

As in other countries, tax treaties are part of Chinese tax law. The FIE and IIT legislation are modified by tax treaty provisions. This part provides an overview of China's treaty policy and discusses major treaty provisions concerning the transfer of technology.

A. Overview of China's tax treaties

1. Historical development

By the end of 1995, China had concluded more than 40 bilateral tax treaties. The first such treaty was signed with Japan in 1983, three years after the introduction of income tax in the People's Republic.[107] Like all bilateral tax treaties, the two main purposes of China's tax treaties are to reduce or eliminate double taxation and to prevent tax avoidance and evasion. In addition, China uses tax treaties as a means of promoting international trade and investment. China needs foreign capital, technology and management skills to modernize its economy; foreign governments and multinational corporations are attracted to China by its relatively cheap and educated labour force, potential market of 1.2 billion people, rich resources and rapid economic growth. Tax treaties offer guidance and provide certainty by following the provisions of the model treaties that are familiar to multinational corporations.

2. China's treaty policy

China generally uses the China-Japan treaty as its model in negotiating tax treaties. Its treaties are a blend of the OECD Model Treaty and the UN Model Treaty. In negotiating treaties with the OECD countries, China's main concerns

95. Where an individual is employed for less than a month, the full deduction of CNY 800 has been permitted. See Ministry of Finance Notices (81) *Cai Shui Zi* No. 185 of 2 June 1981 and (81) *Cai Shui Wai Zi* No. 60 of 7 July 1981. In cases where the salary is paid by the employer for the entire month the salary is apportioned on a per diem basis according to the number of days of stay in China.

96. IIT Law, *supra* note 26, Art. 6. Similar deductions may be allowed for Chinese citizens deriving employment income from foreign countries.

97. Other services include designing, decorating, installation, consulting, lecturing, news reporting, broadcasting, editing, calligraphy, painting, recording, art performance, advertising, exhibitions, technical services, agency, and brokerage. IIT Regulations, *supra* note 26, Art. 8(4).

98. IIT Regulations, *supra* note 26, Art. 11.

99. For a single payment of CNY 4,000 or less the deduction is CNY 800; for a single payment exceeding CNY 4,000 the deduction is 20 per cent of the payment. IIT Law, *supra* note 26, Art. 6(4).

100. Ministry of Finance Notices (80) *Cai Shui Zi* No. 214 of 20 November 1980 and (81) *Cai Shui Zi* No. 56 of 26 February 1981.

101. "Rental income" refers to income for the lease of buildings, land-use rights, machinery and equipment, vehicles, vessels, and other property.

102. Royalties include both authors' royalties and royalties for the transfer or licence of technology or other proprietary rights such as patents, trademarks, copyrights and know-how.

103. Net gains are taxable at a flat rate of 20 per cent if they are derived from the transfer of capital property such as buildings, machinery and equipment, land-use rights, shares and bonds. The net gain is equal to the proceeds of disposition less the original cost of the property and reasonable expenses.

104. "Incidental income" includes awards, lottery winnings and all other income.

105. IIT Law, *supra* note 26, Art. 3(5). This rate is reduced to 10 per cent under the Canada–China treaty.

106. A "single payment" for rental income refers to income from amounts paid within a month for the use of the rental property. A "single payment for authors' royalties" is defined as payment for each publication. A "single payment for fees for the use of proprietary rights" refers to a lump-sum payment for each transfer of the right to use proprietary rights. IIT Regulations, *supra* note 26, Art. 21.

107. The Income Tax Law of the PRC Concerning Joint Ventures Using Chinese and Foreign Investment, passed by the National People's Congress on 10 September 1980; the implementing regulations for this law were promulgated by the Ministry of Finance on 14 December 1980; and the Individual Income Tax Law of the PRC, promulgated by the NPC on 10 September 1980, amended on 31 October 1993 (i.e. IIT Law, *supra* note 26).

seem to be threefold: source jurisdiction, reciprocal treatment in treaty provisions, and tax sparing. Because China is a net capital importer, it has taken the position of a developing country and has insisted on a rather broad scope of source jurisdiction. For example, China's treaties have a broad definition of "permanent establishment" and relatively high rates of withholding tax on dividends, interest and royalties. China has rejected any provision that permits income or capital gains to be taxed solely in the residence state.

Compared to the tax systems in the OECD countries, the Chinese income tax system is "under-developed". To accommodate the concerns of its treaty partners, China has on several occasions agreed to include certain provisions in a treaty where such provisions are only relevant to that other country. However, in these situations China has insisted that the provisions apply to both countries. For example, the China–Germany treaty provides in Article 10 that the rate of withholding tax on dividends is 10 per cent. The protocol to the treaty provides, however, that the withholding rate is 15 per cent "as long as in a Contracting State the rate of corporate income tax on distributed profits is lower than the rate on undistributed profits and the difference between the two rates is 15 percentage points or more".[108] Although Chinese domestic tax law does not provide different corporate income tax rates on distributed and undistributed profits, the provision is drafted in neutral language and applies to both China and Germany. If China ever adopts such rules in its tax law, there will be no need to amend the treaty. China has also consistently received tax sparing credit from OECD countries, with the notable exception of the United States. In treaties with developing countries, such as Malaysia, mutual tax sparing credits are provided. A tax sparing credit is critical to the effectiveness of the tax incentive programmes provided under Chinese domestic law. China wants to use the tax sparing credit to promote economic and technological cooperation with other countries.

3. Treaty interpretation in China

Under Chinese law, in the case of any inconsistency between domestic law and the provisions of a treaty, the treaty overrides domestic law. There have been no reported cases concerning the interpretation of tax treaties by Chinese courts. The Chinese tax authorities have issued interpretation bulletins on certain aspects of its tax treaties.

Where a resident of a treaty state derives dividends, interest or royalties from sources in China and wishes to claim benefits under the treaty, the claimant must complete an application form (printed and distributed by the Chinese tax authorities) and present proof of residence in advance. Otherwise, the Chinese tax authorities will first impose tax at the rates under domestic tax law and refund the overpaid amount when the claimant obtains the proof and completes the application form.[109]

4. Coverage of tax treaties

Tax treaties apply to income or capital taxes payable by persons resident in China or the other treaty country. The definition of "China", "person" and "resident" are provided in the treaties.

Territorial coverage – meaning of "China": For the purposes of tax treaties, "China" is defined as the territory in which Chinese laws are effectively in force. This is a subtle way of indicating that, at present, China refers to the so-called "Mainland". China's existing tax treaties do not apply to Hong Kong, Macau, or Taiwan. Hong Kong[110] and Macau will be excluded from China's treaty coverage after 1997 and 1999 when Hong Kong and Macau respectively revert to China. For example, under the Hong Kong Agreement[111] and the Basic Law on Hong Kong,[112] China will establish a Hong Kong Special Administrative Region (HKSAR) upon resuming the exercise of sovereignty over Hong Kong. The HKSAR will be directly under the authority of the Central People's Government of China. The HKSAR will enjoy a high degree of autonomy, except in foreign and defense affairs, and will be vested with executive, legislative, and independent judicial power. The laws currently in force in Hong Kong will remain basically unchanged for 50 years. The HKSAR will have independent finances and the Central People's Government will not levy taxes in it. Therefore, China's internal tax laws will not be "in force" in Hong Kong even after 1997.

Taiwan has been regarded by the Chinese government as part of the People's Republic for political purposes. For treaty purposes, however, FIE and IIT are not enforced in Taiwan. For purposes of tax treaties, Taiwan will remain outside "China" as long as China's tax laws are not enforced in Taiwan.

Taxes covered under treaties: The IIT is specifically covered under tax treaties. The FIE Tax is also covered because it replaced the two taxes, the joint venture income tax (JVIT) (1980) and the foreign enterprise income tax (FEIT) (1981),

108. The protocol to the China–Germany treaty was signed on 10 June 1985.

109. The State Tax Administration has recently revised the application form and the new form must be used after 1 July 1995. See *Guo Shui Han Fa* [1995] No. 089, 6 March 1995.

110. The Chinese Government has consistently taken the view that Hong Kong is Chinese territory. However, the New Territories of Hong Kong have been leased to Britain since 1898 under a 99-year lease and the remaining portions of Hong Kong were ceded in perpetuity to Britain earlier in the 19th Century. China has announced its intention to resume the exercise of sovereignty over all of Hong Kong upon the expiration of the 99-year lease in 1997 and has concluded an agreement with Britain governing that resumption of sovereign control.

111. The Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, the "Hong Kong Agreement" signed in September 1984, following extensive negotiations between the Chinese and British governments. The Hong Kong Agreement sets out the basis on which Hong Kong will be returned to Chinese sovereignty in 1997.

112. The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (the "Basic Law on Hong Kong"), adopted by the National People's Congress on 4 April 1990 goes into effect on 1 July 1997. This law sets out the constitutional framework under which Hong Kong will become a "Special Administrative Region" of the People's Republic, enabling the "one country, two systems" formula designed by Deng Xiaoping to operate. As is common under Chinese law, Art. 158 of the Basic Law on Hong Kong vests the power of interpretation of the law in the Standing Committee of the National People's Congress subject to the requirement of consultation with Hong Kong.

that are listed in treaties concluded before 1991.[113] The FIE Tax is specified in more recent treaties. China does not currently impose capital taxes.

Personal scope – meaning of "person" and "resident": The term "person" is defined to mean an individual, a company and any other body of persons. "Company" is defined as any body corporate or any entity which is treated as a body corporate for tax purposes. Chinese company laws are based on the concept of "legal person". A Chinese company has most of the features of a company in the West (such as limited liability, continuity of existence and independent identity).[114] Companies in China are generally incorporated in one of two forms: limited liability companies and joint stock companies.[115] A limited liability company is similar to the West's "private" or "close" company, and a joint stock company is similar to a public company. For tax treaty purposes, the term "company" may also include a body treated as a company for tax purposes. For example, cooperative joint ventures in the form of partnerships and other cooperative projects may be taxed as enterprises under both Chinese law and tax treaties.[116]

The term "resident" is generally defined in tax treaties to include any person liable to tax under the laws of a contracting state by reason of domicile, residence, place of head office, place of management or any other criteria of a similar nature. Under Chinese domestic law, individuals are resident in China if their "physical stay" in China exceeds one tax year. Enterprises and corporations are resident in China if their head office is in China.[117] In determining whether an individual is a resident of a treaty country, the Chinese tax authorities generally require proof of passport, tax returns filed in the home country, or a letter of reference by the individual's employer. The residency of a foreign corporation doing business in China is based on the location of its "head office" or "place of central management and control" as indicated on the tax registration certificate or business licence issued by the Chinese government and by supporting corporate documents issued by the home country of the corporation.[118]

B. Business profits

Under China's tax treaties business profits of an enterprise resident in a treaty country are taxed in China only where the enterprise carries on business in China through a permanent establishment and the profits are attributable to the permanent establishment. In order to secure source jurisdiction, China has attempted to define the term "permanent establishment" more broadly than it is defined in the OECD Model Treaty.

1. Permanent establishment

The definition of "permanent establishment" in China's tax treaties is a mixture of the definition in the OECD Model Treaty and the UN Model Treaty. It expressly includes a fixed place of business through which the business of an enterprise is wholly or partly carried on, such as a place of management, branch, office, factory, workshop, mine, oil or gas well, quarry or any other place of extraction of natural resources.

A building site, construction, assembly or installation project, or supervisory activity in connection with such a site or project constitutes a permanent establishment if it continues for more than a prescribed duration. The duration is: six months under the treaties with OECD countries, Brazil, Bulgaria, Czechoslovakia, Korea, Kuwait, Malaysia, Pakistan, Poland, Singapore and Thailand; eight months under the treaty with Malta; 12 months under the treaties with Cyprus, Hungary and Romania; 18 months under the treaty with Mongolia; and 24 months under the treaty with the United Arab Emirates.

Where a foreign enterprise has a construction, assembly or installation project in China, the furnishing of supervisory services for the same or a connected project by the enterprise constitutes a permanent establishment where such activities continue for more than six months within any 12-month period. However, planning and supervisory services are not included if they are carried out by another enterprise whose activities in connection with the project are restricted to planning and supervising the work.[119] Similarly, the furnishing of other services (e.g. consulting services) in China through employees or other personnel engaged by a company resident in a treaty country constitutes a permanent establishment if the activities continue for more than six months within a 12-month period. The treaties with Japan and Switzerland contain an exception to this rule. Under these two treaties, consulting services in connection with the sale or lease of machinery or equipment through employees or other personnel do not constitute a permanent establishment. The China–France treaty provides a similar exception, but limits the exception to the sale of machinery or industrial or commercial plant where the costs for the services represent less than 5 per cent of the total amount of the sale and the services are considered to be auxiliary to the sale.

113. Chinese taxes introduced after the date of signature of a treaty will also be covered under the treaty, provided that the new taxes are substantially similar to those enumerated in the treaty. The Chinese competent authority (the Ministry of Finance or State Administration of Taxation) must notify the other country of substantial changes in Chinese tax laws.

114. A company refers to an enterprise with the status of a legal person which is established in accordance with the relevant regulations, divides all of its capital into equal shares, whose shareholders are liable toward it to the extent of the shares subscribed, and which is liable for its debts to the extent of all of its assets. See the Company Law of the People's Republic of China, promulgated on 29 December 1993 effective as of 1 July 1994. This legislation was the first company law on a national level, though certain local regions, such as Guangdong Province and Shenzhen Municipality, have previously issued their own company legislation.

115. E.g. equity joint ventures and wholly foreign-owned enterprises.

116. See Wang Xuanhui, Introduction of China's Tax Treaties (Beijing, Finance and Economics Press, 1987), at 35-36.

117. FIE Tax Law, Art. 2, *supra* note 25.

118. State Tax Bureau Notice of Opinion on Several Issues in respect of the Implementation of the Tax Treaties with Japan and the United Kingdom, (85) *Cai Shui Wai Zi*, No. 042, 26 March 1985, part 1.

119. If that other enterprise has an office which is used for providing the services, that office may constitute a permanent establishment.

2. Computation of business profits

Where an enterprise has a permanent establishment in China, the profits of the enterprise are taxable in China to the extent that the profits are attributable to the permanent establishment. The amount of profits attributable to a permanent establishment must be computed on an arm's-length basis.

China has rejected the "force of attraction" principle recommended in the UN Model Treaty[120] and follows instead the OECD Model Treaty. This position can be explained by the concerns of the Chinese government that: (a) given the size of the country and the low level of sophistication of the tax administration this principle may be difficult to apply consistently across the country; (b) the force of attraction principle may discourage foreign investment in China.[121] China's treaties generally provide, therefore, that profits are attributable to a permanent establishment if they are derived through the permanent establishment. In other words, the profits of an enterprise resident in a treaty country are examined according to the source of the profits in China; only those profits that come from the permanent establishment are taxable in China. Accordingly, it is possible for a foreign company that has a permanent establishment in China to earn royalties without the use of the permanent establishment and pay Chinese withholding tax on the royalties.

Business profits attributable to a permanent establishment must be computed as if the permanent establishment were an independent enterprise dealing at arm's length with its head office. In computing the business profits of a foreign enterprise's permanent establishment in China, deductions are allowed for expenses incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and administrative expenses, without regard to where such expenses are incurred. In many treaties with the OECD countries, however, no deduction is allowed for expenses, other than reimbursement of actual expenses, paid by the permanent establishment to its head office by way of: (a) royalties, fees or other similar payments in return for the use of patents or other intangibles; (b) management fees and other fees for services; and (c) interest, except where the enterprise is a bank.[122]

C. Royalties

Chinese tax treaties generally permit China to tax Chinese-source royalties received by companies resident in the other treaty country. As a developing country, China seems to have attempted to balance two competing concerns in negotiating tax treaties with developed countries: to encourage foreign investments that bring capital, technology and management skills to China, and to protect its tax revenue as a source country. Withholding tax is limited to 10 per cent in general, and 6 per cent or 7 per cent for leasing fees for industrial, commercial and scientific equipment.[123]

1. Meaning of "royalties"

The term "royalties" is defined in China's tax treaties to include payments received as consideration:

- for the use of, or the right to use a copyright of literary, artistic or scientific work (including cinematography films and films or tapes for radio and television broadcasting);
- for the use of, or right to use a patent, know-how, trademark, design, model, plan, or secret formula or process;
- for the use of, or right to use industrial, commercial, or scientific equipment; or
- for information concerning industrial, commercial, or scientific experience.

The definition of "royalties" under Chinese domestic law appears to be broader than that applying under the tax treaties. Under Chinese domestic tax law, payments for technical services or management services are generally viewed as payments made in respect of a transfer of proprietary technology. In practice, however, the Chinese tax authorities follow the treaty definition quite closely; payments for technical services are not considered royalties unless the transfer of technology or "know how" is involved.[124]

2. Source rule

Unlike the OECD Model Treaty, China's treaties generally contain a source rule for royalty payments. Royalties are deemed to arise in China when the payer is the Chinese government (including a local authority) or a resident of China. If a non-resident payer's permanent establishment in China incurs the liability to pay the royalties and bears the payment,

120. Art. 7(1) of the UN Model Treaty provides:
The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

121. Wang, *supra* note 119, at 55.

122. This provision is based on Art. 5 of the UN Model Treaty.

123. Withholding tax rates under treaties with OECD countries on Chinese-source royalties paid to non-residents where the payment is not connected with a permanent establishment in China

Country	Royalties (General)	Royalties (for equipment)
	%	%
Australia	10	10
Austria	10	6
Belgium	10	6
Canada	10	10
Denmark	10	7
Finland	10	7
France	10	6
Germany	10	7
Italy	10	7
Japan	0	10
Luxembourg	10	6
Netherlands	10	6
Norway	10	10
Spain	10	6
Sweden	10	7
Switzerland	10	6
UK	10	7
USA	10	7

124. State Tax Bureau Notice (86) *Cai Shui Xie Zi* No. 024, 11 November 1986. Payments for such services may be taxed as business profits if the services are provided during a period exceeding six months.

the royalty is considered to arise in China.[125] It may be difficult for the Chinese tax authorities to enforce the source rule. For example, where Company A leases advanced nuclear technology to Company B (both companies are resident in Canada), and Company B uses this technology in its project in China and pays royalties from its bank account in Canada, the royalties are considered Chinese-source income if the royalties are deducted in computing Chinese taxable income. It would be particularly difficult to enforce the source rule if the taxable income of the Chinese project is computed on a deemed profit basis.

3. Royalties as business profits

Royalties derived from China by a person resident in a treaty country are taxed as business profits if the earning of such income is effectively connected with that person's permanent establishment in China. In this situation therefore the income is subject to a net basis taxation rather than withholding tax. Chinese domestic tax law has similar rules.[126]

D. Capital gains

With respect to the taxation of capital gains, China's tax treaties generally allow China to tax all capital gains derived from a source in China, which include:

- gains from the alienation of movable property forming part of the business property of a permanent establishment that a person resident in a treaty country has established in China;.
- gains from the alienation of movable property pertaining to a fixed base available to the person resident in a treaty country for the purposes of performing professional services;
- gains from the immovable property or from the alienation of shares of a company, the property of which consists principally of immovable property situated in China;
- gains from the alienation of any property other than that referred to above if the gains arise in China.[127]

For the purposes of tax treaties, "other property" may include proprietary technology. Chinese domestic law is unclear as to how to determine the source of gains from such property. With respect to the sale of computer software, the view of the Chinese tax authorities seems to be that the gains derived by a non-resident person are not taxable in China. In other words, the source of the gains is the country of residence of the seller. The concepts "sale" or "disposition" or "alienation" are undefined under Chinese tax law. In practice, if technology is transferred to a Chinese entity without imposing any restrictive conditions on its use, the transfer constitutes a "sale" and payments are treated as instalments of the purchase price as opposed to royalties or fees for the use of technology. For example, where computer software is transferred to a Chinese enterprise, the transfer is a "sale" if the Chinese transferee is allowed to reproduce the software, resell it, or allow its free use by third parties.[128] On the other hand, if the Chinese transferee is subject to restrictions on the scope, form and terms of use of the software, the transfer is considered a licence arrangement.[129] Similar treatment may apply to the transfer of patents, copyright and other types of proprietary technology.[130]

The sale of patents, know-how and other types of proprietary technology may also be taxed as business profits if the property is sold in the ordinary course of business. The gains are not taxable in China unless the seller has a permanent establishment in China and the sale is directly connected with the permanent establishment.

E. Personal services

Where technology is transferred to China, it is common for the foreign transferor to provide technical assistance to the Chinese transferee with respect to the use of the technology. If the fees for such services are not taxed as royalties in China, they may be taxed as income from personal services. Persons that provide such services are taxed either as employees under the article on "personal services" or as independent contractors under the article on "independent personal services".

1. Dependent personal services

Tax treaties limit China's jurisdiction to tax Chinese-source salaries, wages and similar remuneration received by a resident of a treaty country. China may tax such income only where: (a) the employee is present in China for more than 183 days in a calendar year; (b) the employer is a Chinese res-

125. Under the treaty with the United States, if under the above rules a royalty payment is not considered to arise in either China or the United States, but it relates to the use of, or the right to use, property in China, the royalty is considered to arise in China where the property is used (or where there is a right to use it). For example, if a company resident in the United States licenses a patent to a German company, which in turn sub-licenses it for use in China, the licence payment by the German company to the US company is a Chinese-source royalty and taxable in China under the China–US treaty. The sub-licence payment by the Chinese user to the German company is not covered by the China–US Treaty and is subject to the China–Germany treaty.

126. FIE Tax Law, *supra* note 25, Art. 1; FIE Tax Regulations, *supra* note 25, Art. 2.

127. China's tax treaties deviate from Art. 13 of the OECD Model Treaty and follow more closely the UN Model Treaty to allow the source country greater jurisdiction to tax capital gains. In general, China can tax all capital gains if the gains have a source in China. China has generally rejected the provision under the model treaties that assign jurisdiction to tax gains from the alienation of "other property" solely to the residence state. Under the treaties with OECD member countries (with the exception of Luxembourg), gains derived from the alienation of any property other than the enumerated property may be taxed in the state in which the gain arises.

128. For example, in *Guo Shui Han Fa* [1994] No. 304, 10 June 1994, the SAT states:
"Where foreign enterprises assign computer software to customers in China not by means of providing the right to use the software and without imposing any restrictive conditions, the revenue derived therefrom by the foreign enterprises may be treated as revenue from the sale of computer accessories and is not subject to income tax".

129. The SAT states in paragraph 1 of *Guo Shui Han Fa* [1994] No. 304, 10 June 1994:
Where a foreign enterprise provides customers in China with the right to use computer software in the form of a patent or copyright licence, or, although the computer software is not treated as patented or copyright, provides customers in China with the right to use computer software by imposing restrictive terms on the scope, form and term of use of the software, the use fee charged therefor by the foreign enterprise shall be subject to income tax as income from royalties.

130. Ibid.

ident; or (c) the compensation is borne by the employer's permanent establishment or fixed base in China.[131]

In the case of technical services provided in connection with the transfer of technology to Chinese entities, Chinese taxation of an employee of the foreign transferor company who provides the services in China depends on two factors: first the number of days the employee is present in China during a calendar year and second whether the employee's salary is borne by the employer's permanent establishment in China. If the employer does not have any permanent establishment, the employee is taxable in China only if he or she is present in China for more than 183 days in a calendar year. The length of stay in China can be established by the date of entry and exit stamped on the passport. Where the stay straddles two calendar years, there is no aggregation in computing the number of days the individual stayed in China. For example, an engineer who works in China from 1 August 1995 to 31 May 1996 is exempt from Chinese tax. If, however, the foreign transferor company has a permanent establishment and the employee's salary is borne by the permanent establishment, the employee is taxable in China irrespective of the length of stay in China. Chinese tax authorities interpret "to be borne" to mean to be deducted as an expense in computing the income of the permanent establishment. Whether salaries are borne by a permanent establishment may be difficult to determine when the permanent establishment is taxed under the FIE Tax on a deemed-profit method. The Chinese tax authorities have taken the position that if the individual is considered "employed" by the permanent establishment or holds a position in the permanent establishment, his or her salary is deemed to be borne by the permanent establishment.[132]

Where an individual is subject to Chinese tax, his or her tax liability is limited to that arising on Chinese-source income from salaries. Chinese-source income refers to income derived from providing services in China. This is generally calculated as the individual's total salary income prorated on the basis of the number of days spent in China.[133]

2. Independent personal services

Income derived by a resident of a treaty country from providing independent services in China is only taxable in China if one of the following two conditions is met: (a) the person is present in China for more than 183 days in the calendar year;[134] or (b) the person has a fixed base regularly available in China and the income is attributable to the fixed base. The computation of the number of days is similar to that for persons providing dependent services. The concept of "fixed base" is analogous to that of a "permanent establishment". A fixed base means a fixed place of business used with some continuity for performing independent services. For example, it would not include a hotel room unless it was used as an office or work site on a continuing basis. The rules for computation of business profits are applied in computing profits attributable to a fixed base.

F. Tax sparing credit

As discussed earlier, Chinese domestic law provides numerous tax incentives to foreign businesses and investors. Under the normal tax credit system, however, the investor's home country allows a credit only for taxes that are actually paid in China. Consequently, the net result is that taxes "spared" in China are paid instead to the home country and the investor does not benefit from Chinese tax concessions. In order to avoid this result, China has insisted on a "tax sparing" credit under which Chinese taxes exempted or reduced are deemed to be paid for the purposes of the foreign tax credit in the home country. In other words, the investor's home country allows a credit for taxes that have been "spared" by China where China has jurisdiction to levy such taxes. All of China's tax treaties with developed countries (except the United States[135]) include a tax sparing credit.[136]

131. The treaties also provide that remuneration derived in respect of an employment exercised aboard a ship or aircraft operated by an enterprise in international traffic is taxable only in the residence country of the employer. This treaty provision effectively extends the exemption period from 90 days under the domestic law to 183 days.

132. See *Guo Shui Fa* [1994] No. 148, part 2, para. 2; Notice on Questions regarding the Calculation of Individual Income Tax with respect to Individuals Who Are Not Domiciled in China; issued on 29 March 1995.

133. See *supra* note 132.

134. The China–UK treaty uses "fiscal year" instead of calendar year, whereas the treaties with New Zealand, Norway and Thailand refer to a period of 12 months.

135. The United States has consistently refused to grant "tax sparing" credits to developing countries. The Protocol to the China–US Treaty nonetheless provides that the treaty shall be promptly amended to incorporate a tax sparing credit should the United States subsequently amend its laws concerning the provision of tax sparing credits or agree to grant such a relief to another country.

136. In treaties with developed countries, tax sparing is given to China by the developed country. Reciprocal tax sparing credits are provided under China's treaties with Cyprus, India Italy, Korea, Kuwait, Malaysia, Malta, Pakistan and Thailand.

Tax Sparing under China's Tax Treaties

Country	Taxation of Business Profits if Tax Waived or Reduced in China	Deemed Rate (per cent) of Chinese Withholding Tax on Royalties
Australia	yes	15
Austria	exempt	20
Belgium	exempt	20
Brazil	n/a	n/a
Bulgaria	exempt	n/a
Canada	yes	15
Cyprus	yes (mutual)	10
Czech Rep.	yes	20
Denmark	yes	20
Finland	yes	20
France	exempt	20
Germany	exempt	15
Hungary	exempt	n/a
India	yes (mutual)	n/a
Italy	yes (mutual)	15
Japan	yes	20
Korea	yes (mutual)	10
Kuwait	yes (mutual)	20
Luxembourg	exempt	10
Malaysia	yes (mutual)	n/a
Malta	yes (mutual)	10
Mauritius	yes (mutual)	n/a
Mongolia	n/a	n/a
Netherlands	exempt	15
New Zealand	yes	10
Norway	exempt	20
Pakistan	yes (mutual)	15
Poland	exempt	10
Romania	n/a	n/a
Singapore	yes	20
Slovak Rep.	yes	20
Spain	exempt	15
Sweden	exempt	20
Switzerland	exempt	10
Thailand	yes (mutual)	n/a
UAE	yes	20
UK	yes	n/a
USA	n/a	n/a

With respect to royalties, Chinese tax is generally deemed to be paid at the rate of 10 per cent or 15 per cent irrespective of the amount of Chinese tax actually paid.[137] Under the China–Canada treaty, for example, although the withholding tax rate is 10 per cent on royalties, for the purposes of tax credit in Canada, the Chinese tax is deemed to have been paid at the rate of 15 per cent. As a result of the tax-sparing credit, a Canadian company that receives royalties from China is able to claim a credit for Chinese tax at 15 per cent when the royalty is either exempt from Chinese withholding tax or subject to the reduced withholding rate of 10 per cent.

G. Arm's length principle

All of China's treaties contain the arm's length principle identical to Article 9(1) of the OECD Model Treaty. According to this article, where an enterprise of a treaty country and an enterprise in China are related through management, control, or capital and their commercial or financial relations differ from those which would prevail between independent enterprises, the profits of the enterprises may be adjusted to reflect the profits which would have accrued if the two enterprises were independent.

The OECD Model Treaty provides in Article 9(2) that, where one of the Contracting States increases the profits of an enterprise of that State by applying the arm's length standard, the other State shall, to the extent it agrees that the redetermination accurately reflects arm's length conditions, make a corresponding adjustment, decreasing the amount of tax which it has already imposed on those profits. This provision is missing from China's treaties with Austria, Belgium, Brazil, Canada, France, Germany, Italy, Japan, Malaysia, Norway, Poland, Singapore, Spain, Switzerland, Thailand, and the United Kingdom.

V. TAX PLANNING AND AN ANALYSIS OF THE TAX IMPLICATIONS FOR SOME COMMON METHODS OF TRANSFERRING TECHNOLOGY

Technology transfers to China may take many forms and each form may attract different tax consequences. This part discusses the tax treatment of each of these forms under Chinese domestic tax law and tax treaties.

A. Sale of technology

Where a foreign company "sells" a patent, know-how, copyright, computer software and other forms of proprietary technology to a Chinese entity, gains from the sale are generally not subject to Chinese income tax. Under both domestic law and tax treaties, if the gains are treated as business profits, the foreign company is liable to Chinese tax only if the gains are derived through a permanent establishment in China. Where the gains are treated as capital gains, the gains are not taxable in China.

B. Transfer of technology in connection with the sale or lease of equipment

The intermittent sale of equipment by a foreign company to China does not attract any Chinese income tax. If technology is transferred along with the equipment sale, the portion of payments attributable to the technology transfer is treated as royalties. If services are provided in China to the Chinese purchaser, the services may constitute a permanent establishment under the relevant tax treaty. In that case, service fees will be taxed in China as business profit. Under contracts for the sale of equipment to China, it is common for the foreign supplier to transfer the relevant technology to the Chinese purchaser. Fees payable under such contracts are generally treated as follows: (a) fees for the proprietary rights are "royalties"; (b) fees for the supply of documents and designs in relation to proprietary rights and for the technical training of Chinese personnel are also considered to be "royalties"; and (c) fees for the supply of documents and designs and for the training of Chinese personnel in relation to the installation and operation of the equipment or machinery are not considered to be royalties.

The transfer of technology in connection with leasing is an important form of technology transfer to China. Chinese enterprises are interested in leasing foreign capital equipment. Among other advantages, leasing may enable them to avoid some of the foreign exchange and import licence regulations that hamper the outright purchase of this type of equipment. Where a portion of the leasing payments is considered as fees for the use or right to use proprietary technology, such amount is taxed as royalties. Special tax treatment applies to "lease-sale" or "hire-purchase" transactions. In "lease-sale" transactions, a leasing company rents a piece of equipment to a Chinese entity, with ownership ultimately passing to the Chinese entity. Hence, in contrast to an actual "rental" transaction, the payments made by the Chinese party in a "lease-sale" arrangement may contain three elements: (a) a portion attributable to the "principal" or purchase price of the equipment; (b) a component that may be characterized by the parties as a "lease" fee but is, in fact, interest, which is usually computed at a rate that represents the leasing company's cost of financing the purchase of the equipment in question; and (c) a service charge or spread imposed by the leasing company over its own cost of funds, that is, over the interest component mentioned above. The Chinese tax implications for foreign companies involved in lease-sale transactions are as follows: (a) the portion of payments attributable to the purchase price is not taxable if the contract was concluded before 1996; (b) service fees are probably not taxable as a "royalty" within the meaning of the treaty unless the services are considered part of a transfer of technology. Leased assets in China are unlikely to constitute a permanent establishment of the foreign lessor; as a result, the profits earned through these transactions are not taxable in China.

137. For example, Chinese tax on dividends is deemed to have been paid at the rate of 10 per cent under treaties with Canada (on shares representing more than 25 per cent of the equity), Denmark, Finland, France, Germany, Japan, Singapore, Sweden.

C. Transfer of technology in connection with compensation trade

In a typical compensation trade, or counter-trade project, a foreign company provides machinery, equipment, or technology to a Chinese entity and receives payment in kind. The payment in kind may consist of goods produced with the transferred assets, other goods, or some combination of the two. The foreign company usually resells these goods on the international market or in its own domestic market.

Compensation trade can be broadly characterized in two ways: the Chinese sometimes describe compensation trade as a loan transaction: the foreign company "lends" the machinery or equipment to the Chinese unit and the loan is repaid in kind. Under this interpretation, the value of the repayment in kind represents both principal and interest; alternatively, compensation trade may be viewed as an instalment sale of the machinery or equipment, (i.e. what the Chinese term a "deferred payment" arrangement). Under this interpretation, each payment in kind represents a partial payment of the purchase price and an interest component.[138]The foreign company may also provide technology in connection with the use of the equipment or production process as well as some training or technical services. In that case, a portion of the payment in kind would be considered to be payment for the use of technology (that is, royalties) and provision of services.

Although the FIE Tax Law does not refer explicitly to compensation trade arrangements, Chinese tax authorities have indicated that they do not view compensation trade arrangements as creating establishments. Therefore, withholding tax is only imposed on the portion of the payments that represent payments of interest or royalties.[139] Unless the service fees can be regarded as "royalties", payments in kind that represent such fees are not taxable in China. Certain exemptions from withholding tax may be available in compensation trade transactions. For example, interest has been exempt from tax where both principal and interest payments in a compensation trade arrangement are paid in kind. Although no specific exemption exists for technology fees paid in kind under compensation trade arrangements, the rules granting special "preferential terms" often extend to compensation trade transactions.[140]

D. Licence of technology

The granting to Chinese enterprises of the right to use a patent, trademark, franchise, copyright, or know-how is an important way for foreign companies to exploit business assets in China without establishing a full presence there.[141] A licence contract may be attached to equipment sales or leases. In general, if the foreign licensor does not have a Chinese permanent establishment to which assets are attributable, Chinese tax on royalties is limited to 10 per cent under tax treaties. The withholding tax may be waived under domestic tax law if the technology is "advanced" and offered on "preferential" terms. By virtue of the tax sparing credit in treaties, the licensor may be deemed to have paid Chinese tax at 10 per cent or 15 per cent.

Where the licence of technology involves computer software,[142] Chinese tax on the payment for the software depends on whether the technology for writing and developing the software is transferred. Where such technology is not transferred and only the computer programmes are transferred to a Chinese entity for use without any restrictions, the transfer is regarded as a sale. The payment for the computer programmes is not a royalty. On the other hand, where the technology for creating computer programmes is transferred to the Chinese, and the Chinese transferee is subject to various restrictions affecting the use of the technology, the resulting income is treated as royalties and subject to withholding tax. Similarly, where computer software is transferred together with patents, copyrights or know-how and can only be used in specified situations, the payments for the software are treated as royalties.

E. Transfer of technology to FIEs

Where a foreign company transfers technology to a FIE, in which the foreign company has a stake, special tax issues occur. If the technology is made available to a FIE by way of a licence agreement, a principal tax concern is the deductibility of royalty payments. According to the transfer pricing rules in China, the foreign company is "associated" with the FIE. Where a FIE pays royalties at a non-arm's-length price, the Chinese tax authorities may adjust the amount of royalties deductible by the FIE or assess the excessive portion as a "constructive dividend" subject to a 20 per cent withholding tax.[143]

Where technology is transferred as part of a capital contribution to a FIE, the FIE may amortize the cost of acquiring the property during a ten-year period. The foreign investor will then receive dividends instead of royalties. Since dividends are exempt from Chinese withholding tax, whereas royalties are generally taxable a tax saving is thus effected. Furthermore, the FIE may qualify as an "enterprise with advanced technology" and be eligible for tax reductions.

138. Related to this characterization is a lease sale or hire purchase, where each payment in kind includes a "lease fee" consisting of interest and a partial payment of the purchase price of the equipment.

139. FIE Tax Regulations (Art. 62, *supra* note 25) appear to contemplate such an application of the withholding tax, stating that income on which the withholding tax is to be applied may include payments made in kind. The Chinese payer in this type of situation apparently withholds products equal in value to 20 per cent (or the relevant lesser amount) of the total payback and converts these into cash for payment to the tax authorities.

140. See STB Notice on the Question of Levying Tax on Compensation Trade and Royalties for Technology, (87) Cai Shui Wai Zi No. 132 of 25 May 1987; and Proprietary Technology Provisions, Art. 1, *supra* note 70. Because in-kind payments save foreign exchange for China, their use will be a positive factor in determining whether technology is being offered on "preferential terms". If the "advanced" test is satisfied, the technology may also be eligible for the withholding tax exemptions. See Ministry of Finance Notice (83) *Cai Shui Zi* No. 65 of 9 March 1983.

141. For a further discussion, see Catherine Brown, Tax Aspects of The Transfer of Technology: The Asia-Pacific Rim, *Canadian Tax Paper*, No. 87, Canadian Tax Foundation, 1990, at 237-290.

142. See Reply to the Question of Imposing Tax on Fees for the Use of Computer Software Provided by Foreign Businesses, (86) *Cai Shui Wai Zi* No. 235 of 29 August 1986.

143. Transfer Pricing Notice, *supra* note 57.

F. Technical services

In connection with the transfer of technology, the foreign transferor generally undertakes to provide technical or other services at the Chinese transferee's site over a period of time. Chinese tax authorities interpret "services" to include: (a) technical services for engineering construction; (b) consulting services in improving the management of Chinese enterprises; (c) consulting services in preparing feasibility studies for investment projects; or (d) technical assistance to redesign, readjust, or manufacture products. From a Chinese tax perspective, the tax liability of the transferor depends on the nature of the services and whether the service activities constitute an "establishment" in China. If the technical services involve the transfer of technology, fees for such services are generally treated as "royalties". Where the payments are treated as business profits, they are exempt from Chinese tax unless they are attributed to an establishment. Under China's treaties with OECD countries, service activities are deemed to be a permanent establishment if they last more than six months. For example, where a German company sells machinery to China and sends engineers to China to help the Chinese purchaser to assemble, install and operate the machinery, the services of the engineer constitute a permanent establishment if they last more than six months.[144]

The tax liability of individuals providing services in China depends on the relationship between the individual and the foreign transferor. An individual who is an employee of a transferor is exempt from Chinese tax unless his or her presence in China exceeds 183 days in a calendar year or the salary is borne by the permanent establishment of the foreign transferor. If the individual is liable to Chinese tax, tax is imposed at progressive rates on a monthly basis. Taxes are generally withheld by the employer. On the other hand, an individual who is an independent contractor is liable to tax in China only if he or she has a "fixed base" in China or is present in China for more than 183 days. Where the individual is liable to Chinese tax, the tax is levied at the flat rate of 20 per cent.

Where technical services are provided to FIEs with which the foreign transferor is associated, FIEs are required to pay arm's-length fees for the services. The arm's-length price for services is generally the "normal service fees for similar services".[145] Where a FIE pays excessive fees for services provided by an associated enterprise, there may be a "constructive dividend" under the Chinese transfer pricing rules.

G. Tax planning

In structuring technology transfers to China, tax planning is important in ensuring that both Chinese tax and tax in the home country are minimized. Tax can be minimized by combining the advantages of tax incentives offered under the domestic law with the provisions of tax treaties. For example, Chinese withholding tax on royalties may be reduced or exempted under domestic law and is generally limited to 10 per cent under treaties. Before signing a contract, it is advisable to seek a ruling on the tax consequences of any transaction in China and to include it as an appendix to the contract. If rulings cannot be obtained before signing a contract, the contract should spell out the anticipated tax treatment for the transaction, obligate the Chinese party to assist the foreign party in obtaining available tax preferences, and tie the contract's effectiveness to official approval of the desired tax treatment. The foreign party cannot put the entire burden for payment of Chinese taxes on the Chinese party through a tax "gross-up" clause. Such practice has been consistently rejected by the Chinese tax authorities. Contracts with such clauses may not receive approval.

To minimize Chinese tax on royalties, the foreign company transferring technology to China may want to limit the amount of Chinese-source income. For example, where a technology transfer contract requires the foreign party to undertake certain activities both inside and outside China, it is advisable for the foreign party to specify the portion of total payments for activities outside China. With respect to the licence of patents, trademarks and know-how to a Chinese enterprise, a foreign licensor may undertake to provide technical training of the personnel of the Chinese licensee both inside and outside China, undertake research in an effort to improve or supplement the licensed technology, maintain government registrations of the technology and take legal action against unauthorized users, etc. To the extent that a portion of the total consideration agreed upon by the parties is attributable to the licensor's activities outside China, the contract should clearly specify such amount, as opposed to stating a lump-sum payable to the licensor as "fees for the right to use the technology". Two separate contracts may be used in such a situation.

Chinese income tax can be minimized by taking advantage of tax treaties. Withholding tax is generally reduced to 10 per cent for royalties and, under some treaties, 6 per cent or 7 per cent for leasing payments for industrial and commercial equipment. If a foreign company wishes to benefit from treaty provisions, the company should ensure that the licensor is resident in a country that has a tax treaty with China. To achieve worldwide tax savings, technology transfers to China may be structured by involving a holding company resident in a low-tax jurisdiction that has a treaty with China, such as Cyprus or the Netherlands.[146] For example, under Cypriot law, offshore companies are subject to income tax at a rate of less than 5 per cent. No withholding tax or other tax is imposed on dividends paid to foreign shareholders. Under the China–Cyprus treaty, Chinese withholding tax is limited to 10 per cent.

Moreover, where a foreign company has a permanent establishment in China and the royalties are attributed to the permanent establishment, the royalties are taxed as business

144. Ministry of Finance Notice (87) *Cai Shui Xie Zi*, No. 009, 1 April 1987.
145. FIE Tax Regulations, *supra* note 25, Art. 56.
146. Other jurisdictions may include Malaysia. Labuan is a political subdivision of Malaysia and imposes income tax at the rate of 3 per cent on offshore business profits. No withholding tax on dividends is imposed. Under the China–Malaysia treaty, a company in Labuan is considered a resident of Malaysia. See Jefferson Vander Wolk, Practical China Tax Planning (Hong Kong, *Law & Tax Asia Pacific*, 1995), at h5/5.

profits and are ineligible for any tax incentives. The foreign company may want to take steps to ensure that the royalties are not attributed to the permanent establishment, or even avoid creating a permanent establishment, especially where technical services are involved in a transaction. If a foreign company does not have a "fixed place of business" in China, it is possible to avoid creating a permanent establishment by limiting the duration of services in China to less than six months.

VI. CONCLUSIONS

The legal framework for the protection of intellectual property rights in China has been established. The Chinese government is taking steps to curb infringements of intellectual property rights. Foreign companies that plan to transfer technology to China are well advised to register their technology under the relevant Chinese laws, where possible, to gain protection. The tax treatment of technology transfers to China depends on the form of the transfers. Various tax reductions and exemptions are available under both the Chinese domestic tax law and tax treaties. International tax planning is necessary to minimize not only Chinese taxes, but also taxes in the home country of the transferor. Although the FIE Tax is expected to be consolidated with a tax applicable to Chinese domestic enterprises, the treatment of foreign companies in general, and royalty payments to foreign companies in particular, is likely to remain unchanged.

BELGIUM

HYBRID ENTITIES FROM A BELGIAN PERSPECTIVE*

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* In this second and final article, analysing the phenomenon of hybrid entities, Kurt Debrier examines the classification of US entities from a Belgian perspective.

I. INTRODUCTION

This article focuses on the Belgian tax classification of US entities. Section II discusses the conflict between the accounting law approach and the approach adopted by company and international private law in determining entity classification. The article concludes by examining the relevancy from a tax perspective of a US partnership being held to have legal personality.

II. CLASSIFICATION IN BELGIUM

A. Criteria

1. General

Belgian tax law is unclear as to the treatment of participations in foreign entities which do not have all the characteristics required under Belgian law to constitute a legal person.

Under Belgian law, the following characteristics normally only apply, to legal persons:
- the ability to sue or to be sued;
- the ability to act and conclude contracts in one's own name and on one's own account;
- entitlement to assets;
- entitlement to become a shareholder or a partner;
- the possibility of being indebted against third parties;
- no relationship exists between the bankruptcy of the entity and the bankruptcy of the partners;
- the entity's creditors must seek satisfaction against the entity's assets;
- no set off is possible between the claims of a third party against a partner and the debts of that same party towards the entity.

Below is an overview of the different opinions which currently exist in Belgium as to the treatment of participations in foreign entities.

2. Accounting law

The Belgian Commission for Accounting Standards (the Commission) has been asked how contributions of Belgian corporations to foreign entities, which do not have all the characteristics which only apply to legal persons, should be shown in the Belgian corporations' financial statements. In particular, the question was raised as to whether the contribution of a Belgian corporation to a German and Dutch partnership[1] has to be accounted for as a participation in a separate legal entity.[2] The Commission decided that although these partnerships have no legal personality according to either German or Dutch law, they are considered by Belgian law to have legal personality because they have some of the main characteristics which, under Belgian law, only apply to legal persons.

The Commission found the following characteristics to be relevant in determining the classification of a partnership:
- the ability of the partnership to act in its own name and on its own account;
- the extent of the partnership's distinct equity;
- the ability of the partnership to sue and be sued;
- the capacity of the partnership to be declared bankrupt.

The Commission is therefore of the opinion that, in order to determine whether or not non-Belgian entities have legal personality, Belgian law needs to be applied. This is the application of the *lex fori* principle, meaning that expressions must be interpreted in accordance with their meaning in the common language or according to the common law (*droit commun – gemeen recht*) of the state applying them.

3. Company law and international private law

The judicial basis for the Advice of the Commission applying the *lex fori* principle when determining the legal personality of non-Belgian entities, is contested by Belgian doctrine.[3] The Commission quotes authoritative company law doctrine[4]

1. I.e. contribution to a German *Kommanditgesellschaft* and a Dutch *Commanditaire Vennootschap*.
2. Advies 168/1, *Bull. C.B.N.*, 1993, nr. 30, 31.
3. Luc De Broe, "Nederlandse en Duitse Commanditaire vennootschappen: fiscale consequenties van een twijfelachtig advies van de Commissie voor Boekhoudkundige Normen", *T.R.V.*, (1995), at 38; contra: S. Van Crombrugge, "Kroniek Boekhoudrecht", *T.R.V.*, (1994), at 323-324.
4. J. Van Ryn en J. Heenen, "Principes de droit commercial", Brussel, Bruylant, deel II, nr. 1132.

to support the application of the *lex fori* principle, but takes the relevant quotation out of context. According to general principles of traditional Belgian company law and international private law,[5] the legal personality question needs to be examined in accordance with the *lex societatis*, i.e. the law of the country in which the entity is established. The application of the *lex societatis* principle implies that Belgium must recognize the legal personality which foreign jurisdictions attribute to entities established in accordance with their domestic law. *Mutatis mutandis*, Belgium can not attribute legal personality to entities which, according to the law of their home country, do not have legal personality.

The authors to whom when forming their opinion the Commission referred, state that only when, according to the home country jurisdiction, a non-Belgian entity has legal personality, does it need to be determined based on *lex fori* whether the entity qualifies as a civil or a commercial corporation for the application of Articles 196 and 198 of Belgian company law.[6] Taking into consideration that the Commission misinterpreted the authoritative doctrine on which its Advice was based, the actual value of the Advice can be questioned.

4. Tax law

According to Article 29, Paragraph 1 of the Belgian Income Tax Code (ITC), profits realized by civil companies and associations that do not have legal personality, are considered to be profits realized by the partners. The transparency principle of Article 29 also applies to Belgian corporations that are members or partners in entities established outside Belgium. Since the ITC does not define what "an association without legal personality" means, one must turn to the common law to find a definition.

As mentioned above, the Commission is in favour of determining an entity's legal personality based on the *lex fori* principle. Under Belgian law, it is a generally accepted principle that the rules set forth in common law (including accounting law) also apply in tax law. Only in cases where the tax legislation explicitly deviates from the common law, does this general principle not hold.[7] The question arises as to the persuasiveness of an advice of the Commission. According to Belgian legal doctrine, the accounting law *sensu lato* does not only consist of statutes and Royal Decrees, but also of the Advices of the Commission (although the Advices are not binding, not even for accounting purposes).[8] The Commission itself compares the authority of its Advices with the legal force of authoritative legal doctrine.[9] From the above, it follows that, notwithstanding the fact that an Advice of the Commission does not constitute accounting law *sensu stricto*, there might be arguments to defend, from a tax point of view,[10] the approach of recognizing a foreign entity's legal personality based on Belgian law principles.

Considering that the Advice of the Commission is based on an erroneous interpretation of the application of the *lex fori* concept; that Belgian Courts are not obliged to follow the Advices of the Commission; and that there is a generally accepted application of the *lex societatis* principle in company law and international private law,[11] it is conceivable that the Belgian courts would reject the application of the *lex fori* principle. Moreover, in the official comments of the Belgian tax administration on the Belgian Income Tax Code, it is explicitly mentioned that an entity established outside Belgium is deemed to possess legal personality if, according to the home country jurisdiction, it possesses legal personality and this even in the case where it was established in a form which, under Belgian law, would not qualify as possessing legal personality.[12]

In its decision of 4 June 1974, the Court of Appeal of Brussels took the same approach.[13] The Court held that Belgian law must recognize the legal personality which French law attributes to a French *société civile immobilière*, based on the principles of *lex rei sitae*, *locus regit actum*, and *lex contractus*.[14]

Finally, the official comments of the Belgian tax authorities on the Belgian Income Tax Code state that an entity established outside Belgium, which has no legal personality according to the law of the country of incorporation, is considered not to have legal personality even where it is established in a form which, under Belgian law, would be ascribed legal personality.[15]

5. The "legal personality" of US partnerships

Contrary to the law of, for example, Belgium and France, US law does not give a clear cut answer to the question whether partnerships have legal personality, i.e. whether the partnership is to be considered a separate legal entity distinct from its partners. From a civil law point of view, one could say that a US partnership has a dual nature. The Uniform Partnership Act, which has been adopted by all states in the United States (except for Louisana) combines the "entity approach" with

5. See *supra* note 4, at nr. 1130, and including references to relevant jurisprudence; see also *supra* note 3, (S. Van Crombrugge,).
6. Arts. 196 and 198 of Belgian company law define the rights and obligations of non-Belgian commercial corporations.
7. Cass., 9 June 1931, *Pas.*, 1931, I, 218; Cass., 23 November 1989, *Arr. Cass.*, 1989-90, 414.
8. S. Van Crombrugge, "De rol van de Commissie voor Boekhoudkundige Normen op fiscaal gebied", *Fiskoloog* 424, 22 April 1993, at 2.
9. Advies 14/1, *Bull. C.B.N.*, 1993, nr. 30, 13.
10. Moreover, the Commission has recently stipulated that all of its decisions that might have consequences from a tax point of view, are discussed prior to publication with the competent tax authorities, more in particular with high ranking figures within the Belgian tax administration. (Advies 14/1, *Bull C.B.N.*, 1993, nr 30, 15.)
11. Company law and international private law are both also part of Belgian common law.
12. Com. I.B., 102/1; see also H. Levy – Morelle, "La résidence fiscale des sociétés", *Ch. Dr. Fisc. Int.*, 1987, at 231–235, and Ph. Hinnekens", *Ch. Dr. Fisc. Int.*, 1995, at 99.
13. Brussels, 4 June 1974, *JDF*, 1975, 82. This case can be considered decisive for the Belgian tax treatment of foreign entities which are, according to their home country legislation, fiscally transparent.
14. The Court stipulated that the fact that the *société civile immobilière* is considered, according to French tax law, as a fiscally transparent entity, does not necessarily result in the application of tax transparency to the *société civile immobilière* from a Belgian perspective. Based on the principle of territoriality of tax law, the fiscal transparency rules which exist in other jurisdictions can never be transposed to Belgian tax law. In the absence of a specific provision in Belgian law which allows the application of fiscal transparency, the Belgian tax authorities could not treat the *société civile immobilière* as a fiscally transparent vehicle for Belgian tax purposes.
15. Com. I.B., 94/4,5°.

the "aggregate approach". The definition of the aggregate approach includes, for example, the fact that the partners of a (general) partnership are all principals and agents for each other, that no partner is free to substitute another partner for himself in the partnership, that the partners are personally liable for the partnership's debts, and that the partnership will generally be dissolved upon the bankruptcy or death of a partner. On the other hand, a partnership functions as a distinct entity in economic life by doing business in its own name, keeping books and records, earning profits and by suing and being sued. Also, a partner's creditor can seek satisfaction against the partnership interest, but not against the partnership's assets.

Authoritative legal doctrine concludes that in view of the above, a US partnership normally lacks legal personality.[16] It should however be noted that the partnership regulations in the different states as well as the partnership agreement must be taken into consideration when determining whether a separate legal personality exists.

B. US partnerships which realize profits in Belgium: combination of the *lex fori* and the *lex societatis* principle

While it is contested whether the *lex fori* principle can be applied when classifying contributions of Belgian corporations to foreign entities, the application of Belgian classification rules is explicitly foreseen in Belgian law for the determination of the tax treatment of non-Belgian entities which realize profits in Belgium. According to Articles 227 and 235 ITC, non-Belgian entities or organizations are subject to the Belgian non-resident income tax regime for corporations if they have legal personality or, where they do not have legal personality, if they are constituted in a legal form similar to a Belgian commercial corporation. For US partnerships which have a permanent establishment in Belgium, this implies that if they are established, in the United States, in a legal form similar to that of one of the Belgian commercial corporations the profits which are taxable in Belgium will be taxed at the level of the partnership itself, and thus not in the hands of each partner. If the partnership has no legal personality, or is not established in a form similar to a Belgian commercial corporation, the profits realized in Belgium are taxable according to the rules of fiscal transparency.

It could be deduced from Article 227 ITC (which distinguishes between entities with no legal personality, and entities which are established in the home country jurisdiction in a legal form similar to that of a Belgian commercial corporation) that the legal personality question needs to be examined in accordance with the *lex societatis* principle. The classification in accordance with Belgian principles would only be required (for the application of Article 227 of the Code) if the foreign entity is not considered to have legal personality under its home country jurisdiction.

A US partnership should normally be considered to be established in a legal form similar to that of a Belgian commercial corporation.

US general partnerships are normally to be treated as comparable to the Belgian VOF since they are, unless otherwise specified, usually characterized by the following main factors:[17]
- unlimited liability;
- discontinuity of existence;
- no free transferability of interest;
- management and control of the business is not centralized.

If, on the other hand, the partnership has limited liability, it could be considered as comparable or similar to the Belgian GCV, taking into consideration the fact that US limited partnerships are, unless otherwise specified, generally characterized by the following main factors:[18]
- two types of partners: general and limited partners;
- unlimited liability for the general partner and limited liability for the limited partner;
- no free transferability of interest;
- the management and control of business is centralized.

III. RELEVANCY FROM A TAX PERSPECTIVE

Whether a US partnership has legal personality from a Belgian tax perspective, is crucial in determining the tax consequences resulting from a Belgian corporation's participation in that US partnership. The classification (and the tax treatment) in Belgium should be seen in light of the fact that every non-US partner in a (general or limited) US partnership is, for US tax purposes, deemed to be engaged in a trade or business in the United States if the partnership itself is engaged in a trade or business in the United States[19] Following from this every non-US partner in a US partnership is deemed to have a permanent establishment in the United States if the partnership itself has a permanent establishment in the United States.[20]

A. Legal personality

If the US partnership is considered (from a Belgian tax perspective) to have legal personality, the normal system of participations in a corporation will be applicable. From a treaty perspective, the power of taxation would normally be allocated to Belgium based on Article 22 of the Belgium–US income tax treaty (and not on the basis of Article 10 of the treaty, since at the treaty level, dividends can only be paid by a corporation).

16. A. Haelterman, "Fiscale transparantie. Theorie en praktijk in België", at 454; Dr Ton H.M. Daniels, "International partnerships: comparative law remarks on the taxation of income and the classification of foreign entities", *Intertax* 1991/89, at 70.
17. These four characteristics are also found in the Belgian VOF, see Kurt Debrier "Hybrid Entities from a US perspective" 50 *Bulletin for Fiscal Documentation* 6 (1996), at 236.
18. These four characteristics are also found in the Belgian GCV, see *supra* note 17.
19. Sec. Code 875 and related Regs.
20. See *Donray Ltd. v. U.S.*, 61-1 USTC 9373; *Ungur v. Commissioner* T.C. Memo 1990-15.

It could be questioned whether Belgium can use internal law to categorize a payment. Article 3 (2) of the Belgium–US treaty provides that any term used in the Convention shall, unless the context requires otherwise, have the meaning which it has under the laws of the contracting state whose tax is being determined. Although some authors argue that the residence state should wherever possible avoid interpreting treaty terms based on its internal law, considering that the interpretation of treaties should aim at minimizing double taxation, the "contracting state whose tax is being determined" should normally not refer solely to the source state of the income based on a literal interpretation of the text.[21] This means that in order to determine whether Belgian taxes are due, where there is a participation by a Belgian corporation in a US partnership, Belgium may interpret the treaty based on its internal law. The latter interpretation method is also followed by the Belgian Supreme Court.[22]

The income earned by the partnership would not be currently taxed in Belgium. Taxation would only arise in Belgium upon distribution of the profits (dividends). Where the partnership realizes losses, they would have no tax impact in Belgium (since losses on shares are not deductible in Belgium). Article 203 ITC provides for the participation exemption, for foreign source dividends and certain foreign source liquidation proceeds received by a Belgian corporation, of up to 95 per cent of the net amount. The exemption is subject to the condition that the shareholder has a minimum participation of 5 per cent (or a participation of minimum BEF 50 million) in the distributing company at the moment of the payment or attribution of the dividends. Furthermore, the dividend must be paid by a company which is subject to a tax similar to the Belgian corporate income tax. In view of the fiscal transparency of partnerships in the United States, the Belgian tax authorities could argue that the latter condition is not fulfilled, and consequently refuse the participation exemption, which would lead to the double taxation of the partnership's profits.

To avoid the exposure to double taxation, it is advisable to work with an intermediate US corporation to be held by the Belgian corporation. Although internal Belgian law provides for a look through rule for such a structure, double taxation could be avoided based on the treaty provisions. Article 203, paragraph 2, 4° ITC provides that no participation exemption is available for dividends received from a foreign corporation, where the income which the corporation itself receives (and which is passed through) would not qualify for the participation exemption. Article 23(3)(d)of the US–Belgium income tax treaty provides that where a Belgian corporation owns shares in a US corporation which is subject to tax on its profits in the United States, the dividends which are paid to it by the latter corporation and which may be taxed in the United States in accordance with the treaty provisions on dividends, shall be exempt from corporate income tax in Belgium to the extent that exemption would have been accorded if the two corporations had been corporations in Belgium. Since Belgian internal law does not have a look through rule for dividends received by one Belgian corporation from another Belgian corporation (nor any other regulation that would prevent the Belgian parent company from claiming relief for dividends received from a Belgian subsidiary), and in view of the fact that under Belgian law it is generally accepted that tax treaties overrule internal Belgian legislation,[23] the use of a US intermediary corporation would prevent the Belgian tax authorities from disallowing the participation exemption.

B. No legal personality

If the US partnership is considered (from a Belgian tax perspective) not to have legal personality, the tax treatment will be fundamentally different. In such case, the transparency rule as laid down in Article 29 ITC would be applicable, and the Belgian partner company would also be deemed to have a permanent establishment in the United States from a Belgian perspective.

The classification of a US partnership as an entity without legal personality, can be more advantageous for Belgian partner companies than the qualification as an entity with legal personality. First of all, profits which are to be allocated to the permanent establishment in the United States will be fully exempt from taxation in Belgium (under the participation exemption regime, the exemption is limited to 95 per cent of the distributions received, while one should also consider the specific provisions of Article 203 ITC). Secondly, potential losses allocated to the permanent establishment in the United States can be offset against local country income. Article 23(3)(g) of the Belgium–US income tax treaty provides that when in accordance with Belgian law, losses incurred by a resident of Belgium in a permanent establishment situated in the United States have been effectively deducted from the profits of that resident for his taxation in Belgium, the exemption provided in sub-paragraph (a) (i.e. the exemption of profits realized by a US permanent establishment) shall not apply in Belgium to the profits of other taxable periods attributable to that establishment to the extent that those profits have also been reduced for US tax purposes by reason of the offsetting of the losses. This recapture rule has been included in the treaty in order to avoid the double deduction of foreign branch losses. However, the recapture of prior year foreign source tax losses is only subject in Belgium to the reduced rate of one-fourth of the normal corporate tax rate.[24] Therefore, even if the double use of losses is prohibited, the recapture of the losses will benefit from a favourable tax regime in Belgium, since the foreign branch loss is first offset against profits taxable at 40.17 per cent and eventually taxed at 10.0425 per cent.

In certain circumstances however, the classification of a US partnership as an entity without legal personality can be less beneficial for Belgium partner companies. This will be the case where profits are realized by the Belgian company in the permanent establishment situated in the United States, but

21. See *supra* note 16, (A. Haelterman), at 457.
22. Cass., 29 June, *F.J.F.* 1984, nr. 84/164.
23. Cass., 27 May 1971, *Pas.*, 1971, I, 886.
24. Com. Conv., 23/118, and confirmed by the Minister of Finance in 1989 (P.V. nr. 70 of 21 December 1988, *Bull. Bel.*, 687/10.89, 2180).

losses are incurred by the Belgian operations. In accordance with Article 78 of the Royal Decree to the ITC, the profits attributable to the US permanent establishment will (although exempt from taxation in Belgium) decrease the tax losses which can be carried forward by the Belgian company. Although authoritative legal doctrine almost unanimously considers these provisions in Belgian tax law to be contrary to the tax treaties concluded by Belgium,[25] it has been confirmed by the Belgian Supreme Court.[26] If the partnership were to be classified as an entity with legal personality such absorption of Belgian losses would not occur if no profit repatriation were made.

25. L. Hinnekens, "Velasquez, het arrest van de gemiste kans", *A.F.T.*, 84/11, at 194; K. Vogel, *Vogel on Double Taxation Conventions*, Deventer, Kluwer, 1991, 1007, nr. 68.
26. Cass., 29 June 1984, *F.J.F.* 1984 nr. 84/164; confirmed by Cass., 27 October 1995.

BELGIUM

Recent Changes in Belgian Tax Law

Professor Marc Dassesse and Caroline Docclo

I. INTRODUCTION

This article examines two anti-abuse measures recently introduced into Belgian tax law. The first measure restricts the interest deduction allowed in certain cases, whilst the second is designed to deny the offsetting of taxable profits against the losses of an artificially merged loss vehicle.

II. DIVIDEND RECEIVED DEDUCTION

A. Background

Belgium previously modified its dividend received deduction regime (*régime des revenus définitivement taxés* – RDT regime) in 1991 in the framework of implementing the Parent-Subsidiary Directive of 23 July 1990. Under these rules which applied until assessment year 1995, Belgian companies were allowed to combine the interest deduction and the RDT regime in order to obtain a double deduction.

Example: A company borrows funds to buy a stock. Interest is paid to the lender with the dividend derived from the stock. In its books, the company breaks even. Nevertheless, the cash flows trigger a tax saving: the company includes the dividend in its income but is entitled to a 95 per cent RDT deduction plus a 100 per cent deduction of the interest.

	Accounts	*Tax return*
Dividend	100	100
RDT		(95)
Interest	(100)	(100)
	Nil	(95)

The Law of 20 December 1995 introduces an anti-abuse provision: interest deductions will no longer be allowed under certain circumstances.

B. Summary of the Belgian RDT regime

Under Articles 202 to 205 of the Income Tax Code (ITC), 95 per cent of distributed profits received by a Belgian company from a Belgian or foreign company are tax exempt, provided that the receiving company holds the stock of at least 5 per cent or BEF 50 million (acquisition value) in the distributing company, and the distributing company is subject to a corporate tax which is not notably more favourable than Belgian corporate tax.

Technically, the 95 per cent exemption is a deduction of 95 per cent of the dividend (before Belgian withholding tax, if any) from the taxable profits. The maximum deductible amount is the taxable profit less disallowed expenses. Any excess is not refundable.

There is no requirement that the company holds these shares for a minimum period of time. The exemption is available regardless of whether or not the shares are booked as a financial fixed asset.

For the purposes of the RDT regime, certain events are treated as dividend distributions. Consequently, corporate shareholders treat the capital gains realized upon the following events as a dividend and are allowed to deduct 95 per cent.

- Upon the redemption of shares, the excess of the price paid by the issuing company to its shareholders over the amount of the paid-up capital (if any) represented by the redeemed shares, is treated as a dividend in the hands of the issuing company.

  However, when the issuing company redeems its shares according to the provisions of the Belgian Company Law, the dividend treatment is suspended until that company cancels the shares, sells the shares incurring a capital loss, redeems the shares, or is liquidated.

  If the dividend treatment applied to the issuing company by virtue of either the Belgian ITC or similar foreign law provisions, the corporate shareholder treats the excess of the amounts received in return for its shares over the original acquisition cost or investment price as a dividend.

  The suspension of the dividend treatment in the hands of the issuing company implies that the shareholders should be informed of the possible liquidation of that company or of the sale, cancellation or write-off of the relevant shares so that they may apply the correct tax treatment.

- Upon partial liquidation of the issuing company, the excess of the amount paid to the shareholders over the amount paid up on their shares is treated as a dividend distribution at the level of the issuing company.

  If such treatment applies to the issuing company either under the Belgian ITC or under foreign tax law, the corporate shareholder treats the excess of the amounts received over the acquisition cost or investment price of its shares as a dividend.

- Upon the liquidation of the issuing company, the excess of the amounts distributed over the paid-up capital is treated as a dividend in the tax return of the liquidated company.

The corporate shareholder receiving a liquidation bonus to which the dividend treatment applied at the liquidated company's level either under the Belgian ITC or under foreign tax law, treats the excess of the amounts received over the acquisition or investment price of its shares as a dividend.

C. Interest deduction

1. General rule

The Law of 20 December 1995 denies an interest deduction on an amount equal to the aggregate amount of income benefiting from the RDT regime, when such income is derived from shares acquired by a company and the shares are not held for an uninterrupted period of at least one year.

For the purpose of this provision:

(1) The income benefiting from the RDT regime is 95 per cent of the dividend received.[1]

Example: In the example above, the income tax basis is

	Accounts	*Tax return*
Dividend	100	100
RDT	(95)	
Interest	(100)	(5)
	Nil	Nil

(2) Shares purchased from the company at original issuance, i.e. either on incorporation or upon a subsequent capitalization, are not "acquired".

(3) The deduction disallowance applies regardless of the purpose of the loan pursuant to which the interest is paid. There is no condition that the loan be related, even indirectly, to the financing of the acquisition of shares. The reason is simply that no tracing rule has been considered efficient or appropriate.

2. Safe harbour rule

As set out above, the denial of the interest deduction is determined by reference to the amount of the dividend deduction under the RDT regime.

However, for the purposes of calculating the quantum of disallowed interest, only selected forms of dividend income are taken into account. The law excludes from the computation dividends derived from:

– shares held in an affiliated company or in a company linked by a participating interest, even if these are held as current investments;
– shares booked as financial fixed assets; or
– shares held for at least one year.

When compared to the accountancy definitions of the balance sheet items, the exceptions seem quite generous:

Shares are deemed to be financial fixed assets when:

– they are held in affiliated enterprises. The test is the control exercised by or on the enterprise;
– they are held in other enterprises linked by a participating interest. The general test is the existence of 10 per cent of the stock being held directly or indirectly in or by the enterprise; or
– they are held in other enterprises with which lasting interests exist and these interests contribute to the enterprise's own activity.

Current Investments include:

– shares which do not qualify as financial fixed assets and which are held for at least one year,
– shares which do not qualify as financial fixed assets and which are held for less than one year, and
– shares held in affiliated enterprises in which a participating interest exists and either such shares have been acquired with the intention that they be sold within 12 months *or* they are now expected to be sold within 12 months.

Consequently, the interest disallowed is 95 per cent of the dividends benefiting from the RDT regime where such dividends are derived from shares which have not been purchased at original issuance and are held as current investments in the second category described above.

3. Impact of the disallowance on the taxable basis

As mentioned earlier, RDT is deductible up to the amount of the taxable profit less disallowed expenses. In order to avoid a double disallowance, even though the non-deductible interest is a disallowed expense, the Law of 20 December 1995 provides that this interest is not deducted from the taxable profit when determining the RDT deduction ceiling.

D. Practical issues

The law provides for a minimum holding period requirement of one year. The test is satisfied if the corporate shareholder retains the shares for one year prior to transferring the shares. Such a provision will certainly raise difficulties. When filing its tax return the corporate shareholder genuinely may not know whether or not some of its shares satisfy the one year test.

Example: Company A buys 5 per cent of the shares of company B on 1 November and books them as a current investment. Company B distributes a dividend on 1 December. Company A closes its fiscal year on 31 December and must file its tax return by 30 June. At that date, Company A has held the shares for only eight months. Is the dividend derived from these shares included in the computation of the interest disallowance? Unfortunately the new law does not provide an answer to this question.

1. Subject to the limitations described above.

III. LOSSES CARRIED FORWARD

A. General rules

Belgian tax law provides for the carrying forward of losses. Originally companies were allowed to carry forward their losses over the following five tax years, unless certain exceptions applied. The Law of 6 August 1993 withdrew the time limitation and replaced it with an amount limitation: the deduction for losses was restricted to the higher of BEF 20 million per year or 50 per cent of the taxable profits of the current tax year.

The amount limitation has been lifted by the Law of 4 April 1995. Accumulated losses may now be offset against the profits of any subsequent year without restriction, subject to a transitory regime applicable to losses accumulated before assessment year 1996. (As from assessment year 1998, all the accumulated losses will be deductible without restriction.)

In addition, the ITC provides a specific limitation for tax free business acquisitions and mergers or demergers. In these cases the losses are permanently reduced according to the same ratio as the net assets of the loss making company prior to such a transaction bears to the total net assets of the surviving company.

B. New limitation

1. Dormant companies

The Law of 4 April 1995 has also introduced an "anti-abuse" rule. The Government targeted the use of dormant companies and shell companies as tax shelters. The purpose was to prohibit profitable businesses from offsetting their taxable profits against the losses of an artificially merged loss vehicle.

Example: A company no longer runs any business. Its financial statements show no assets. The company has accumulated tax deductible losses. A potential buyer might realize a tax saving by buying and swallowing the loss company. The purchase price that the buyer would be willing to pay for such a shell company is determined by the expected tax saving.

2. Turnover/assets ratio

A company loses the right to deduct its accumulated losses from profits arising in any subsequent period if its average turnover over the past three years is less than 5 per cent of its average total assets over the same period.

The total on the assets side of the balance sheet is taken into account. The Law of 4 April 1995 makes no distinction between operational assets and current investments or cash. Furthermore, rented installations or machinery are excluded. These shortcomings have led legal commentators to severely criticize the new provision as being an inappropriate test for determining whether a company is a dormant company or a shell company.

The provision also handicaps those companies that start a new business or implement ambitious investment programmes which initially generate low turnovers. Generally these companies accumulate losses for the first few years. Such companies will no longer be allowed to carry forward their losses due to their low turnover/ assets ratio.

Consequently, the new provision discriminates against companies making large investments. Such discrimination is neither appropriate nor needed to achieve the legislator's goal. A request for the annulment of this alleged anti-tax shelter provision has been filed with the Belgian Court of Arbitration on the grounds that the measure is discriminatory and disproportionate to its purpose.

CUMULATIVE INDEX – 1996

I. ARTICLES

INTERNATIONAL

TRANSFER PRICING AND CUSTOMS DUTIES

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This article is an extension of an outline that the author prepared during his term as an IFA scholar in the summer of 1995. The author is grateful for the generous support he received from IFA and the IBFD, as well as the valuable comments that he received from J.C. Wheeler, principal research associate IBFD. However, the article does not necessarily reflect the views of either the IBFD or IFA.

I. INTRODUCTION

In 1986, the United States added Section 1059A to its Internal Revenue Code (IRC), requiring importers in a related party transaction to use the same valuation for the purposes of both income tax[1] and customs duties. Ever since then the relationship in a transfer price setting between income tax and customs duties has become a focus of attention among commentators[2].

This article addresses the fundamental issue as to what the relationship should be between income tax pricing and customs valuation. Should the determination of an arm's length price under income tax conform to the valuation for customs purposes? Or may different valuations be used? In an effort to answer this question this article assesses country practice and points out potential administrative issues. In particular, Section (II) discusses the transfer pricing issues that arise under customs duties, as contrasted with transfer pricing issues under other taxes. Section (III) examines the grounds for and against linking the income tax valuation with the customs valuation. The last section (IV) concludes that issues in transfer pricing and customs duties are one aspect of the multiple linkage between tax policy and trade policy.

II. TRANSFER PRICING UNDER CUSTOMS DUTIES

A. Relevance of transfer prices under customs duties

Transfer prices are relevant for customs duties as well as for income taxes. Customs duties are usually charged on the value of imported goods. Under an arm's length setting, such value normally reflects an open market value. However, where taxpayers are related, they may be induced to declare a customs value which is lower than the fair market value because a lower value reduces the amount of duties payable. Similarly, customs authorities may seek to increase the value of imported goods when they have doubts about the declared value.

The potential conflict of interest between taxpayers and tax authorities, described above, derives from the structure of customs duty as a single levy imposed at the time of the entry of goods into a jurisdiction.

B. Customs valuation under the GATT rule

1. The relevance of the GATT rule as a model

Customs valuation is governed by the domestic laws of each country or, in the case of a customs union, by a common customs code.[3] To examine the valuation standard applicable in a specific case, it is necessary to look at the underlying legislation. Given the number of different domestic standards it is not very practicable to proceed with the analysis on a country by country basis. Fortunately the General Agreement on Tariffs and Trade (GATT) provides an alternative to this approach and serves as a model for the purposes of this article.[4]

1. For the purpose of the discussion in this article, the term "income tax" includes both individual and corporate income taxes.
2. The Economist Intelligence Unit (1994), *International Transfer Pricing 1994*, at 157, (highlighting the interaction of tariff law with transfer-pricing regulations, a description of customs valuation is also given); Levine and Littman, "The Use of Middlemen in Importation of Goods: Inconsistencies Between Tax and Customs Valuation Rules", 23 *Tax Management International Journal* (1994) at 233, (discussing PLR 9406026 in light of previous case law); Neville, "Customs Planning May Avoid Conflict With IRS Transfer Pricing Rules", 4 *Journal of International Taxation* (1993) at 70, (describing the standards in customs valuation); Dorn and Doris, "Transfer pricing between related parties – a comparison of United States customs valuation and tax allocations under Section 482," 2-3 *Intertax* (1989), at 72, (outlines framework of customs valuation, compares customs valuation and valuations under Section 482, and discusses the effect of Section 1059A); Gordon and Donahue, "Tax Reform Act of 1986: Transfer Prices for Imported Merchandise", 35 *Canadian Tax Journal* (1987) at 1543, (exploring issues in Section 1059A and its relationship with the Canada–US income tax treaty).
3. Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code. For its structure, see Ben Terra and Peter Wattel, *European Tax Law* (1993), at 97, ; Williams, "A Wider European Customs Union", 3 *Intertax* (1993) at 123.
4. Nonetheless, it must be recognized that the goal of the GATT is to remove trade barriers. Presumably as a reflection of this goal, the valuation principles of the GATT are not necessary designed for the specific purpose of regulating transfer prices.

The agreement which has been signed by more than 120 countries contains a provision on valuation for customs purposes[5] Contracting parties recognize the validity of the general valuation principles set forth in Article VII and have an obligation to review, upon a request by another contracting party, the operation of their domestic law relating to the valuation of goods for customs purposes.

2. Transaction value as a basis for valuation

The preamble to the Agreement on Implementation of Article VII(2) (hereafter "the Agreement") states that the basis for valuation should, to the extent possible, be the "transaction value" of the goods being valued. "Transaction value" is defined in Article 1 of the Agreement as "the price actually paid or payable for the goods when sold for export to the country of importation".

3. Alternative valuation methods

The "transaction value" cannot be a basis for customs valuation under Article 1 of the Agreement, when;
- there are restrictions as to the disposition or use of the goods by the buyer;
- the sale is subject to some condition for which a value cannot be determined with respect to the goods being valued;
- proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller; or
- the buyer and seller are related.

When the customs value cannot be determined under the provisions of Article 1 of the Agreement, a process of consultation between the customs administration and the importer will be instituted, with a view to arriving at a basis of value under Article 2 (transaction value of identical goods) or Article 3 (transaction value of similar goods). Article 2 takes precedence over Article 3. Valuation methods under Articles 2 and 3 resemble the Comparable Uncontrolled Price method used to determine the arm's length transfer price for income tax purposes, the former being similar to the use of exact comparables and the latter to the use of inexact comparables.

When the customs value cannot be determined on the above basis, resort may be made to deductive value (Article 5) or computed value (Article 6). These methods correspond to the Resale Price Method and Cost Plus Method respectively. The importer can use either deductive or computed value.

When customs value cannot be determined under either of the above methods, Article 7 of the Agreement permits the use of other "reasonable means consistent with the principle and general provisions" of the Agreement.

C. Contrast with other taxes

1. Contrast with the income tax

For income tax purposes, the price under scrutiny is one element of a computation of the total net income. The revenue authorities of an importing country are interested in making downward adjustments to lower the costs of inventories. However, since for customs duties purposes, the basis for taxation is the total value of imported goods, the customs officer in an importing country will normally seek an upward adjustment to increase the value of imported goods.

2. Contrast with a destination-based VAT

Under a destination-based VAT, transfer prices do not create problems as long as the chain of transactions are traced properly under the VAT net.

Suppose, for instance, that goods are transferred from a company resident in State A to a company resident in State B. With the zero rate output tax on exported goods, the State A company may get a refund of the input tax that it had incurred. Notice that the amount of the refund has no connection with the value of exported goods under the zero-rating system of border tax adjustment. In other words, there is no incentive for the State A company to overstate or understate the value of exported goods.

The zero-rating of goods for export implies that all the VAT that had been incurred within State A was rebated at the time of export. Therefore, the goods in question are free of any foreign VAT when they are imported into State B. The State B company has to pay a VAT on the import, but such VAT on import is usually creditable as an input tax on the occasion of eventual resale to other domestic businesses. This is why as a matter of general proposition there is no incentive for the State B company to manipulate the value of the imported goods. The only exception would be the case where the State B company has an exempt status with regard to domestic transactions under the VAT system of State B. In such a situation the State B company may be induced to push down the import price in order to reduce the VAT amount on import which cannot be credited. But again such incentive for manipulation is a result of the break of the VAT chain due to the exemption status of the State B company, and not a result of the general structure of the destination-based VAT.

Under the destination principle tax jurisdictions share revenue solely on the basis of the situs of final consumption. The relative increase or decrease of cash flow for businesses, as a result of distortive transfer prices, is irrelevant in determining the division of revenue among different tax jurisdictions.

This neutrality of destination-based VAT towards transfer prices contrasts sharply with the relative vulnerability of customs duties to transfer price manipulation. The difference derives from the fact that the former assures an imposition of tax on final consumption by the use of a multiple-stage collection mechanism, whereas the latter is merely a one-off levy imposed at the time goods are transferred into the jurisdiction.

Another strength of destination-based VAT lies in its broad coverage of both goods and services, whereas customs duties

5. GATT (1994), *Analytical Index: Guide To GATT Law And Practice*, at 233-242, 6th ed., 1994.

merely cover goods and cannot be extended to payments for services.

3. Contrast with an origin-based VAT

Under an origin-based VAT transfer prices will create problems that are similar to those that arise under income tax. Under the origin principle, the jurisdiction to tax is determined by the origin of value added by each business. Thus, in the example cited above, State A can impose its VAT on the portion of value added within its jurisdiction. State B, by the same token, may tax on the value added by the State B company after the goods are imported. In this situation, transfer prices across the border between States A and B determine the division of revenues between the two states.

Transfer pricing issues under an origin-based VAT will become increasingly significant for transfers within the EU[6] and NAFTA. This is true even if the tax rates among countries converge (and there is no huge incentive for businesses to create artificial prices) since there still remains the issue of dividing the tax revenue among the states involved.

4. Contrast with anti-dumping duties

Dumping means an act of introducing products of one country A into the commerce of another country B at less than the "normal value" of the products. Dumping may cause material injury to an established industry in the territory of country B or may materially retard the establishment of a domestic industry of country B. In order to offset or prevent such dumping, country B may impose an anti-dumping levy. Such countervailing duties specifically target goods imported (and intended to be sold) at artificially low prices.

There are conditions for, and restrictions on, the use of anti-dumping duties. Among others, Article VI(2) of the GATT puts a ceiling on the amount of anti-dumping duties so that they may not exceed the margin of dumping, i.e. the difference between the "normal value" and the actual transaction price of the products.

The "normal value" for this purpose is defined as:
- the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country; or
- in the absence of such domestic price, the higher of either;
  (i) the highest comparable price for the like product for export to any third country in the ordinary course of trade; or
  (ii) the cost of production of the product in the country of origin plus a reasonable addition for selling costs and profit.

As is clear from the above description, an anti-dumping levy is a response to one aspect of abusive transfer prices from the perspective of trade policy. Its aim is to offset or prevent dumping. An anti-dumping levy works as a backstop to abusive transfer prices, whereas the customs valuation under GATT rules rely on the transaction value and are not designed to combat dumping.

III. ARM'S LENGTH PRICE UNDER DIFFERENT TAXES

A. Pros and cons of uniform valuation

Should the determination of an arm's length price under income tax conform to the valuation for customs purposes? In theory, it is possible to make good arguments both for and against the proposition that the basis for valuation should be the same for either tax.

Arguments in favour of a uniform valuation:
- the arm's length price theoretically should be an objective value, pointing to a single amount rather than plural different amounts;
- inconsistent standards create perception issues for taxpayers;
- the government should be consistent in applying the arm's length standard to all taxes;
- the government may be whipsawed if taxpayers take an inconsistent position in declaring customs values and transfer prices in order to minimize tax payable (a "whipsaw" problem for the government), and taxpayers may be whipsawed if the government takes an inconsistent position in assessing transfer prices to maximize revenue (a "whipsaw" problem for taxpayers).

Arguments against a uniform valuation;
- different standards for valuation are appropriate because the purpose of ascertaining arm's length price is different between the two taxes;
- non-uniform standards of valuation for different taxes do not actually harm taxpayers;
- different branches of a governmental body may pursue their own objectives to implement different laws;
- the alleged "whipsaw" problem may be explained away by saying that the two taxes are completely independent and that there is nothing wrong with taking the most beneficial position for each tax.

B. The theological nature of the controversy

The controversy over the desirability of uniform valuation takes on a theological nature, because there seems to be no decisive arguments favouring either position. It is not productive, then, from a practical point of view, to dwell upon such a controversy. Instead, the query should be recast in a more pragmatic fashion: is there anything wrong with different valuations being used for income tax and for customs duties? If there are potential problems, how can we eradicate them?

6. The transition regime was closely examined in Seminar C "VAT in internal markets – European experience" in the 49th Congress of IFA in Cannes on 20 September 1995.

C. OECD guidelines

The 1995 OECD transfer pricing guidelines[7] do discuss the use of customs valuations for establishing arm's length prices under income taxes. However, the guidelines do not address the effect of customs valuations on the determination of arm's length prices under income tax. Without taking a position about the theoretical relationship between the two prices, the guidelines merely support the use of information exchange between income tax and customs administrations. Paragraph 1.66 of the guidelines notes that "customs valuations, because they may occur at or about the same time the transfer takes place, may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price". Paragraph 1.67 further states that "[C]ooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa". It is clear from these passages that only the procedural coordination is sought.

Moreover, the guidelines do not address either the effect of income tax transfer pricing adjustments on the customs valuation[8] or the theological controversy posed by the relationship between valuation standards under income tax and under customs duties.

D. Country practice

Countries employ diverse approaches to this issue. Some countries explicitly deny a substantive link between valuation standards for income tax and for customs duties purposes. On 12 November 1970, a Dutch court decided that the customs value was not of overriding importance for establishing the profit of a company for purposes of corporate income tax.[9] The 1983 Transfer Pricing Guideline of the German tax authorities states that the arm's length price for income tax purposes does not necessarily correspond to a customs duties value or to a value under the import turnover tax provisions.[10]

Other countries whilst taking measures for administrative coordination do not make their position clear on this point. In the United Kingdom, for instance, information may be shared between the Inland Revenue and the Board of Customs and Excise although no explicit relationship between the customs and income tax valuations is stated.[11]

As noted at the outset, the United States seeks to prevent taxpayers from taking inconsistent positions for income tax and for customs valuation. The 1986 Tax Reform Act introduced a provision (IRC Section 1059A) according to which an importer in a related party transaction, for the purpose of computing the basis or inventory cost of imported property, cannot claim a transfer price that is greater than would be consistent with the value used for customs purposes. This provision addresses only the effect of customs value on inventory valuation under income tax, not the effect of a IRC Section 482 adjustment on the valuation for customs purposes. From 1 October 1995, however, the US Customs Service has started to test the use of "reconciliation" for related party importers who believe upward adjustments should be made to the price of imported merchandise for IRC Section 482 purposes.[12]

The US developments cannot be interpreted as evidence of the theoretical superiority of a position supporting uniform valuation for two reasons. First, the two valuation methods were not linked historically. Indeed prior to 1982, the methods of determining arm's length value for IRC Section 482 purposes had little in common with customs valuation. Second, it was clearly stated in the legislative history that the US Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for US income tax purposes.[13] The legislative documents also state that the Section was understood by Congress not to constrain the ability of the Commissioner to adjust transfer prices under IRC Section 482.[14]

E. Administrative issues under the system of uniform valuation

It is the position of this article that there are no overwhelming theoretical grounds for adopting a uniform valuation between income tax and customs duties when establishing transfer prices. However, some countries may wish to implement such uniform valuation for perception problems. Such uniformity in valuation can be implemented in a variety of ways, as shown below.

1. Sequence of adjustments

Adjustments may be initiated either from the income tax side or the customs duties side. Issues concerning an income tax adjustment should be discussed in connection with other aspects of secondary adjustments in transfer pricing.

2. Persons bound

Three alternatives exist for defining the persons who are bound by the valuation:

- taxpayers only;
- tax authorities only; or
- both taxpayers and tax authorities.

7. OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris.
8. Such effects may be discussed as one aspect of secondary adjustments, but the paragraphs concerning secondary adjustments, 4.67 to 4.77, do not mention this issue.
9. Hof Amsterdam, Eerste Meerv. Belastingk., 12 November 1970, *BNB* 1971/205.
10. Verwaltungsgrundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen, BdF vom 23.2.1983, IV C 5-S 1341-4/83, *BStBl.* I S.218, 3.1.2.5.
11. Collins (1995), "Transfer Pricing in the United Kingdom", *The Tax Treatment of Transfer Pricing*, IBFD loose-leaf, at 25.
12. *Highlights & Documents*, 7 July 1995 at 195.
13. "Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986" (Public Law 99-514, 22 October 1986, H.R. 3838, 99th Congress) in, *Federal Taxes*, (11 May 1987) at 1061.
14. Id.

3. Statute of limitation

The structural time lag between the customs declaration and the filing of an income tax return complicates the general issue as to whether or not an adjustment is still necessary after several years have elapsed. In this regard statute of limitation issues may be particularly relevant.

4. Relationship with the mutual agreement procedures

Transfer pricing disputes often involve mutual agreement procedures under Double Tax Conventions. Therefore the following questions may arise;[15]

- when the domestic law of one Contracting State requires that the income tax adjustments should be made according to the customs value, does it preclude the competent authorities from reaching a different result?
- if the competent authorities determine an arm's length price in accordance with the provisions of the Convention, does it become necessary to adjust the customs value according to such determination?

5. Services component in mixed payments

Customs duties are imposed on the payment for goods, not services. However, income tax covers payments for both goods and services. Thus, apportionment is necessary in the case of mixed payments involving consideration for both goods and services in order to ensure the uniform valuation of the goods.

6. Use of profit-method

If under income tax a profit method is employed in order to establish arm's length prices, a corresponding adjustment becomes very difficult to make. The same applies to the secondary adjustments for customs duties valuation. Customs duties are imposed on the value of the goods. Thus, when a profit method is employed in an income tax adjustment for transfer pricing purposes, it is difficult to work back to compute the arm's length price of the goods which should be the basis for the customs valuation.

7. Objective scope

Should uniform valuation be extended to other taxes? As explained in Section II Part C, transfer prices have a different significance for destination-based VAT, origin-based VAT and anti-dumping duties. Uniformity with the customs valuation does not seem necessary especially for destination-based VAT, which has an inbuilt protection against transfer pricing, and anti-dumping duties, which themselves constitute a counter measure against abusive valuation.

F. Evaluation: what form of uniformity is required and at what cost?

Since as explained in the previous section there exists various methods of implementing a uniform valuation, it is necessary to identify a particular method in order to evaluate the merits and demerits of requiring uniformity in valuation. In this regard, no country has ever required tax administrators and taxpayers alike to be completely bound by one unique value. Even in the United States, which seems to be the driving force in this area, a consistency requirement is imposed only on the part of taxpayers.

Certainly there is good reason why total conformity in valuation is not observable in the real world since requiring such uniformity would greatly increase administrative costs. Moreover, requiring taxpayers to conform to a uniform standard of valuation increases compliance costs. Such costs, both administrative and compliance, should be weighed against the benefits of reducing potential "whipsaw" problems.

Is it, then, really worthwhile incurring these costs just for the sake of solving the perceived problems of "whipsaw"? True, it may seem unfair, to allow an inconsistent valuation for different taxes in respect of the same economic transaction. However, this article asserts that a requirement of complete conformity in valuation for every party inflicts far too high a price. Yet, a requirement solely for taxpayers to take a consistent position meets only one side of the "whipsaw" problem; fairness, as a matter of logic, requires symmetric treatment both for taxpayers and for governments.

In any event "whipsaw" may not be such a serious problem. It is quite possible for taxpayers and governments to defend the position that different taxes may use different valuations. Furthermore information exchange between the income tax authorities and customs officials can be justified as a matter of fairness since taxpayers are already in the position to know both declared values.

Incidentally, the discussion above on the merits of uniform valuation has focused on the resulting figure in various valuation situations. Such a result-oriented perspective should strictly be distinguished from the attempt to streamline general valuation rules per se. Often, rationalizing miscellaneous complex valuation rules is very helpful in reducing administrative costs. For instance, Pakistan recently harmonized its excise tariff nomenclature with its customs duties and sales tax in order to avoid classification disputes.[16]

IV. TAX POLICY AND TRADE POLICY

From a broader perspective, issues in "transfer pricing and customs valuation" are but a subset of the emerging problem area that exists at the crossroads between tax policy and trade policy.

At the international level, the link between tax and trade policies finds its expression mainly in the GATT regime, as well as in the emerging regional institutions such as NAFTA and the European Customs Union.

The interface between indirect taxes and the GATT regime can hardly be called a new issue. In the 1960s, there was a

15. Steven P. Hannes, *Tax Notes* (28 December 1987) at 1358.
16. Government of Pakistan (1994), Budget Speech of Makhdoom Shahab-Ud-Din, Minister of State for Finance, 1994-1995, at 32.

debate whether border VAT adjustments made by the EEC were a trade barrier for imports and a subsidy for exports. The GATT concluded that such border adjustments are legal.

The discussion entered a new stage when disputes spread over to direct taxes. In the 1970s, the so-called DISC case questioned the legality of the beneficial US tax treatment of Domestic International Sales Corporations (DISCs) vis-à-vis the GATT. The dispute reflects the increasing recognition that all taxes potentially influence trade.

Recently, some commentators even questioned whether or not the present bilateral network of tax treaties violates the multilateral, non-discriminatory, most-favoured nation system of GATT[17].

With the establishment of the World Trade Organization (WTO) in 1994,[18] the multilateral agreement concerning international trade came to have a greater impact on the power of member countries' to exercise their jurisdiction to tax. For example, the General Agreement on Trade in Services (GATS) is applicable not only to indirect taxes, but also to direct taxes, such as income or capital-based taxes. GATS also is explicitly made applicable to sub-national measures.[19]

In essence, tax policy and trade policy have become inseparable. The link between the two has been frequently examined by economists and also by policy makers who became known as proponents of "strategic trade policy."[20] This development implies a structural role-shifting for lawyers and bureaucrats who shape tax policy; it is therefore necessary for tax experts to enter into more dialogue with trade lawyers, customs officials, and trade policy makers. On the other hand, it seems increasingly necessary to maintain the integrity of the analysis by separating the two processes; first, tax policy should be evaluated within its own legislative framework and second, it should be examined by reference to its connection with trade policy.

17. Fischer-Zernin, "GATT versus tax treaties? the basic conflicts between international taxation methods and the rules and concepts of GATT", 6/7 *Intertax* (1989), at 236 and 310.

18. For an inquiry into the aspects of the WTO which have made it acceptable to the United States, see Vernon "The World Trade Organization: A New Stage in International Trade and Development", 36 *Harvard International Law Journal* (1995) at 329.

19. Hellerstein, "Implications of the Uruguay Round Multilateral Trade Agreements for American Subnational Taxation of International Commerce," 49 *Bulletin for International Fiscal Documentation* 1 (1995) at 3.

20. Another significant expression of the linkage between tax and trade is the recent US discussion of switching over to the exemption system of foreign corporate income to improve the US trade position. Gary C. Hufbauer (1992), *US Taxation of International Income, Blueprint for Reform*; *International Tax Reform, an Interim Report* (1993), Department of Treasury.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

JULY 1996

Fundamentals of Corporate Taxation in Singapore, Singapore, 15-17 July 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

AUGUST 1996

Summer Course on Principles of International Taxation, Amsterdam, the Netherlands, 19-30 August 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Indonesian Tax and Foreign Investment Seminar, Singapore, 23 August 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

SEPTEMBER 1996

International Tax Avoidance and Anti-Avoidance, Amsterdam, 25-26 September 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1996

International Commissionary Arrangements, Amsterdam, 4 October 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Aspects of VAT, Amsterdam, 23-24 October 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

NOVEMBER 1996

13th Asia-Pacific Tax Conference: Practical Problems in International Taxation, Singapore, 18-19 November 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

DECEMBER 1996

Double Taxation Relief: Practice, Theory & Planning, Amsterdam, 12-13 December 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

ITALY

FOREIGN TAX CREDIT RELIEF

Isabella Pandolfini

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I. INTRODUCTION

In a recent decision (No. 423, of 19 September 1995), the first Instance Tax Court of Florence has finally settled a question on which the opinions of the tax authorities and tax practitioners have been sharply divided for many years. The decision, which concerns the credit available under Articles 15 and 92 of the Income Tax Code ("ITC"), for taxes paid abroad on foreign source income has very important implications for Italian companies which hold participations in companies resident for tax purposes outside the EU.

II. BACKGROUND

Dividends received by Italian corporate shareholders from a non-resident company are normally subject to the Italian corporation tax (IRPEG). However, to mitigate the effects of economic double taxation, Article 96 ITC provides for a partial exemption regime which is applicable to dividends received by Italian corporate entities from associated companies resident abroad.[1] Under this regime only 40 per cent of such dividends are to be included in the taxable base, 60 per cent being therefore exempt.

The aim of the partial exemption is to prevent the economic double taxation which occurs when income that generates dividends is subject to corporate income tax in the hands of the distributing company *and* the dividends are subject to income tax in the hands of the recipient in his country of residence (i.e. the same income is taxed on two different taxpayers).

Economic double taxation has to be distinguished from juridical double taxation where the same income is taxable in the hands of the same taxpayer by more than one state. With intercorporate profit distributions, juridical double taxation occurs when dividends are subject to withholding tax at source *and* income tax in the beneficial owner's country of residence. Under Italian domestic tax rules, this juridical double taxation is eliminated either by the tax credit provided by Article 15 ITC (as recalled in Article 92 ITC for corporate entities), or by conventional provisions if the state of source has signed a tax treaty with Italy. In particular, Article 15 ITC allows a credit for foreign taxes (e.g. foreign withholdings) up to an amount equal to that part of the Italian tax which is proportional to the ratio between foreign source income and gross income.[2]

III. THE FACTS

The facts of the case may be summarized as follows, in 1989, an Italian company ("ItaCo"), received dividends from its French subsidiary. In accordance with Article 8(2) of the at-the-time in force Italy–France treaty, a 15 per cent withholding tax was levied in France on the dividends. In accordance with Article 96 ITC, only 40 per cent of the dividends were included in ItaCo's taxable base for corporate income tax purposes.

Under Article 15, ItaCo was entitled, upon receipt of the dividends, to a tax credit for the 15 per cent withholding tax levied in France. However the tax authorities interpreted[3] the interrelation of the foreign tax credit and partial exemption provisions to mean that only 40 per cent of foreign dividends are included in the total foreign income when calculating the ratio between foreign source and gross income. The tax authorities' interpretation, thus effectively restricted ItaCo's relief for the foreign tax credit to 40 per cent of the credit.[4]

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1. For this purpose, the association requirement is met in the event that one company can exercise a "considerable influence" on the other. The influence is deemed to be "considerable" when at least 20 per cent, or at least 10 per cent in the case of quoted companies, of the voting rights may be exercised by the first company in the ordinary shareholders' meeting of the second company.
2. The maximum amount of foreign tax credit available to the taxpayer can be calculated using the following formula:

$$\text{foreign tax credit} = \frac{\text{foreign income}}{\text{worldwide income}} \times \text{Italian income tax on worldwide income}$$

For example, if foreign-source income is 100 and Italian-source income is 200, then worldwide income is 300. The tax due in Italy on such income is 111 (37% of 300). The credit for the tax paid abroad on foreign-source income is granted up to 37, which corresponds to the corporate income tax that would be paid in Italy on the foreign-source income.
3. The tax authorities position is set out in Circular No. 33/12/1154, dated 4 October 1984.
4. An example of how the limits imposed on the foreign tax credit calculation can considerably reduce the value of the partial exemption is as follows:

Profits of the foreign company	100
Corporate tax (e.g. 40%)	(40)
Distributable profits	60
Withholding tax (e.g. 30%)	(18)
Net Cash to shareholder	42

(1). Calculation of the foreign tax credit and the total tax burden according to the interpretation of the tax authorities:

$$\text{Foreign tax credit} = \frac{24(=40\%\text{ of }60)}{24} \times 8.88(=37\%\text{ of }24) = 8.88$$

Total tax burden = 40 (foreign corporate tax) + 18 (foreign withholding tax + 8.88 (Italian corporate tax) – 8.88 (foreign tax credit) = 58. cont. →

In order to avoid tax penalties, ItaCo computed its tax liability in accordance with the ministerial interpretation described above. However the company then filed a request for the refund of corporate income tax paid in excess.[5] The tax authorities did not reply to the request, and ItaCo submitted the case to the Tax Court.

IV. THE DECISION

The Tax Court of Florence fully accepted the arguments of the claimant. In particular, the judges, after having pointed out that the starting point in order to settle the controversy is the interpretation of Article 15 ITC, noted that Article 15 may not be interpreted so as to limit the amount of the tax credit to a given percentage of the foreign tax. Rather, it is to be interpreted as imposing a limit to the tax credit equal to the amount of the Italian corporate income tax applicable to the foreign source income. The Court held that the interpretation given by the tax authorities would amount to a distortion of the *voluntas legis* of Article 15 ITC. Accordingly, the Court ordered the refund of the excess corporate income tax paid by ItaCo and of the interest accrued thereon computed at the legal rate.

In spite of the court's ruling, the restrictive interpretation asserted by the tax authorities in Circular 33/12/1154 has not been modified and must be considered to be still in force. Indeed the tax authorities may appeal the court's decision.

It is to be noted that the restrictive interpretation favoured by the tax authorities has been much criticized in the tax literature in particular because it is felt that the tax authorities have erroneously created a connection between two provisions (Article 96 and Article 15 ITC) which regulate two different phenomena: economic double taxation and juridical double taxation.[6]

The tax literature therefore considers that the opinion of the tax authorities represents, a further shortcoming of the Italian tax system, since the impossibility to get a full credit for foreign withholding taxes suffered by Italian corporations partially nullifies the benefits of the partial exemption regime provided for in Article 96 ITC.[7]

V. CONCLUSION

Subsequent to the implementation in all EU Member States of the Parent-Subsidiary Directive, the regime described above no longer applies with regard to dividends received from a qualifying EU subsidiary. In this case the new Article 96-bis applies. Article 96-bis provides that 95 per cent of dividends are exempt from corporation tax in the hands of the Italian parent company if certain conditions are met.[8] Furthermore, withholding tax shall no longer be levied on dividends paid by an EU subsidiary to its Italian parent company and Article 15 ITC therefore becomes irrelevant. Nevertheless, the decision of the Tax Court of Florence applies in all cases in which the old Italian system is still applicable, and in particular when dividends are received from a subsidiary resident outside the EU or from an EU subsidiary which does not meet all the conditions required by the rules that implemented the Parent-Subsidiary Directive

(2) Calculation in absence of the partial exemption regime:

$$\text{Foreign tax credit} = \frac{60}{60} \times 22.2 \ (=37\% \text{ of } 60) = 22.2^*$$

* The maximum allowed is 18

Total tax burden = 40 + 18 + 22.2 minus 18 = 62.2.

(3) According to a reasonable interpretation, the foreign tax credit should be calculated prior to the partial exemption of the dividends:

$$\text{Foreign tax credit} = \frac{60}{24} \times 8.88 = 22.2 \text{ (therefore 18)}$$

Total tax burden = 40 + 18 + 8.88 – 18 = 48.88.

From this example it is evident that the benefits derived from the partial exemption are almost completely annulled by the reduction of the foreign tax credit from 18 to 8.88. See A. Manganelli, "Implementation of the Parent-Subsidiary Directive in the EC Member States. Italy", 32 *European Taxation* 4/5 (1992), at 156.

5. The refund claimed equalled the amount of the tax credit for which relief was not available under the tax authorities interpretation.

6. See B. Gangemi, "Credito d'imposta e redditi esteri", 4 *Bollettino Tributario* (28 February 1990); see also *supra* note 4 (A. Manganelli).

7. The difference between juridical and economic double taxation is confirmed by the OECD Model Tax Convention on income and capital (the model most frequently used in bilateral treaties signed by Italy). Paras. 49 to 54 of the Commentary to Arts. 23A and 23B, concerning the methods for elimination of double taxation, clarify that the Model's provisions, which for these purposes provide the exemption method and the credit method, "effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company" first at the level of the subsidiary and again at the level of the parent company". As such recurrent taxation creates a very important obstacle to the development of international investments, the Committee on Fiscal Affairs has considered whether it would be appropriate to modify Arts. 23A and 23B in order to settle this question, but in the end it took the view that this would have caused many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. For this reason, if a State wishes to avoid economic double taxation it must do so either by domestic law or by bilateral agreements. So, an Italian tax treaty could include different rules which provide separately for the tax credit for foreign withholdings (Art. 15 ITC) and the tax credit for the underlying corporation taxes paid by the controlled company in the State of source (Art. 96 ITC), without interfering with one another.

8. The conditions to be met in order to benefit from the exemption are as follows:

- the non-resident subsidiary must have one of the legal forms listed in the Annex to the Directive, be fiscally resident in an EU Member State and be subject to one of the corporation taxes listed in Art. 2 of the Directive;
- the Italian parent company must be an entity subject to IRPEG which has held not less than 25 percent of the shares of the distributing company for an uninterrupted period of at least one year before the date on which the distribution of the profits has been resolved upon.

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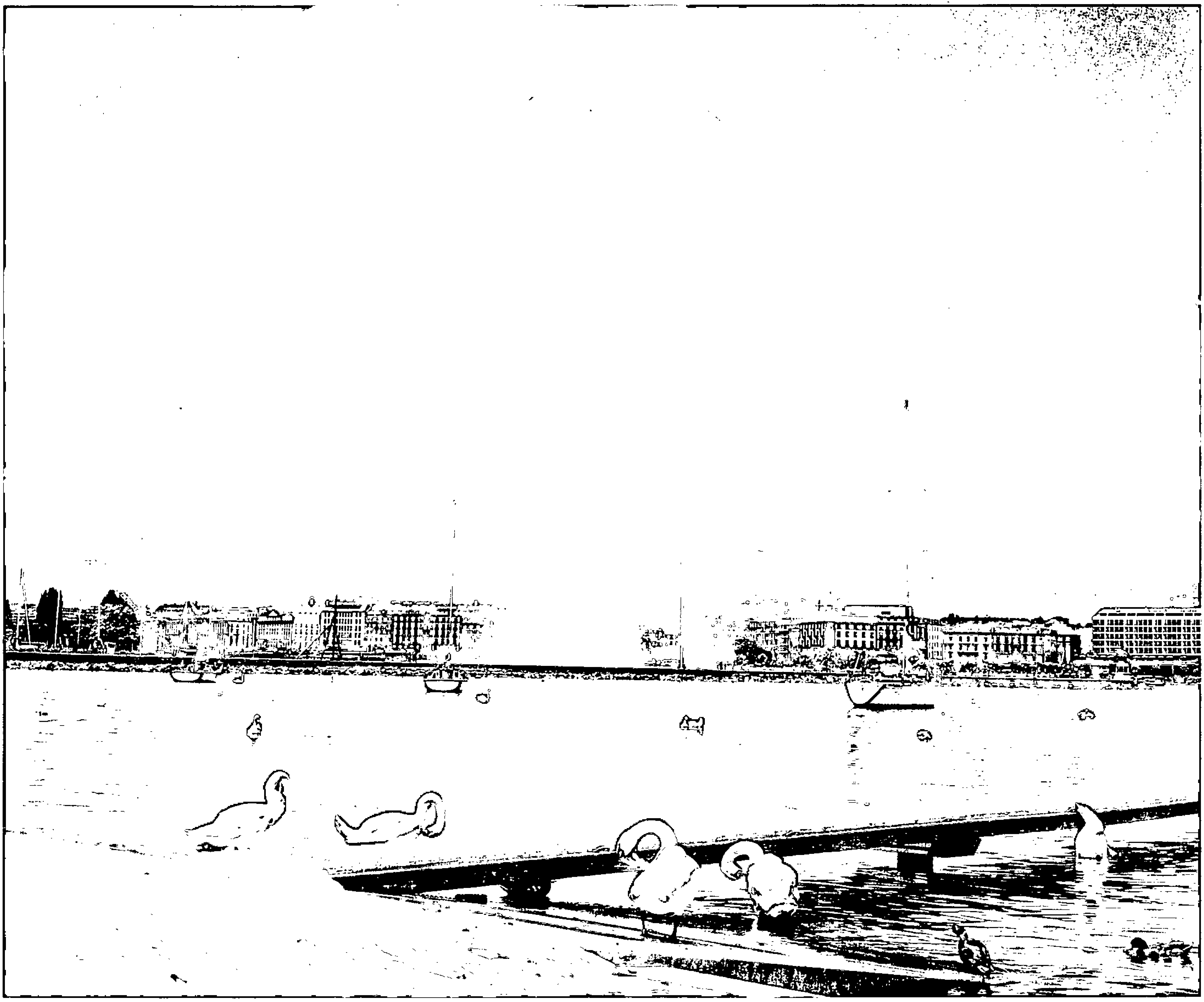
Introduction

The 50th IFA Congress – Geneva 1996

Prof. Avv. Pietro Adonnino



Not since the Lausanne Congress in 1973, has IFA held its congress in Switzerland.

The ever increasing interval between two congresses being held in the same country demonstrates the progressive growth of the organization. In particular, the creation of new "Branches", has led to an ever increasing number of invitations, which in turn has been reflected in the globally oriented venues chosen by the organization for its congresses.

The fact that the IFA's annual congress has returned to Switzerland has a particular significance because this is the 50th congress, an important landmark in the history of the Association.

It is symbolic that such an important congress is organized in such an international city, as Geneva. A city that has always played a crucial role in the history of international relations. Indeed, since the foundation of the League of Nations it has been the seat of many international organizations.

In addition, Geneva is a very beautiful and welcoming city, located on Lac Léman. Its outskirts offer a great variety of landscapes, ranging from the mountains to a green and very productive countryside at the borders with France and near its Italian border. This city lies at the heart of Europe and connections are easy by train, car or airplane.

Hospitality from Swiss people in general and from our friends of the IFA Branch in particular is well-known and this is one of the reasons why Geneva has been chosen as the seat of the 50th congress. In addition, I don't think the pleasantness of the surroundings for the congress participants could have been improved upon.

The IFA's congresses are especially characterized by the interesting topics that are debated and for the strict procedures followed for their preparation.

As always, the Permanent Scientific Committee selects from among the several topics proposed, the two main themes as well as the topics of the seminars. The Permanent Scientific Committee also makes the selection of the persons holding a great recognition and capability who are assigned the task to be general rapporteur, discussion leader, or members of the panels.

The important contributions that are normally given to the general rapporteur by national rapporteurs named by the respective branches should not be overlooked. This practice enables a global overview to be given for each topic.

The subjects selected for the Geneva Congress are very topical and of great interest. At the moment, financial activities are ever increasing and the attention of the law-makers is devoted to the setting up of anti-avoidance measures.

The first topic of the Geneva Congress will debate the principles for the determination of the income of permanent establishments and in particular the application of these principles to banks and insurance companies. This is an especially appropriate topic since everybody is aware of Switzerland's highly prestigious banking sector.

The second theme will be devoted to the international aspects of thin capitalization regimes. These regimes tend to limit the possibility for reducing the taxable base in subsidiaries. Thin capitalization is the practice of assigning to subsidiaries a capital lower than is needed and by replacing this shortage of capital with loan finance.

The topics that will be debated during the seminars are interesting as well. The first topic will debate tax issues affecting a federal system. Switzerland is a country based on a federal organization, therefore as far as this aspect is concerned, Geneva is expected to provide some excellent contributions to the debate.

At present, economic relations with Eastern European countries are rapidly being developed and raise several serious problems as far as aspects of taxation of international investments are concerned. This is going to be the topic of another seminar.

A problem which has always been faced and debated in the different law systems is that of the influence of civil law and accounting principles in determining taxable income. This topic too has been chosen as a seminar topic.

As requested several times at the Toronto Congress in 1994, at Cannes for the first time, on a trial basis, a seminar was organized, under the joint responsibility of the OECD and IFA, regarding the updating of the Model Treaty. This seminar has now become permanent, which means it is going to be held every year. Following this decision, in Geneva a Seminar will debate the OECD Model Treaty – 1996 and beyond.

We are close to the turn of the century. The problems of international taxation must be considered by keeping an eye to the future because many solutions that have been considered until now as valid may be modified in relation to the variation of the development of the economy, of international trade and of new economic and political situations. In particular, the use of innovative technologies will take on a great importance both for transnational operations and for the setting up of a tax system. The Jubilee Symposium will therefore debate the visions of international taxation in the 21st century.

I am sure that the 50th IFA Congress, held in Geneva, will be, like the previous ones, of great interest. The members of our Association have to take due note not only of the interest as for scientific and professional know-how but also, last but not least, of the pleasantness of a one-week stay in Geneva.

In conclusion, I expect a strong participation from all the members and in this perspective, I give to all of those who will participate a warm welcome to Geneva and a hearty thanks to our friends in the Swiss Branch for the organizational effort they have exerted. This effort will surely be crowned by a great success!

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SEMINAR C
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Sekretär: Xavier Oberson (Schweiz)

SWITZERLAND'S TREATY POLICY

Daniel Lüthi

Vice Director, Federal Tax Administration

I. DEVELOPMENT OF THE TREATY NETWORK

Switzerland concluded its first comprehensive double taxation convention on income and capital in 1931 with Germany; a comparable convention was concluded in 1937 with France. In the following decade, conventions with Hungary and Sweden were added. Between 1950 and 1960, the network was extended by new conventions with Austria, Denmark, Finland, the Netherlands, Norway, Pakistan, the United Kingdom and the United States.

In the 1960s, the Organisation for European Economic Cooperation (OEEC, later OECD) began to study double taxation problems and other fiscal issues. In 1963, this work led to a "Draft Double Taxation Convention on Income and Capital". Following the recommendations of the OECD Council, Switzerland used the Draft (and the subsequent amendments) as a basis when concluding new or revising existing conventions. In the second part of the 1960s new conventions with Ireland, South Africa and Spain were concluded. Between 1970 and 1980 eight conventions followed (Belgium, Canada, Italy, Japan, Malaysia, Portugal, Singapore and Trinidad and Tobago). While in the 1980s Switzerland negotiated ten new conventions (Australia, Egypt, Greece, Iceland, Indonesia, Ivory Coast, New Zealand, South Africa, the Soviet Union and Sri Lanka).

In recent years Switzerland has pursued a particularly active treaty policy resulting in an important extension to its treaty network (Bulgaria, China, Ecuador, India, Jamaica, Liechtenstein (limited convention), Luxembourg, Morocco, Mexico, Poland, Romania, Czech Republic, Thailand, Tunisia and Vietnam).

For the time being, 44 double taxation conventions are in force and ten conventions are in the process of being signed (Albania, Argentina, Belarus, Canada (revision), Moldavia, Pakistan (revision), Slovenia, the Slovak Republic, Venezuela, and the United States (revision)).

II. PRINCIPLES OF SWISS TAX TREATY POLICY

A. In general

The Swiss policy is traditionally characterized by stability and continuity. The solutions aimed at on important issues take into account the specific situation of Switzerland. Our country has intense economic relations with many countries in the world; it exports capital, goods and services and has important investments abroad. Therefore, Switzerland has to follow liberal solutions in its tax treaty policy which guarantee that cross border economic activities do not suffer from fiscal impediments. The efforts to maintain and improve Switzerland's prosperous economy have for many years been facilitated by the ongoing extension of the Swiss tax treaty network. Switzerland is therefore primarily interested in the conclusion of double taxation conventions with countries in which important economic interests already exist or are expected to develop in the future.

The tax treaty policy of Switzerland is mainly based on long-standing Swiss domestic concerns and on the OECD Model Convention. Developments in the OECD area as well as in the European Union have also had a significant impact. Furthermore Switzerland's treaty policy distinguishes between countries falling into the following economic categories:
- industrialized nations;
- emerging economies;
- Eastern European countries; and
- former Soviet Republics.

B. The influence of developments in the OECD

Apart from the existing Swiss practice the OECD Model Convention serves as a basis when negotiating double taxation conventions.

The OECD Model of 1963 was revised in 1977. Further partial revisions took place in 1992, 1994 and 1995. Those revisions resulted in few substantial changes to the Model itself; on the other hand, the Commentaries have been considerably enlarged.

For Switzerland, the change in Article 12 (Royalties) is of particular importance; a consequence of the change is that the taxation of income from the leasing of industrial, commercial or scientific equipment will in future no longer be governed by Article 12, instead the rules for the taxation of business profits (Articles 5 and 7) will apply to such income. Of relevance also is the change in paragraph 2 of Article 3 (General definitions); the provision now clarifies that where different laws of a Contracting State define a term differently, the meaning given to the term in the tax legislation relating to taxes to which the Convention applies shall prevail.

Switzerland considers that the Commentaries to the Model Convention constitute an important source of interpretation of tax treaties which should be used by OECD member countries, subject to their observations, when applying and interpreting their tax conventions. As a result of the above-mentioned revisions, the new Commentaries contain important statements on base and conduit companies, on thin capitalization, on triangular cases, on the tax treatment of software payments, on the attribution of income to permanent establishments and on the taxation of new financial instruments.

The following issues are among those currently being examined by the relevant Working Party of the Committee on Fiscal Affairs:

- the application of the Convention to partnerships;
- the taxation of pensions under Article 18 as well as the concept of "permanent establishment" under Article 5;
- the source taxation of dividends and interest;
- the need for Article 14 (Independent personal services);
- the functions of Article 19 (Government service); and,
- the legal status of the Commentaries under both public international law and the domestic law of the member countries.

Of special interest to Switzerland is the work undertaken by the OECD in the field of transfer pricing and multinational enterprises. For the Swiss business community the principles laid down by the OECD for intra-group transfers of goods, capital and services are of the utmost importance. The basic OECD transfer pricing report of 1979 is under revision; the revised version will form an integral part of the Commentary to Article 9 (Associated enterprises) which establishes the arm's length principle for the relations between associated enterprises.

C. The influence of developments in the European Union

In the field of international taxation, two directives and a convention are of particular importance to Switzerland.

The Parent-Subsidiary Directive[1] provides firstly, that dividends from a participation should be fully relieved from tax in the hands of the parent company and secondly, that the subsidiary should not be subject to withholding tax in its residence country. Since Switzerland is not a member of the EU, a total relief from the dividend withholding tax can only be achieved through bilateral agreements. The Swiss double taxation conventions with Denmark, Finland, Luxembourg, the Netherlands and Sweden already grant such a withholding tax exemption. The revised convention with France which is not yet in force will contain a similar provision. (Negotiations with Austria and Germany, are still pending.)

With respect to the Mergers Directive[2] the situation in Switzerland is different. Contrary to the route chosen by the EU, Switzerland taxes the reserves in case of a cross-border merger or division. A move in the direction of the EU would call for changes in civil law as well as in the tax laws.

The Arbitration Convention[3] provides for a procedure to resolve cases of economic double taxation in connection with the adjustment of profits of associated enterprises. The arbitration procedure is mandatory if the competent authorities fail to eliminate the double taxation in the mutual agreement procedure. In view of the federal structure of Switzerland, a mandatory arbitration procedure would raise many problems. On the other hand, nothing should prevent Switzerland from providing in its new double taxation conventions an optional arbitration procedure to be invoked when the taxpayer as well as the tax authorities of the Contracting States agree.

The draft directive which provided that under given conditions interest and royalties should be taxed exclusively in the country of residence of the recipient has been withdrawn. This is regrettable since it is a long-standing treaty policy of Switzerland to exempt interest and royalties from withholding tax.

The EU has yet to reach agreement on the question of the taxation of savings. In discussion are the levying of a withholding tax on the interest notwithstanding the residence of the recipient and a notification of the interest payments made by banks to the tax authorities. Since in Switzerland a withholding tax of 35 per cent is levied on interest irrespective of the recipient of the income, there is at present no need to make any changes.

III. PARTICULARITIES OF THE SWISS TAX TREATY POLICY

A. Double taxation conventions with industrialized countries

1. Residence

The conventions rely on the concept of residence as laid down in the domestic laws of the Contracting States. However, a person is only considered to be a resident of a Contracting State if it is subject to an unlimited tax liability in that State.

According to the Swiss view Contracting States, political subdivisions and local authorities are considered to be residents of a Contracting State and therefore entitled to treaty benefits.

Swiss partnerships are not treated as taxable entities under Swiss law; instead each individual partner is subject to tax on his share of the partnership's profits, whether or not he is a resident of Switzerland. For this reason, Switzerland reserves the right to clarify in its conventions that Swiss partnerships are considered to be residents of Switzerland.

Some conventions concluded by Switzerland contain restrictions in relation to persons subject to lump-sum taxation. Such persons are not considered to be residents of Switzerland if they are only taxed on the rental value of their dwellings or, in other cases, if they are not subject to the generally imposed income taxes in Switzerland with respect to all income from sources in the other Contracting State.

Where a change of domicile of an individual occurs, unlimited tax liability normally ends at the time the taxpayer leaves the country. However, a number of conventions contain specific provisions for this situation. The conventions with Den-

1. *Official Journal of the European Communities*, L 225/6 of 20.8.1990
2. *Official Journal of the European Communities*, L 225/1 of 20.8.1990
3. *Official Journal of the European Communities*, L 225/10 of 20.8.1990.

mark and Sweden provide that an individual who is leaving the country continues to be subject to unlimited tax liability in Denmark or Sweden for a limited time period if given conditions are met; the convention with Germany restricts such taxing right to German source income and property. In addition, the conventions with Austria, Germany, the Netherlands and Norway grant those countries a taxing right for capital gains derived by persons having left the given country; in the case of Austria, Canada, Germany and Norway, the taxation is limited to gains from the alienation of a substantial participation; under the convention with the Netherlands the taxing right is extended to dividends distributed by Dutch companies. If pursuant to the domestic law an individual is considered to be a resident of both Contracting States, a classical case of double residence arises which has to be solved based on special rules in order to determine which of the two concepts of residence is to be given preference. In these situations, the criterion referring to the centre of vital interests is in general of primary importance. However, the convention with Germany deviates from this principle; where the residence in Switzerland is given preference, Germany retains an unlimited taxing right if the taxpayer continues to have a permanent home in Germany or if his stay in that country exceeds 183 days in the calendar year concerned.

2. Business profits

Switzerland applies the relevant provisions also to income from a participation in a partnership.

In connection with the exploration and exploitation of natural resources in the North Sea, the bordering states do not closely follow the principles of the OECD Model. They agree bilaterally that such an activity constitutes immediately or after a short period of time a permanent establishment. Since, as a land-locked country this is not acceptable to Switzerland a limitation of the territorial scope of the given convention may be the only way of resolving the issue.

3. Profits adjustments between associated enterprises

Swiss double taxation conventions provide for a profit adjustment between associated enterprises in accordance with Article 9 paragraph 1 of the OECD Model Convention. The tax authorities of a Contracting State may therefore adjust the profits of the enterprises if as a result of the special relations between them they are lower than the profits that could have been achieved in an unrelated situation. Where the adjusted profits have already been taxed in the other Contracting State, economic double taxation arises. In order to eliminate such double taxation, paragraph 2 of Article 9 of the Model obliges the other Contracting State to grant a correlative adjustment. Since Switzerland is only in a position to grant such an adjustment in the framework of a mutual agreement procedure, a number of Swiss conventions refer explicitly to this procedure.

4. Taxation of dividends, interest and royalties

In general, Switzerland favours the residence principle for the taxation of such income. However, in its treaty practice it has to take into account that the OECD Model grants to the source country a limited taxing right for dividends and interest.

For dividends the Swiss double taxation conventions follow to the extent possible the OECD recommendation providing for a 5 per cent withholding tax on dividends distributed by subsidiaries and a 15 per cent rate in all other cases. With respect to intercompany dividends Switzerland is nevertheless favouring the regime applied in the European Union according to which such dividends are taxable only in the residence country of the parent company. As mentioned earlier, some conventions with EU Member States are already based on this. Where a limited taxing right of the source country has to be accepted, the question arises whether tax exempt institutions, e.g. pension funds, should be entitled to receive dividends exempt from withholding tax. Furthermore, the fact that a number of countries grant resident shareholders an imputation credit for the corporate income tax paid by the distributing company has caused Switzerland to ask for a full or partial credit to be granted to Swiss shareholders or, in case no credit is available, to provide for a lower withholding rate in the country applying an imputation system. Under the conventions with France, Ireland and the United Kingdom, Swiss shareholders may benefit from such a credit if given conditions are fulfilled; the convention with Finland grants a unilateral reduction of the Finnish withholding tax.

In relation to interest, most Swiss conventions provide for a limited taxation right of the source country; however, in many instances given categories of interest are exempt from withholding tax, a solution which is also favoured by a growing number of countries.

Many industrialized countries are not yet prepared to follow the OECD recommendations for taxing royalties exclusively in the residence country. This situation which is reflected in Swiss double taxation conventions may not change in the near future.

5. Gains from the alienation of property

With respect to gains from the alienation of shares or other rights in a real estate company, Switzerland is prepared to provide for a taxing right of the country in which the immovable property is situated.

6. Dependent personal services

For the calculation of the 183 days, paragraph 2 of Article 15 of the OECD Model in its revised version no longer relies on the fiscal year concerned but on any twelve-month period commencing or ending in a fiscal year. Switzerland intends to continue its liberal policy in this respect and therefore will propose to its treaty partners the former OECD solution.

7. Artistes and sportsmen

According to Article 17, paragraph 2 of the OECD Model, the Contracting State in which the activities are exercised may tax income not directly received by an artiste or sportsman but which accrues to another person. Switzerland is of the opinion that this provision should only apply in cases where the intermediary is controlled by the performer. Such a clarification can be found in a number of Swiss conventions.

With respect to artistes and sportsmen substantially supported from public funds, Switzerland is prepared not to apply the specific rules contained in Article 17 but to refer to the other provisions of the Convention.

8. Methods for the elimination of double taxation

Switzerland applies the exemption method with progression. In relation to income subject to a limited withholding tax in the other Contracting State, a lump-sum-tax credit is granted pursuant to the Decree of the Federal Council of 22 August 1967.[4] For foreign dividends received by a Swiss company, the same fiscal relief is granted as for dividends from Swiss sources.

9. Exchange of information

Switzerland has always maintained a reserved position in the field of administrative assistance in tax matters. The first Swiss double taxation conventions did not contain a clause on the exchange of information. Nevertheless, assistance was granted to the extent necessary for the correct application of the Convention or for the prevention of its abuse. From a legal point of view, the assistance was based on the relief procedure for withholding taxes, on the mutual agreement procedure or on the Decree of the Federal Council of 14 December 1962 against the improper use of Swiss double taxation conventions.[5] Accordingly in 1963, Switzerland entered a reservation to Article 26 of the OECD Model. The more recent conventions concluded by Switzerland contain a restricted exchange of information provision which reflects a long-standing Swiss practice to exchange information for the application of a convention or for combating its abuse. The exchange is subject to the condition that the person involved has asked for a treaty benefit. In contrast to this practice the OECD Model provision also allows for an exchange of information for implementing the domestic law of the requesting State.

The Swiss policy in this field does not follow the growing international tendency for a closer cooperation amongst countries which may not only include assistance for the taxes covered by a convention but also for other taxes, e.g. for indirect levies, as well as assistance in the recovery of tax claims or for the service of documents. In this context, reference is made to the European Council/OECD Convention on mutual assistance in tax matters[6] and to the relevant directives of the European Union[7] which provide for an extended administrative assistance.

10. Treaty abuse

By the Decree of the Federal Council of 14 December 1962, Switzerland enacted effective measures against the improper use of Swiss double taxation conventions. Of primary importance is the requirement against the conduit and the obligation to distribute treaty favoured income as well as the applicable debt/equity ratio. Parts of the abuse Decree have been inserted into the Swiss double taxation conventions with Belgium, France, Germany and Italy. These conventions further require that interest and royalties[8] must be subject to the ordinary cantonal taxes in order to be granted treaty benefits.

In the field of combating treaty abuse Switzerland is confronted with developments which are based on differing concepts and which can have as a consequence the fact that certain Swiss companies may be excluded from treaty benefits despite having a business activity of their own.

B. Tax conventions with economies in transition

The political and economic opening in Eastern Europe gave Switzerland the chance to extend its treaty network in this area. The existing network only comprised a convention with Hungary of 1981 which had replaced the convention of 1942/48, and a convention of 1986 with the Soviet Union; the latter convention is of a limited nature and reflects the differing economic and social structures as well as the restrictions for doing business in the Soviet Union at the time the convention was concluded. A new convention based on the OECD Model has been signed in 1995 and will replace the existing treaty. In addition, Switzerland concluded a comprehensive double taxation convention with China in 1990.

The treaty policy of Switzerland in relation to Eastern European countries does not markedly deviate from the policy followed when negotiating treaties with industrialized countries. In addition to the conventions already mentioned, Switzerland has concluded tax treaties with Bulgaria, Poland and Romania which are already in force. Conventions have been signed with the Czech Republic and initialled with Albania and Slovenia. The negotiations with the Slovak Republic will soon be finalized.

C. Tax conventions with developing countries

The basic principles of the Swiss tax treaty policy are also valid in relation to developing countries. However, special

4. Decree of the Federal Council of 22.8.1967 on the lump-sum tax credit, SR 672.201.
5. Decree of the Federal Council of 14.12.1962 against the improper use of Swiss double taxation conventions, SR 672.202.
6. Multilateral Convention on Mutual Administrative Assistance in Tax Matters, S.T.E 127.
7. *Official Journal of the European Communities*, L 336/15 of 27.12.1977; L 331/8 of 6.12.1979; L 76/1 of 25.2.1992; L 390/124 of 14.12.1992.
8. In the case of Germany capital gains are also subject to this provision.

concessions are granted to take into account the unilateral economic and financial relations with these countries.[9]

1. Permanent establishment

With respect to building sites and installation projects, Switzerland is prepared to agree to a six-month instead of a twelve-month period and to provide that supervisory activities constitute a permanent establishment if they exceed six months. A stock of goods out of which an agent makes deliveries constitutes in general a permanent establishment of the enterprise. In addition, the furnishing of services in the other Contracting State by employees of the enterprise may be considered to be a permanent establishment if the activity exceeds six months; an alternative solution may provide for a limited withholding tax on the service fees paid.

2. Business profits

Developing countries often ask for a force-of-attraction rule in order to attribute certain activities of the head office to the permanent establishment if these activities are of the same or a similar kind to those undertaken by the permanent establishment. Switzerland is only prepared to accept such a rule in order to prevent abuses. Furthermore, Switzerland refuses to limit the deduction of expenses if they are incurred for the purposes of the permanent establishment.

3. Dividends, interest and royalties

Switzerland is prepared to accept withholding tax rates which are slightly higher than the rates usually applied between industrialized countries. In relation to countries in which Switzerland has important economic interests and whose treaty practice include high withholding rates, Switzerland applies a limited tax credit; the part of the withholding tax which exceeds the amount as determined according to the rates provided for in the Swiss treaty practice will only be deductible as an expense and not credited against the Swiss income tax.[10]

Where a developing country, based on incentive measures, grants an additional relief on interest or royalties compared to the relief agreed upon in the convention, Switzerland may provide for a matching credit in order to ensure that the investor will benefit from the incentive.

4. Capital gains

For the taxation of gains from the alienation of movable property Switzerland follows the residence principle. In exceptional situations, the country in which the property is situated may be given a subsidiary taxing right if a credit for the Swiss taxes levied is granted. However if no credit for the Swiss tax is given, such gains will be taxable according to the domestic laws of the Contracting States.

5. Independent personal services

Apart from the usual fixed base criterion Switzerland can agree on a 183-day period as an alternative criterion.

6. Professors and teachers

Switzerland in general rejects a tax exemption for such persons in the host country. Nevertheless a tax exemption can be agreed for a period not exceeding two years if overall the provisions contained in a convention are highly satisfactory.

7. Other income

Switzerland only accepts the taxation of such income in the residence country of the recipient. Where the treaty partner is not in a position to agree to such a solution the general clause will be dropped.

8. Exchange of information

Conventions with developing countries do not in general contain a provision on the exchange of information.

IV. OUTLOOK

Switzerland will continue in its efforts to extend its treaty network and to adapt treaties to new developments in order to facilitate an environment conducive to transnational business activities. In addition, the principles of the traditional Swiss tax treaty policy will be maintained subject to any adaptations necessitated by developments in the field of international taxation.

9. Message of the Federal Council of 18.4.1973 on the double taxation convention with Trinidad and Tobago, BBl 1973 I 1228.
10. Message of the Federal Council of 3.10.1994 on the double taxation convention with India, BBl 1994 V 225.

Tax Relief on Share Transfers

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I. INTRODUCTION

There are numerous different ways in which the legal ownership of shares may be transferred from one taxpayer to another. First, they may be transferred by means of a gift or a bequest on death; second, they may be granted to an employee via a share purchase scheme; third, they may be exchanged against consideration in cash or in kind. This article explains the Swiss tax implications of the latter method of share transfer.

In Switzerland, there are no taxes which specifically cover share transfers. It is therefore necessary to refer to the general principles of Swiss income tax, withholding tax and stamp tax laws. The exceptions to these general principles are introduced under "Special considerations".

Income tax is levied on the worldwide income earned by Swiss residents and certain types of Swiss source income earned by non-residents. With regards to capital gains, income tax is only levied on the sale of business assets. Indeed, capital gains on the sale of privately held assets are totally exempt. This exemption is common knowledge among international tax practitioners and constitutes one of the more important incentives for individuals to become Swiss resident. However, since taxpayers have a natural tendency to characterize as much as possible of their earnings as tax-exempt capital gains arising on privately held assets, Swiss case law has recently become increasingly restrictive in defining both "capital gains" and "privately held assets".

Withholding tax is levied on certain types of Swiss source investment income, including dividend income, irrespective of the residency of the beneficiary. Capital gains, on the other hand, are not subject to withholding tax. Hence, taxpayers try to characterize as much as possible of their Swiss source earnings as capital gains. This has given rise to abuses which have been curbed by recent Swiss case law.

Transfer stamp tax is levied on share transfers which involve Swiss securities dealers. When applying this tax, it is rare that transactions are re-characterized to the advantage of the tax administration. Nevertheless, a recent change in legislation has extended the definition of Swiss securities dealers so that even industrial companies may now qualify in certain circumstances.

II. GENERAL PRINCIPLES

A. Income tax

The Swiss income tax system is made up of a number of different taxing jurisdictions. Although federal tax is common to all taxpayers, each of the 26 cantons has its own tax system, which is usually further subdivided between numerous communes. Switzerland has been undergoing a total reform of its income tax system with a view to harmonizing federal, cantonal and communal tax laws. Firstly, a new Direct Tax Law[1](hereafter: DTL) entered into force on 1 January 1995. Secondly, a Tax Harmonization Law[2] (hereafter: THL) was introduced on 1 January 1993 which lays down the foundations of a new tax system upon which all cantons must be based before the end of the year 2000.[3]

Swiss residents are subject to income tax in Switzerland on their worldwide income regardless of source. The only exceptions to this rule concern income generated by foreign businesses, permanent establishments and immovable property.[4] Non-residents are only subject to a limited taxation on certain specific types of Swiss source income. They are not subject to income tax on earnings generated by share transfers unless they are effectively connected to a Swiss enterprise or permanent establishment.[5]

The method of taxing share transfers depends on whether the earnings derived therefrom are characterized as passive income or capital gains. Passive income includes dividend distributions, liquidation proceeds, stock dividends and constructive dividends (hidden profit distributions). Capital gains, however, are often defined as the income generated from the sale of assets which corresponds to the differential between the price of acquisition of the assets and the price of sale. They include gains from the sale, exchange, re-evaluation of participations and exchange rate gains etc. In Switzerland, share transfers are characterized as capital gains in the vast majority of situations. The exceptions to this rule are described under "Special considerations" (see below).

Although passive income is subject to taxation in the same manner as any other earned income, capital gains are taxed very differently depending on whether they are generated on personal assets or business assets. The tax implications as well as the criteria used to differentiate between personal assets and business assets are explained hereafter.

1. Loi fédérale du 14 décembre 1990 sur l'impôt fédéral direct, *RS* 642.11.
2. Loi fédérale du 14 décembre 1990 sur l'harmonisation des impôts directs des cantons et des communes, *RS* 642.14.
3. Art. 72, para. 1 THL.
4. Arts. 6, para. 1 & 52, para. 1 DTL.
5. Arts. 4, para. 1 & 51, para. 1 DTL.

1. Relief on personal assets

Capital gains realized on the sale of privately held assets are tax exempt.[6] They are neither taken into consideration to determine the basis of taxation nor the tax rate. On the other hand, any capital losses sustained on privately held assets are not deductible.

This rule is applicable to all types of assets; i.e. movable assets (e.g. shares, bonds, priority subscription rights, precious metals, works of art) and immovable assets (e.g. real estate).

2. Relief on business assets

Capital gains realized on the sale or revaluation of business assets are fully taxable.[7] The conversion of business assets into private assets or the transfer of assets to a foreign enterprise or permanent establishment all constitute deemed sales.

Capital gains earned on business assets are subject to income tax in the same manner as any other commercial income. The basis of taxation is the difference between the consideration received for the assets and their book value at the time of sale. Since capital gains are fully taxable, it follows that capital losses are deductible. In addition, commercial assets may take advantage of capital depreciation provisions[8] as well as reinvestment relief.[9]

Businesses can often obtain special relief on capital gains by virtue of incentive provisions.[10] For Swiss federal tax purposes, capital gains are outside the scope of the relief for qualifying dividend income. Hence, relief is only available for newly established enterprises which are totally exempt from income tax for a limited period of time.[11] However, for cantonal and communal tax purposes, in addition to the relief for newly established enterprises, capital gains may be totally exempt or taxed at substantially reduced rates if the business qualifies for holding company or domiciliary company status.

Holding company status is granted to joint-stock companies[12] and cooperatives which are mainly active in the management of long-term financial investments in affiliated companies. To qualify, at least two thirds of their assets (or income) must be derived from long term participations and they may not be engaged in commercial activities in Switzerland. Holding companies are exempt from corporate income tax on all forms of income, including capital gains.[13]

Domiciliary company status is granted to joint-stock companies, cooperatives and foundations which have administrative activities in Switzerland but which are exclusively engaged in commercial activities abroad.[14] Capital gains realized by domiciliary companies whose tax residence is, for example, in the canton of Geneva, are tax exempt if realized on the disposal of long-term investments.[15] They are however taken into consideration to determine the tax rate. It follows that any capital loss which occurs from the disposal of long-term investments is not tax deductible, but can be taken into consideration for the tax rate. Other Swiss source capital gains are taxed at ordinary rates. However, other foreign source capital gains are taxed at a favourable rate of approximately 7 per cent.[16]

3. Personal and business assets defined

Having established the importance of the distinction between personal and business assets for the taxation of capital gains, it is necessary to define these notions as precisely as possible.[17]

As a rule, all assets which entirely or primarily serve to promote business activity are treated as business assets (Articles 18, paragraph 2 DTL and 8, paragraph 2 DTL)[18]. Assets are therefore to be considered as business assets if they are directly or indirectly necessary for business purposes.

It is often very difficult to determine whether assets promote a business activity or not. The mere fact that the assets have been omitted from the financial statements of the business is not in itself sufficient to classify the assets as forming personal wealth.[19] Indeed, the economic use of the assets is the primary factor to be taken into consideration. However, it is interesting to note that where a taxpayer makes a capital depreciation on an asset in his financial statements, it is almost certain that this asset shall be characterized as a business asset.

The Swiss Supreme Court's rulings on this subject are not always very predictable. For example, the shares of a company which exploited a quarry were considered to be the business assets of an individual who owned a transportation business.[20] The shares of a construction company were considered to be the business assets of an individual who had his own construction business.[21] Finally, shares in a medical clinic were considered to be the business assets of a medical

6. Art. 16, para. 3 DTL.
7. Arts. 18, para. 2 & 58, para. 1 DTL.
8. Arts. 28 & 62 DTL.
9. Arts. 30 & 64 DTL.
10. Hull H.R., "Income tax incentives for corporations", 50 *Bulletin for international fiscal documentation*, 1 (1996), at 29.
11. Art. 7, Arrêté fédéral instituant une aide financière en faveur des régions dont l'économie est manacée du 6 octobre 1978 (*RS* 951.931); Ordonnance sur l'aide financière en faveur des régions dont l'économie est menacée du 21 février 1979 (*RS* 951.931).
12. Corporations, limited liability companies and corporations with unlimited partners.
13. Art. 28, para. 2 THL.
14. Art. 28, para. 3 THL.
15. Information 4/94, "Imposition des sociétés holding et des sociétés auxiliaires: Nouvelles règles applicables dès le 1er janvier 1995", *Geneva Tax Administration*, 12 December 1994.
16. 20 per cent of taxable gains are taxed at ordinary rates.
17. See Yersin D., "Les gains en capital considérés comme le revenu d'une activité lucrative", *Archives* 59, 137.
18. Circular No. 2, "Revenu provenant de l'activité lucrative indépendante selon l'article 18 LIFD", *Swiss Federal Tax Administration*, 12 November 1992; Constantin C., "Fortune commerciale et fortune privée", *L'Expert-comptable suisse* 5/93, at 333; Hull H.R., "Gain en capital: les modifications fondamentales quant à l'imposition des immeubles servant en même temps à des fins privées et commerciales", *PME* 5,1993, at 37.
19. Supreme Court decisions of 27 June 1975, *Archives* 44, 292; 24 November 1978, *Archives* 49, 72; 14 June 1968, *Archives* 38, 313;
18 May 1986 *Archives* 53, 506; 2 October 1992 *Archives* 63, 37.
20. Supreme Court decision of 4 November 1970, *Archives* 41, 332.
21. Supreme Court decision of 24 November 1978, *Archives* 49, 72.

doctor who wanted to be assured of the use of beds in that same clinic.[22]

The active management of personal wealth may imply that shares are characterized as business assets rather than personal assets. As a rule, assets which form part of the personal fortune of individuals fall within the definition of tax-exempt personal assets. However, if the taxpayer acts in a professional manner, i.e. if his or her activities exceed the mere management of personal wealth, the assets so managed shall be considered as taxable business assets.

A taxpayer acts in a professional manner if he or she systematically buys and sells assets with the intention of making a gain instead of merely taking the occasional opportunities which he or she is presented with.[23] There are no strict rules or safe harbours which must be observed. However, the following factors are among the more important criteria which have been developed by the Swiss Supreme Court:

1. *The number of acquisitions and sales.* The more frequent the transactions, the more probable it is that the taxpayer shall be considered to be acting professionally.
2. *Time lapse between acquisition and sale.* Where there is a short time interval between acquisition and sale, the transaction shall be viewed as more speculative. This will of course increase the likelihood that the individual will be held to be acting professionally.
3. *Knowledge in the field.* Where an individual has training or works in the same field, the probability that the individual will be considered to have acted in a professional manner increases.
4. *Financing.* Where the acquisition of the assets is made possible by a loan rather than by using funds readily available to the taxpayer, the probability that the transaction will be characterized as a professional activity increases. The same is true if the acquisition is financed by accumulated business earnings.
5. *Intention of making a gain.* When an individual has the intention of making a capital gain at the time of the acquisition of the asset, the probability of being characterized as a professional increases.

Although most of the jurisprudence relating to the management of personal wealth is derived from capital gains on immovable property, the Swiss Supreme court has also considered the situation with regards to the sale of shares.[24] According to these decisions, it is necessary to look at each situation on a case by case basis in light of the above mentioned criteria.

In a somewhat surprising decision on 2 October 1992[25], the Supreme Court ruled that a Swiss resident taxpayer was a professional after having invested with two portfolio managers who had been granted a discretionary mandate. The taxpayer had no special knowledge in the field, no infrastructure for portfolio management, and the exterior financing was perfectly justifiable in light of the favourable credit available to him at the time. It was nevertheless considered that the number of transactions, the amount of turnover, and the modest amount of other earned income was sufficient to characterize the transactions as being of a professional nature. It was further mentioned that the fact that the taxpayer does not manage the funds himself is not significant. This decision demonstrates that the mere act of granting a portfolio to an investment manager with instructions to manage in a dynamic way using sophisticated financial instruments, may very well lead to a refusal of the capital gains exemption.[26] This position is very aggressive and has been subject to much controversy.[27]

B. Withholding tax

Withholding tax is levied on certain types of Swiss source investment income as well as on lottery gains and insurance benefits. Investment income is taxed at a flat rate of 35 per cent regardless of the State in which the beneficiary is a resident.[28] Investment income includes interest from bonds and other similar negotiable debt instruments, interest on deposits with Swiss banks, profit distributions from legal entities (dividends) as well as profit distributions from investment funds.

With regard to profit distributions from legal entities, "withholding tax on investment income is levied on interest, annuities, profit sharing and all other income derived from shares, social participations in limited liability companies and cooperatives, participation certificates or profit sharing certificates, issued by a person who is domiciled in Switzerland" (Article 4, paragraph 1(b) Swiss Federal Withholding Tax Law, hereafter: WTL[29]). Profit distributions are defined as any benefit which may be financially quantified and which is granted to the creditor or shareholder in excess of the par value of share-capital. They include ordinary dividend distributions, liquidation proceeds, stock dividends and constructive dividends (Article 20, paragraph 1 Swiss Federal Withholding Tax Ordinance, hereafter: WHTO[30]).

Capital gains are not subject to withholding tax. Nevertheless, in situations where earnings from share transfers are recharacterized as passive income, withholding tax is levied. These exceptional situations are explained under "Special considerations" (see below).

If withholding tax is levied, the implications are very different depending on whether or not the beneficiary of such income is a Swiss resident.

22. Geneva Cantonal Court of Appeal, 14 July 1955, *RDAF* 1955, 283.
23. Supreme Court decision of 27 October 1978, *Archives* 48, 417; 9 November 1990, *Archives* 59, 709.
24. 21 December 1988, *Archives* 58, 666; 9 November 1990, *Archives* 59, 709; 17 February 1986, *Archives* 56, 366; 9 March 1984, ATF 110 Ia 1.
25. *RDAF* 1994, 189 = *Archives* 63, 43.
26. Dubois-Ferrière H.J., "La gestion privée dans le collimateur du fisc", *L'Expert-comptable suisse*, 6/95, at 543.
27. Oberson X. "Jurisprudence récente de droit bancaire en matière administrative et fiscale", *Journée 1994 de droit bancaire et financier*, vol. 1, 1994; Decision rendered on 14 September 1993 by the Zurich Administrative tribunal, *Revue Fiscale* 1994 at 362.
28. The only exception to this rule is under the provisions of the Switzerland–United States tax treaty whereby, under certain conditions, it is possible for a Swiss company to directly pay the reduced treaty rate of 5 per cent on dividend distributions to US majority shareholders.
29. Loi fédérale sur l'impôt anticipé du 13 octobre 1965, *RS* 642.21.
30. Ordonnance d'exécution de la loi fédérale sur l'impôt anticipé du 19 décembre 1966, *RS* 642.211.

For Swiss resident recipients of such income[31], withholding tax is a means of enforcing compliance with Swiss income tax reporting requirements. Withholding tax is reimbursed by way of cash refunds (corporate taxpayers) or as a credit against income tax payable (individual taxpayers). This is subject to the condition that the assets and the income derived therefrom are correctly reported for income tax purposes by the beneficiary[32] and that the recovery of Swiss withholding tax does not lead to an abuse of law.[33]

For most non-resident recipients, Swiss withholding tax represents a final tax on Swiss source investment income.[34] However, if the non-resident beneficiary is a resident of a State with which Switzerland has concluded an international tax treaty, he or she may be able to obtain a partial or total reimbursement.[35]

C. Transfer stamp tax

Share transfers which involve a Swiss securities dealer are usually subject to transfer stamp tax at a rate of 0.15 per cent on shares in Swiss resident companies, and 0.3 per cent on shares in non-resident companies. (Articles 13, paragraph 1 & 16, paragraph 1 Swiss Federal Stamp Tax Law, hereafter: STL[36]). Shares, participation certificates and profit sharing certificates in Swiss or foreign corporations, as well as participations in limited liability companies or cooperatives are all considered as taxable securities.[37]

Swiss securities dealers include banks and bank-like financial institutions as defined by Swiss banking law[38] as well as investment fund managers. They also include individuals, companies, partnerships and branches of foreign companies whose essential activities are linked to trading in taxable securities or acting as intermediaries in deals involving taxable securities. In addition to these finance operations which one would typically imagine to be covered under the definition of "securities dealers", Swiss tax law has recently extended this definition to include other companies which are not predominantly in the securities trading business. Indeed, companies who own taxable securities with a book value in excess of CHF 10,000,000 also qualify as securities dealers.[39]

Securities dealers are considered as Swiss when they are either domiciled in Switzerland, reside in Switzerland on a long term basis, or have their place of incorporation in Switzerland.[40]

The tax rates are applied to the fair market value of the shares being transferred and the tax is payable upon conclusion or completion of the transaction. Usually, each party suffers the cost of one half of the transfer stamp tax. The securities dealer pays the tax on behalf of any party who is not a Swiss securities dealer.

Relief on share transfers may be obtained on the following transactions:

- share issues;[41]
- share redemptions;[42]
- purchase of trading stock by banks and professional traders;[43]
- transactions between registered securities dealers;[44]
- transactions in foreign securities between a Swiss dealer and foreign banks or traders.[45]

III. SPECIAL CONSIDERATIONS

The following is a brief checklist which introduces some of the more important situations in which the taxation of share transfers differs from the general principles described so far. Some are based on legislation, others on case law; still others are based on administrative practice.

With regard to case law, there are a number of situations in which the Swiss Supreme Court has re-characterized a tax-exempt capital gain as taxable income. At the outset, it is worth mentioning that this only happens in exceptional circumstances. Indeed, "in business, it may often occur that a company is transferred to another without being dissolved. Such reorganizations are not suspect per se. However, this may be the case in other circumstances".[46] The Supreme Court grants itself the possibility of applying the substance over form doctrine to suspect transactions.

A. Share issues

Share issues are usually not subject to Swiss income tax or withholding tax. However, where the share issue of a Swiss company is the result of the incorporation of reserves (stock dividends)[47], income tax and withholding tax is due on the amount of reserves which are converted into share capital.[48] There is nevertheless a possibility of avoiding the payment of the withholding tax by using the declaration method.[49] Under this method, the share issue is merely declared to the Swiss Federal Tax Administration. This is only possible if the bene-

31. Including individuals subject to lump-sum taxation.
32. Arts. 23 & 25 WTL.
33. Art. 21, para. 2 WTL.
34. With the exception of Art. 24, para. 3 WTL which allows Swiss permanent establishments of non-resident enterprises to recover Swiss withholding tax, and Art. 27 WTL which allows for foreign investors in Swiss investment funds to obtain reimbursement of Swiss withholding tax if more than 80 per cent of the income is generated from foreign sources.
35. E.g. Art. 10, para. 2 OECD Model Tax Convention on Income and on Capital.
36. Loi fédérale sur les droits de timbre du 27 juin 1973, *RS* 641.10 (last major modification concerning transfer stamp tax on 1 April 1993: RO 1993 222 227; FF 1991 IV 481 505).
37. Art. 13, para. 2a STL.
38. Loi fédérale sur les banques et les caisses d'épargne, *RS* 952.0.
39. Art. 13, para. 3 STL.
40. Art. 4, para. 1 STL.
41. Art. 14, para. 1b STL.
42. Art. 14, para. e STL.
43. Art. 14, para. 3 STL.
44. Art. 17, para. 2 STL.
45. Art. 19 STL.
46. *RDAF* 1971, 31.
47. "Actions gratuites".
48. Art. 20, para. 1c DTL & Art. 20, para. 1 WHTO.
49. Arts. 20 WTL & 24 WHTO.

ficiaries are all Swiss residents who declare their income regularly (i.e. would normally qualify for reimbursement), and where the number of shareholders does not exceed 20.

Share issues by Swiss companies escape transfer stamp tax.[50] However, they generally give rise to an issuance stamp tax.[51] As of 1 January 1996,[52] this tax is levied on all share issues in excess of CHF 250,000 at a rate of 2 per cent. It is levied on the amount paid in exchange for the shares received. If there is a premium i.e. if the subscription price exceeds the nominal value of the shares, any costs linked to the share issue as well as the issuance stamp tax itself may be deductible.[53]

B. Dormant companies

In Switzerland, the sale of the majority of shares in a dormant company is considered to constitute tax evasion.[54] This is due to the fact that, other than to save on taxes, there is no commercially justifiable reason to sell a dormant company rather than to liquidate it and create a new company.

A dormant company[55] is a legal entity which is economically liquidated or whose assets have been rendered liquid.[56] A company is "economically liquidated" if it has no substance at the time of the share transfer. The term "rendered liquid" is more difficult to interpret. Liquid assets are those which may be realized at short notice (cash, bank accounts, short term shares and bonds and short term loans).[57] It should however be noted that the liquidity of the assets must be a result of the realization of assets which are necessary for ordinary commercial purposes. In addition, this realization must be a consequence of a decision to cease all activity. In other words, there must be both a cessation of the commercial activity and a realization of assets.[58]

Where finance companies are concerned, their commercial activity is often restricted to the management of moveable assets which can very easily be realized. Therefore, in light of current Swiss case law, a transfer of the shares in such a company should not be considered as abusive since there is no cessation of commercial activity. That being said, all share transfers in dormant companies which have been considered by the Supreme Court have involved commercial companies who had evidently ceased all activities. At the present time it is not possible to predict whether Swiss case law may go a step further and rule that there is an abuse of law on the sale of shares in a company whose assets have always been relatively liquid.

The taxes that the parties aim to save by transferring shares in a dormant company may be considerable. The savings arise because a sale of shares is considered as a tax neutral capital gain (with the exception of capital gains realized on business assets). However, where a company is liquidated, there is a distribution of income rather than a capital gain. This is subject to Swiss withholding tax and income tax. In addition, the creation of a new company implies a share issue upon which issuance stamp tax is levied.

As a result of the possibility of tax evasion mentioned above, the Swiss competent authorities apply the substance over form doctrine and look through the legal structure. The share transfer is therefore not considered as a capital gain, but is recharacterized as a liquidation of the company by the seller followed by a creation of a new company by the purchaser.[59] This leads to the following tax liability:

- withholding tax is due on the deemed liquidation proceeds which is calculated as the difference between the sales price and the amount paid up on the shares;[60]
- income tax is levied on the seller on the above difference;[61]
- issuance stamp tax is levied at 2 per cent on the net value of the transferred company if such value exceeds CHF 250,000.[62]

If the dormant company is in a loss situation at the time of the share transfer, there are no liquidation proceeds upon which withholding tax or income tax may be levied. However, withholding tax is levied if the new shareholder does not inject enough funds into the company to fully cover the share-capital. The reason being that the share-capital will have to be covered by future income and this has the same consequences as a share issue effected through the incorporation of reserves. With regards to corporate income tax, it should be noted that any loss which may have existed prior to the share transfer may not be carried forward. Issuance stamp tax is levied on the value of the share capital regardless of the net value of the company (provided the share-capital is in excess of CHF 250,000).

C. Privately held shares transferred to closely held businesses

The Supreme Court considers that a Swiss resident individual obtains an unintended tax advantage when he or she transfers privately held shares to a business (such as a personal holding company) which he or she controls, for a consideration exceeding par value.

The tax advantage from this reorganization of personal wealth is derived from the fact that the potential income tax liability on the difference between the nominal value of the shares and their market value at the time of the share transfer disappears. Indeed, if it is considered as a capital gain, the share transfer is tax exempt in the hands of the seller. In addi-

50. Art. 14, para. 1b STL.
51. Art. 5 STL.
52. FF 1995 I 85.
53. Art. 5, para. 2b STL.
54. *RDAF* 1961, 302 = *Archives* 30, 105; *RDAF* 1966, 179 = *Archives* 34, 376; *RDAF* 1976, 317 = *Archives* 44, 378; *RDAF* 1989, 164 = *Archives* 55, 646; *RDAF* 1995, 50 = *Archives* 62, 628.
55. "Commerce de cadres juridiques ou vente de manteau d'actions".
56. Art. 5, para. 2b STL.
57. Rivier J.M., "Introduction à la fiscalité de l'entreprise", *Lausanne*, 1994, at 235.
58. Rivier J.M., "La liquidation partielle des sociétés anonymes" *Revue Fiscale* 1/90, at 14.
59. Stockar C., "Aperçu des droits de timbre et de l'impôt anticipé", *Lausanne* 1994, at 92 & 137.
60. Arts. 4, para.1b WTL & 20, para. 1 WHTO.
61. Art. 20, para 1c DTL.
62. Art 5, para. 1b STL.

tion, since the buyer is a business, any capital gains realized on a subsequent sale of the shares is subject to taxation on the difference between their book value (usually the market value at the time of the initial share transfer) and the consideration received.[63]

This is considered as abusive since the shares are never really sold to a third party.[64] Indeed, although the shares are sold to a separate legal entity, they indirectly continue to be a part of the seller's wealth by becoming the property of a company over which the seller has control.

As a result of this reasoning, the Swiss competent authorities consider that the individual realizes taxable income rather than a capital gain. Hence, income tax is levied on the difference between the nominal value of the shares transferred and their transfer price.[65]

This adverse tax liability may be avoided by using the so called "agio" method. This has been introduced so that the various taxing jurisdictions are not deprived of the potential income tax on the difference between the nominal value of the shares and their market value at the time of the initial share transfer. The method allows the buyer to make a clear distinction between the nominal value of the shares and the amount paid in excess of par value. The latter should be accounted for as a reserve in the financial statements so that any capital gain on their subsequent sale is subject to taxation.

The transfer of shares to closely held businesses can also have withholding tax repercussions if a non-resident shareholder transfers his or her shares to a Swiss company shortly before a distribution of dividends or liquidation. (See below.)

D. Share acquisitions using target company financing

This paragraph concerns share transfers where the reserves in the target company are taken out and used by the buyer to pay off the seller. This practice is often referred to as the sale of a wallet with the money inside[66] and results in a partial liquidation of the target company.[67] There are many different methods by which the reserves of the target company may be used by the buyer to finance the transaction (open dividends, constructive dividends, merger with holding company etc.). Among the methods which are more commonly used is the loan which is granted to the buyer (leveraged buy out) or the transfer of a company loan from the seller to the buyer (assignment of a debt).

Usually, this transaction triggers a tax-exempt capital gain[68] in the hands of the seller. In addition, if the buyer is a business, any capital gains realized on a subsequent sale of the shares is subject to taxation on the difference between their book value (usually the market value at the time of the initial share transfer) and the consideration received. Hence, the potential income tax liability on the difference between the nominal value of the shares and their market value at the time of the share transfer disappears.

However, this tax exemption is considered as abusive where the partial liquidation of the target company is the result of a concerted action between buyer and seller. As a result, the Swiss competent authorities consider that the seller realizes taxable income rather than a capital gain if the following conditions are fulfilled:

- the seller is a Swiss resident individual whose shares form part of his personal assets;
- the buyer is a business;
- the share transfer is financed using the reserves of the target company; and
- the seller has actively or passively collaborated in the financing aspects of the transaction.

If these conditions are fulfilled, income tax is levied on the difference between the nominal value of the shares transferred and the amount which is used to finance the acquisition.[69]

Target company financing also has withholding tax implications where the share transfer takes place between a non-resident seller and a resident buyer. Indeed, the distributions made by the target company which lead to its partial liquidation are subject to withholding tax. This tax is usually reimbursed in full to the Swiss resident shareholder upon request. However, the Swiss Federal Tax Administration can disallow the reimbursement of the withholding tax by arguing that there is an abuse of law. (Article 21, paragraph 2 WTL).[70]

E. Dividends and liquidation proceeds subsequent to share transfers

Many share transfers are motivated by the possibility of reducing the 35 per cent Swiss withholding tax payable on subsequent dividend distributions or liquidation gains. Such transfers are usually done by non-residents who own cash-rich companies and who are unable to obtain full or partial

63. In other words, the nominal value principle for the evaluation of capital gains is replaced by the accounting principle.
64. "Théorie de la transposition": See Gurtner P., "Changement de système d'imposition lors de transfert de participations", *Archives* 57, 23; Houriet I, "Cas particulières de prestations appréciables en argent", IFF & OREF seminar, Montreux, 26 March 1996; Neuhaus H.J. / Lampert J., "Ventes de droits de participation: Bénéfices privés en capital ou Rendements de fortune imposables", *Revue fiscale* 8/92, at 372; Rouiller A., "Problèmes fiscaux découlant des apports de participation à une société holding dominée par le même actionnaire", *Berne*, 20 October 1988; Yersin D., "A propos de la distinction entre le rendement de fortune et les gains en capital", *Archives* 50, at 491.
65. *RDAF* 1970, 243 = *Archives* 37, 43; *RDAF* 1975, 167 = *Archives* 42, 393; *RDAF* 1976, 179 = *Archives* 43, 588; *RDAF* 1988, 193 = *Archives* 55, 206; *RDAF* 1992, 85 = *Archives* 58, 689; Circular No. 6 "Apport de participations dans une société dominée par le même actionnaire", *Swiss Federal Tax Administration*, 3 February 1987.
66. Lampert J., "Ventes de droits de participation: bénéfices privés en capital ou rendements de fortune imposable", *Revue Fiscale* 9/92, at 423.
67. "Liquidation partielle indirecte": *RDAF* 1986, 374 = *Archives* 54, 211; *RDAF* 1991, 1 = *Archives* 58, 587; *RDAF* 1991, 7 = *Archives* 58, 594; *RDAF* 1991, 12 = *Archives* 58, 600; *RDAF* 1993, 20 = *Archives* 59, 717; STE 1995 B24.4 No. 38.
68. With the exception of capital gains realized on business assets.
69. Béguin P., "Des dangers de la création administrative de l'impôt: la liquidation partielle indirecte", L'Expert-comptable suisse 12/93; Rivier J.M., "La liquidation partielle des sociétés anonymes" *Revue Fiscale* 1/19, at 16; Ryser W., "De la terre ferme au marécage", *Archives* 60, at 577.
70. *RDAF* 1970, 304 = *Archives* 39, 114; *RDAF* 1973, 27 = *Archives* 40, 512; *RDAF* 1982, 34 = *Archives* 50, 145; *RDAF* 1982, 267 = *Archives* 50, 583.

relief of Swiss withholding tax based on tax treaty dispositions. In the absence of treaty dispositions, the Swiss withholding tax becomes a final liability. There is therefore a strong temptation to sell the shares to a Swiss resident or to a resident of a State with which Switzerland has a favourable tax treaty in order to obtain a full reimbursement of the Swiss withholding tax. This is often done by way of a share transfer to a personal holding company rather than a straight third party transaction. However, the Swiss competent authorities do not look kindly upon this practice.[71]

Where the shares of a Swiss company held by non-residents are sold to Swiss residents shortly before being totally or partially liquidated[72], the entire amount of the withholding tax levied can usually be reimbursed to the Swiss resident purchaser on the basis of Swiss domestic withholding tax legislation.[73] However, the reimbursement of Swiss withholding tax is refused in situations of tax evasion.[74] Based on this rule, the Swiss Federal Tax Administration refuses the reimbursement of withholding tax if the Swiss shareholder acquires shares shortly before a complete or partial liquidation.[75]

Similarly, where the shares of a Swiss company held by non-residents are sold to residents of a State with which Switzerland has a favourable tax treaty, the treaty rate shall not automatically be applied. In particular, both the Swiss federal tax administration and the Supreme Court are very attentive with regards to dividend distributions made from Swiss resident companies to residents of States with which Switzerland has the zero per cent treaty rate on dividend distributions.[76] Switzerland has a zero per cent treaty rate on dividend distributions to majority shareholders in its tax treaties with the Netherlands, Denmark, Luxembourg and Sweden[77] and is currently negotiating a zero per cent rate with France and Germany. Where the shares of a Swiss company are transferred to residents of these States after having been held by shareholders in other States for a certain length of time, the zero per cent treaty rate shall often be refused on any open reserves existing at the time of the share transfer.

In practice, it is often possible to obtain a partial reimbursement of Swiss withholding tax by virtue of the tax treaty between Switzerland and the State in which the previous shareholders are resident. This is justified by the presumption that the open reserves which exist before the share transfer should normally have been distributed to the previous shareholders. If the distribution had been done prior to the share transfer, it is the treaty dispositions between Switzerland and the State of which the previous shareholders are residents which would have been applicable. It goes without saying that if the previous shareholders did not qualify for treaty relief on dividend distributions, no relief from Swiss withholding tax is available. The Supreme Court does not always follow this line of reasoning.[78]

F. Related party transfers

Related party transfers involve the sale of shares between two companies of the same multinational group. Swiss tax laws at both cantonal and federal levels have no rules specifically dealing with transactions between members of the same multinational group. However, general tax principles dealing with the concept of corporate profits allow the Swiss tax administration to look through a given transaction to determine whether artificial shifting of income is taking place i.e. whether a company is involved in inappropriate transfer pricing practices. Furthermore, most tax treaties allow for the correction of accounts based on inappropriate transfer pricing practices. In particular, Article 9, paragraph 1 of the OECD Model Treaty provides as follows:

> Where
>
> (a) 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
>
> (b) 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.

Based on these general rules, transactions with affiliates may be closely analysed by the tax administration. The tax administration may reconsider transactions which appear to be contrary to what should normally take place between unrelated parties in similar circumstances and adjust the company's books as appropriate.

It should be pointed out that the need to meet arm's length principles, and arrive at a proper level of taxable profits, arises irrespective of the existence of a tax avoidance motive.

In the event that the Swiss tax administration considers there to be an inappropriate transfer price in favour of another person, the taxable income of the company shall be adjusted by adding the missing fair consideration. The income tax based on the adjusted profits shall be increased accordingly. The right to modify an assessment for a given year is time-barred five years after the end of the year during which the tax is due.

Swiss withholding tax law generally considers there to be a taxable constructive dividend distribution (hidden profit distribution) when a company does not receive adequate consid-

71. Clopath G., "Changement d'actionnaire et impôt anticipé", *L'Expert-comptable suisse* 12/93, at 889.
72. *RDAF* 1953, 76 = *Archives* 20, 405; *RDAF* 1958, 305 = *Archives* 26, 371; *RDAF* 1966, 294 = *Archives* 33, 511.
73. Arts. 22 & 24 WTL.
74. Art. 21, para. 2 WTL.
75. See *supra* note 59.
76. Federal tax administration decision of 25 April 1979, *RDAF* 1979, 142; Supreme Court decision of 9 November 1984, ATF 110 Ib 287 = *RDAF* 1986, 142.
77. Art. 9 Switzerland–Netherlands tax treaty; Art. 10 Switzerland–Denmark tax treaty; Art. 10, para. 1 (b) Switzerland–Luxembourg tax treaty; Art. 1 "Protocole du 10 mars 1992 modifiant la convention du 7 mai 1965 entre la Confédération suisse et le Royaume de Suède en vue d'éviter les doubles impositions en matière d'impôts sur le revenu et sur la fortune".
78. *RDAF* 1982, 38.

eration for its performance to a related party. As such, the 35 per cent withholding tax is due. Constructive dividends are payments, whether in cash or in kind, which are made to shareholders or associated persons which are not expressed as dividends. The Swiss Supreme Court has determined that there is a constructive dividend when:

- the company grants a benefit to a shareholder or other affiliated party which may be financially quantified without receiving adequate consideration in return;
- the benefit would not have been made available to a third party under arm's length dealings, or would not have been made in the same manner or amount; and
- the lack of proportion between the benefit granted by the company and the consideration received in return could be, or should have been, apparent to the officers of the company.

G. Real estate companies

The transfer of shares in real estate companies follows the same rules as described above for income tax[79], withholding tax and transfer stamp tax purposes. Hence, individuals who make a capital gain on the sale of Swiss immovable property are not subject to ordinary income taxes or withholding tax. However, most cantons and communes have introduced a special property transfer tax[80] specifically for the taxation of profits from the alienation of immovable property by individuals. These laws often look through the legal structure of real estate companies and levy taxes on share transfers in such companies.[81]

Property transfer tax is normally due on the difference between the cost of acquisition and the sales proceeds. In Geneva tax rates depend on the number of years during which the shares in the real estate company are held.[82] They range from 50 per cent if the shares are held for under two years to a total exemption if the shares are held for more than 25 years. Special relief is often granted where the amounts received from the sale of the Swiss immovable property is reinvested in similar investments within a limited time-frame (roll-over relief).

H. Share redemptions

Share redemptions are usually treated as if they were a partial liquidation of a company.[83] As such, anything received in excess of the share-capital represented by the redeemed shares (whether in cash or in kind) is subject to Swiss withholding and income tax.[84] However, no such tax is payable if the amount received by the former shareholder does not exceed the par value of the redeemed shares.

As per the recently modified Swiss Code of Obligations[85], it is possible for a Swiss company to buy back a maximum of 10 per cent of its own shares if the buy back can be financed by readily available funds.[86] The Swiss Federal Tax Administration considers that the buy-back of shares is subject to taxation in the same manner as a partial liquidation unless the company resells its shares within a two year period.[87] In the latter situation, the seller earns a tax-exempt capital gain rather than taxable income.

79. Capital gains on the sale of real estate companies which own real estate in Geneva are not exempt from income tax under domiciliary company rules.
80. "Impôt sur les bénéfices immobiliers", E.g.: Art. 80 Geneva Cantonal Tax Law (Hereafter: CTL-GE) = Loi générale sur les contributions publiques du 9 novembre 1887, D 3 1.
81. E.g. Art. 80, para. 2 CTL-GE.
82. E.g. Art. 84 CTL-GE.
83. "Liquidation partielle directe".
84. *Supra* note 58 at 15.
85. Art. 659 (revised version entered into force on 1 July 1992).
86. A company may acquire up to 20 per cent of its own shares if the acquisition is the result of a restriction on the transfer of shares which prevents shareholders from transferring their shares to third parties. However, shares in excess of 10 per cent must be sold or cancelled within two years.
87. Letter dated 2 May 1995 addressed by Mr Otto Stich, head of the Swiss finance department to the Swiss Chamber of Certified Accountants and Tax Consultants; Circular No. 25, "Effets de la révision du droit de la société anonyme du 4 octobre 1991 sur l'impôt fédéral direct", *Swiss Federal Tax Administration*, 27 July 1995.

Tax Incentives for New Ventures in Switzerland

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I. INTRODUCTION

Measured by European standards, Switzerland can hardly be viewed as a country threatened by economic hardship. Switzerland's income per capita is the second highest in the world and its economy is considered to be the most competitive in Europe.[1] Nonetheless, there are some Swiss regions currently suffering from economic depression. As a result, most Swiss cantons and, to a certain extent, the Swiss Federation, have developed a wide range of incentives designed to attract new enterprises and generate new jobs in depressed regions. These economic development programmes contain both governmental support (such as loan guarantees, low interest loans or investment premiums) and tax incentives.

The tax incentives are available to nearly all types of venture, including corporations, partnerships and, in most cantons, permanent establishments of foreign entities. They range from favourable provisions for depreciation and reserve allowances to tax holidays, the latter being the most attractive and far-reaching incentive available.

II. LEGAL BASIS OF TAX HOLIDAYS

Swiss taxes are imposed at a federal, a cantonal and a communal (municipal) level (generally, hereafter communal taxes will be included with cantonal taxes.) The cantonal taxes are usually more significant than the federal taxes, at times amounting to as much as three times the federal tariff. The tax holiday regimes at the cantonal and the federal level are based on different historical precedents.

A. Legal basis at the cantonal level

Until recently, the Swiss cantons were almost fully sovereign in their direct tax matters. In the beginning of this century, various cantons made full use of their sovereignty. In some cases, the cantonal tax administration had the authority to negotiate taxation on an individual basis, in order to attract major taxpayers. As a result, the practice of the tax authorities began to contradict the principles of legality and equal treatment.[2]

During this period, the Swiss Federation had no legal means to intervene in this situation because the tax sovereignty of the cantons was explicitly granted by the Swiss Constitution. In a rather exceptional demonstration of self-restriction, however, the Swiss cantons moved to regulate themselves in 1948, creating a treaty (Konkordat)[3] in which each canton agreed to an interdiction of tax rulings.

This inter-cantonal treaty does not provide for a definition of the term "tax ruling". From precedents, it can be determined that the interdiction applies only to tax rulings which are between the tax authorities and the taxpayer on a case-by-case basis which provide for individual tax privileges without legal support. On the other hand, at a general level the cantons are free to grant tax exemption or relief to certain types of companies, e.g. holding, domiciliary or mixed companies, if the tax privileges are clearly defined in the respective tax laws. Furthermore, the tax authorities are not restricted in granting rulings to clarify the tax treatment of specific cases which are covered by sound tax law.[4]

The inter-cantonal treaty names two exceptions in which the cantons can still offer tax relief on a case by case basis; lump-sum taxation for certain categories of individuals, and tax holidays for newly established ventures. Regarding the latter exception, the cantons agreed to grant tax holidays only to new manufacturing enterprises which were of particular economic interest to the canton.

After an amendment to the Constitution,[5] the Swiss Federation was finally granted greater powers to standardize the cantonal tax systems. On 1 January 1993, a Tax Harmonization Law[6] (hereafter, THL) entered into force. Article 5 of the THL confirms the right of the cantons to offer tax relief to new ventures in a more general way[7] than the inter-cantonal treaty. However, the THL is not self-executive. The cantons are obliged to adjust their tax laws to the new standards. The THL provides for a rather long transition period of eight years (which expires at the end of the year 2000). Since most cantons have not yet adjusted their tax laws, the old inter-cantonal treaty is still in force.

Under both the inter-cantonal treaty and the THL, the cantons can provide for tax holidays but they are not obligated to do

1. World Competitiveness Report 1995, published by the World Economic Forum Geneva and the IMD management school in Lausanne.
2. Steuerinformationen, issued by the *Federal Tax Administration*, vol. 1, part A, 2nd. Subpart at 1 and Eveline Oechslin, Besteuerung ausländisch beherrschter Kapitalgesellschaften mit Ansässigkeit in der Schweiz at 46.
3. Interkantonales Konkordat über Steuerabkommen, vom 10. Dezember 1948.
4. As a matter of fact, tax rulings are of major importance in Switzerland, particularly with respect to the wide range of discretion the Swiss tax laws offer to the tax authorities. The rulings ensure that the authorities will not interpret a specific tax provision differently at a later stage.
5. Art. 42 quinquies BV, approved by public vote on 12 June 1977.
6. Bundesgesetz vom 14. 12. 1990 über die Harmonisierung der direkten Steuern der Kantone und Gemeinden, SR 642.14.
7. See section below.

so. Out of the 26 cantons 23 have exercised their right to introduce a privileged tax regime. Only the cantons of Zurich, Zug and Aargau do not have any tax holiday provisions. The canton of Zurich, however, plans to introduce holiday status in 1999.

B. Legal basis at the federal level

In 1978, the federal parliament passed a decree which allowed the Swiss Federation to offer tax relief to new manufacturing ventures. For Constitutional reasons, the term of validity of this "Decree on Financial Assistance for Economically Depressed Regions"[8] was limited. A new "Decree in Favour of Economic Renewal Areas".[9] is scheduled to become effective on 1 July 1996. The new decree essentially follows the pattern of its predecessor. Still, the federal tax holiday regime clearly has its legal roots outside the tax legislation. This is reflected in the new federal Direct Tax Law[10] (hereafter DTL) which has been in force since 1 January 1995. In contrast to the THL, the DTL does not even mention the possibility of obtaining a tax holiday.

III. ACTIVITIES WHICH MAY QUALIFY FOR TAX HOLIDAYS

As a reflection of their history, cantonal and federal legislation provides for different definitions of the activities which may qualify for a tax holiday. In recent years, however, the practices of the cantonal and federal tax authorities have become increasingly similar.

A. Qualifying activities at the cantonal level

According to the wording of the old inter-cantonal treaty, only manufacturing enterprises could be entitled to a privileged tax treatment. However, limiting privileged treatment specifically to manufacturing companies was not mentioned in the protocols of the treaty negotiations. The emphasis was clearly on the economic benefit to depressed regions and not on a narrow interpretation of the qualifying activities of the venture.[11] Consequently, Article 5 of the THL indicates only that those companies representing newly established ventures are entitled to tax relief, and makes no further restrictions regarding their activities.[12] In addition, the article specifies that those companies undergoing a significant change of business are to be allowed the same tax privileges as newly established ventures.

B. Qualifying activities at the federal level

Under the old federal decree, only manufacturing ventures could qualify for a federal tax holiday. However, in practice, manufacturing was given a broad meaning and included other industrial activities. Furthermore, tax relief was not limited to new ventures. Existing enterprises could also apply for a tax holiday if they substantially changed their product lines or their production methods in order to meet the needs of the market. In general, this broader application is still granted under the scope of the new Decree on Economic Renewal Areas. In addition, even service companies may qualify, provided that their services are closely linked to industrial activities.

IV. PROCEDURE

Applications for tax holidays are usually filed with the cantonal government. In most cantons, the decision of the government relies to a larger extent on the opinion of the cantonal economic development agencies than on that of the cantonal tax authorities. This tendency is even more pronounced at the federal level. Consistent with the fact that the federal tax holidays have their legal basis outside of tax law, the tax holidays are granted by the federal Ministry of Economic Affairs, and not by the Ministry of Finance. In practice, the procedure is strongly influenced by the cantonal economic development agencies and the federal Office of Industry and Labour.[13] The temporal limitation and the extent of the tax relief are set out in a ruling which also states the conditions a venture has to observe in order to retain the holiday status.

V. TEMPORAL LIMITATION

One of the few standard conditions attaching to tax holidays is their temporal limitation. The holidays may not exceed a maximum period of ten years. This limitation applies at both the cantonal and federal level.[14] Among the cantons which grant tax holidays, only Basel-Land provides for a shorter period.[15]

The ten year maximum cannot be extended. However, there are several cases in which a company has obtained a tax holiday for a second time. In these cases, the venture could demonstrate that their production was significantly improved and increased, conditions that are recognized as a significant change of business.

VI. EXTENT OF TAX HOLIDAYS

The cantons have a decisive influence on the extent of tax holidays. A federal tax holiday will never extend beyond that granted by a canton.

8. Bundesbeschluss über Finanzbeihilfen zugunsten wirtschaftlich bedrohter Regionen, often referred to as "lex Boni", SR 951.93.
9. Bundesbeschluss zugunsten wirtschaftlicher Erneuerungsgebiete vom 6. Oktober 1995.
10. Bundesgesetz vom 14.12.1990 über die direkte Bundessteuer.
11. Steuerinformation, at 11.
12. See also Irene Salvi, "Investment Incentives for Manufacturers" 31 *European Taxation*, 3 (1991) at 91. At this time, the tax holidays were predominantly limited to manufacturing enterprises.
13. Bundesamt für Industrie und Gewerbe, BIGA.
14. Art. 5 THL and Art. 9 Decree in Favour of Economic Renewal Areas.
15. See Appendix. Limitation to seven years.

A. Extent of cantonal tax holidays

Typically, a cantonal tax holiday ruling covers income taxes and capital (wealth) taxes. Usually, the ruling waives a percentage of the standard taxes. The extent of the waiver depends on various factors involving:

- the number of jobs maintained or created;
- the nature, importance and size of the investment;
- the importance of innovation brought to the renewal area;
- the development of new technologies;
- the encouragement to other ventures to set up a business in the same area; and
- the structural preferences in developing a particular renewal area.

The extent of the waiver is generally not determined in the tax law, and not even in governmental directives or guidelines. As a general rule, it should be possible to reduce the cantonal and Communal taxes by at least half. In the best case, the tax holiday can entirely eliminate income and wealth taxes.

Only one canton, Ticino, names a specific criterion to determine the extent of tax relief. Typically, the more a venture invests, the higher their tax relief.[16] In the other cantons, there is considerable room for discretion among the authorities, regarding both the approval of the application and the determination of the extent of the tax holiday. Although there are no official statistics, it seems that most cantonal authorities have become extremely receptive to applications for tax holidays in recent years. They also appear to be more willing to grant a full waiver of income and wealth taxes to an attractive venture than they had been in the past.

To a certain extent, a venture applying for tax relief may influence the ruling procedure through the quality of the application and their negotiations with the tax authorities. Usually, the often-heard statement that taxes are negotiable in Switzerland is far from reality. With respect to tax holidays, however, negotiations may have a significant impact.

B. Geneva as an example

The canton of Geneva, host of this year's IFA congress, provides a typical example of the process of granting tax holidays. A brief provision in Geneva's cantonal tax law[17] authorizes the cantonal government to grant tax holidays up to a maximum duration of ten years. Details are set out in governmental directives.[18] The directives name various categories of tax relief, including a digressive waiver of income and capital taxes. However, there are no details regarding the extent of the waiver in the directives. In practice, the government typically grants a complete exemption from cantonal and communal taxes for the first year. The tax relief then decreases by 10 per cent annually over the ten year period. Alternatively, some ventures are granted a full exemption from cantonal and communal taxes for the first five years, decreasing by 20 per cent annually up to the tenth year. However, since no specific rule exists, any type of tax relief can be requested within these limits, depending on the company's tax planning. The directives are even flexible enough to allow a full tax exemption over a ten-year period, for cases where the venture appears to present extremely attractive economic renewal possibilities.

C. Granting of federal tax holidays

The Swiss Federation only grants tax holidays to enterprises located in economic renewal areas. In order to qualify as a renewal area, a region must display an unbalanced economic structure e.g. dependence on a single industry, as well as an unemployment rate which is above the Swiss average.

The canton of Geneva, for instance, does not qualify as a economic renewal area, in contrast to various regions in the neighbouring cantons of Vaud, Neuchâtel and Fribourg. Although the federal criteria are stricter than those of the cantons, in the last few years many regions have been declared renewal areas. At the present time, the majority of the cantons have one or more renewal areas. Most of these regions have excellent access to domestic and international air, highway or rail road transportation and many of them are within commuting distance to the major metropolitan areas of Zurich, Geneva, Basle and Berne.

According to both the Decree on Financial Assistance for Economically Depressed Regions and the new Decree in Favour of Economic Renewal Areas, a federal tax holiday may not extend beyond the holiday granted by the canton. On the other hand, the federal authorities have the right to grant less generous tax relief than the canton, if they come to the conclusion that the new venture is less important to the economic development of the area than was assessed by the canton. However, the federal and cantonal authorities typically coordinate their procedures and attempt to come to a consistent treatment of the tax holiday. In compromise situations, the canton may not grant full relief while the relief at the federal level will extend further than originally intended by the federal authorities.

Recent cases show that Switzerland's federal tax authorities have become less reluctant to grant full tax holidays to new ventures which can demonstrate that they will make a substantial contribution to the economic development of the renewal area. However, the federal authorities still resist granting full tax holidays in cases where there has merely been a change of product lines or production methods. This emphasizes the fact that the federal authorities clearly favour new ventures.

VII. OTHER TAX INCENTIVES

The Swiss tax system offers various tax incentives in addition to tax holidays. Special tax privileges are available for certain types of activities, including holding companies, domiciliary

16. See *supra* note 2 (Eveline Oechslin at 50).
17. Loi générale sur les contributions publiques, Art. 14A.
18. Directives sur les allégements fiscaux en faveur des entreprises du Décembre 1995.

companies or auxiliary companies.[19] In addition, the tax system offers various possibilities to defer income taxes. Most of the favourable reserve allowances and provisions for depreciation are granted on a general basis to any type of business. Further tax relief may be obtained in connection with a tax holiday ruling.

A. Tax-deductible reserves

Switzerland's tax legislation with respect to the build up of tax-deductible reserves is possibly one of the most liberal in the world. The tax-effective provision of the following reserves, for instance, is accepted without further substantiation:
- bad debt reserve of 5 per cent on domestic and 10 per cent on foreign accounts receivable;
- inventory reserve of the lower of: one third of the inventory's cost or market value;
- reserve for major building repairs (e.g. 0.5 per cent of fair market value);
- warranty provisions (1 – 3 per cent, depending on the line of business);
- redundancy provisions (e.g. up to 20 per cent of annual salary costs); and
- provision for future research and development up to 10 per cent of taxable profits but not exceeding CHF 1 million.[20]

A tax holiday ruling may allow a venture to build up tax-deductible reserves in excess of the aforementioned standard rates.

B. Depreciation

Swiss depreciation rates are also fairly generous. Manufacturing equipment and machinery, for instance, can be depreciated at 30 per cent (under the declining balance method) and motor vehicles, electronic data processing equipment, and intangible assets (patents, trademarks and goodwill) at 40 per cent.

In addition, various cantons allow the use of special accelerated tax depreciation methods. These methods are also granted in some of the cantons which do not offer a tax holiday regime. The canton of Zurich, for instance, allows 80 per cent of the purchase price of movable assets to be written off as a tax deductible expense in the first year.

Tax holiday rulings in other cantons may allow comparable depreciation rates. With regard to the full or partial tax relief granted under the ruling, it would often be more beneficial to keep the depreciation to a minimum during the holiday period and utilize the write-off potential at a later time when the venture is subject to ordinary taxation. However, this mechanism has been eliminated by some cantonal authorities, who require ventures which have been granted tax holidays to depreciate their assets at the aforementioned standard rates.

C. Non-tax incentives

In addition to corporate tax incentives the cantons and the federation offer various financial incentives, such as:
- government loan guarantees;
- interest subsidies for bank loans;
- equity capital contributions;
- research incentives;
- investment premiums;
- allocation and sale of land at preferential prices;
- training grants; and
- assistance in recruiting personnel and locating appropriate facilities.

In general, the conditions are similar to those required to obtain tax holidays. As a further incentive, many cantons grant special income tax allowances to expatriates.

VIII. MULTINATIONAL GROUPS

For a multinational group, obtaining favourable tax treatment for a subsidiary abroad is only attractive if the benefits can also be kept at the level of the parent company. Many countries have Controlled Foreign Corporation (CFC) laws in place, which can result in immediate taxation of the parent company, despite the fact that the income was realized by the foreign subsidiary. Foreign taxes paid on this income only entitle the parent company to a tax credit. As a consequence, low Swiss taxes are often meaningless, since they will result immediately in higher taxes chargeable on the parent company. However, such CFC-provisions generally do not apply to an active business, particularly if it is engaged in manufacturing.[21] The Swiss tax holiday regime is specially designed to attract manufacturing and related services of an active nature. Thus, CFC provisions are usually not an obstacle to establishing the venture in Switzerland. Under some CFC provisions (for instance, those of the United States), the higher taxation in the parent company's state of residence can be deferred until the date when a dividend is paid.[22] In other cases (for instance, Germany), the dividend income derived from an active business is completely exempt from taxation, based on provisions contained either in the foreign CFC legislation or in the relevant double tax treaty with Switzerland.[23]

IX. CONCLUSION

Clearly, the impact of Switzerland's federal and cantonal tax holidays can be substantial, eliminating income and wealth taxes for a ten-year period in a best-case scenario. So while

19. See for instance Howard R. Hull, 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 29.
20. This provision has been introduced by Art. 63 DTL.
21. For instance according to the definition of Subpart F income in US Internal Revenue Code Sec. 952
22. Internal Revenue Code Subpart F and Sec. 61(a) 7.
23. For instance Art. 24(1)1(b) Germany–Switzerland double tax treaty.

Switzerland is better known as a base for service companies than as a centre for production, the various possibilities for income tax deferral and savings, particularly with respect to tax holidays, can make it an attractive location for multinational companies seeking sites for manufacturing and manufacturing-related services.

APPENDIX

Tax Holidays – an Overview

Canton	Maximum duration (years)	Comments	Federal tax holidays available
Appenzell AR	10	only partial relief	in certain regions
Appenzell IR	10	only partial relief	no
Basel-Land	7	–	no
Basel-Stadt	10	–	no
Berne	10	readily granted	in various regions
Fribourg	10	readily granted	in most regions
Geneva	10	decreasing benefit over period	no
Glarus	10	–	in various regions
Graubünden	10	–	in certain regions
Jura	10	–	throughout the canton
Lucerne	–	only partial	no
Neuchâtel	–	–	throughout the canton
Nidwalden	10	only partial	no
Obwalden	10	only partial	no
St. Gallen	10	only partial	in certain regions
Schaffhausen	10	favours manufacturing enterprises	no
Schwyz	10	–	no
Solothurn	10	–	in various regions
Thurgau	10	–	in certain regions
Ticino	10	favours manufacturing enterprises	in various regions
Uri	10	only partial	in various regions
Valais	10	duration depends on number of new jobs	in various regions
Vaud	10	readily granted	in most regions

No tax holiday is granted in the cantons of Aargau and Zug. The canton of Zurich is planning to introduce tax holidays in 1999.

THE TAXATION OF HOLDING, DOMICILIARY AND AUXILIARY COMPANIES IN SWITZERLAND

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I. TAXATION OF THE INCOME AND CAPITAL OF CORPORATIONS

A. General

In Switzerland, direct taxes on income and on capital are levied at three levels: by the federal Government, the 26 cantons (states) and the communes. Whereas the federal tax laws are applicable throughout the country, each of the 26 cantons has its own tax law. The cantonal tax laws differ considerably from each other and from the federal Law on Direct Taxes (DTL). In order to achieve a greater uniformity a federal Tax Harmonization Law (THL) was introduced and has been in force since 1 January 1993. The principal objectives of this legislation are to reduce the inter-cantonal differences in tax laws and to make cantonal tax laws more similar to the DTL in certain respects, such as the rules governing the determination of taxable income and capital as well as the provisions dealing with certain corporate tax privileges.

All the cantons will have to adapt their respective cantonal tax laws to the THL by 1 January 2001. After this date, the THL will apply directly to cantonal and communal taxation whenever the respective provisions of the cantonal tax laws are not in conformity with it.

Swiss resident corporations[1] are liable to taxes on their worldwide income as well as on their capital at the federal, the cantonal and the communal level. Income and capital which is, however, attributable to either a permanent establishment maintained abroad or to foreign real estate is exempt from Swiss taxation; although such income and capital is taken into account for determining the applicable tax rates.

A corporation is considered resident in Switzerland for tax purposes, if it is incorporated or effectively managed in Switzerland. This means that even a corporation incorporated outside of Switzerland may be held to be Swiss resident if its effective management is performed in Switzerland. Switzerland has not (yet) adopted in its tax laws any "controlled foreign corporation" (CFC) rules, nor do rules for the tax consolidation of a group of companies exist in the field of direct taxation.[2]

The taxable income and capital of a corporation are primarily determined on the basis of its statutory annual balance sheet and profit and loss account, provided that the commercial financial statements are established in accordance with the accounting rules contained in the Swiss Code of Obligations and generally accepted accounting standards. The tax authorities do however have the power to make certain adjustments to the commercial net profit and net equity for tax purposes, e.g. for excessive depreciation, liability provisions and interest deductions on related party debt, etc.

B. Federal income and capital taxes

1. Income taxes: general rules

Switzerland has a classical corporate tax system insofar as corporate profits are first subject to corporate income taxes and subsequently, upon distribution to the shareholders, taxed once more in the hands of the shareholders upon receipt of a dividend. Corporate shareholders receiving dividends from substantial corporate participations are, however, relieved from such economic double (or multiple) taxation of the same profits through a special mechanism.[3]

The taxable net income is subject to federal tax at graduated rates ranging from 3.63 per cent to a maximum 9.8 per cent.[4] Net losses of a tax period can be carried forward for seven years; losses cannot be carried back.

2. Special relief for dividend income from substantial participations

Dividend income from substantial participations[5] in other corporations qualifies for a relief from federal income tax.[6] A participation is considered substantial if it represents control of at least 20 per cent of the share capital of another corpora-

1. More precisely, joint stock corporations, limited liability companies, and cooperative societies.
2. However, a consolidation of a controlled group of tax subjects is possible in the field of the Value Added Tax (VAT).
3. The "participation deduction", as discussed below.
4. The maximum corporate income tax rate applies if the ratio between the net income and the net taxable equity exceeds 23.15 per cent.
5. Participations include shares of a joint stock corporation or a corporation with unlimited partners, including non-voting shares ("participation certificates"), quotas of limited liability companies, and share certificates of cooperative societies, Art. 69 DTL. *Inter alia*, the following are not treated to be qualifying participations: debt instruments such as bonds and notes, intercompany loans and advances, hybrid financing tools such as subordinated or profit-sharing loans, as well as shares in Swiss investment funds (fiduciary relationship).
6. The relief is available to Swiss joint stock corporations, limited liability companies, and cooperative societies, as well as Swiss branches (permanent establishments) of foreign corporations, provided that the participation and the dividend are to be attributed to the permanent establishment.

tion or has a fair market value of at least CHF 2 million. The relief for qualifying dividend income is in the form of a reduction of the corporate income tax owed by the receiving corporation (*Beteiligungsbezug*) which is computed based on the ratio between the "net participation income" and the company's total taxable net income.[7] The "net participation income" is defined as gross dividend income from substantial participations less:

- non-refundable foreign withholding taxes;
- a lump sum of 5 per cent of the gross dividend for administrative costs;
- interest and similar financing costs attributable to the respective participations;[8] and
- any depreciation of participations in connection with a dividend.

Dividends for the purposes of the participation deduction include all ordinary and extraordinary profit distributions, liquidating dividends, stock dividends (if recognized as income in the books), as well as constructive dividends and other financial benefits transferred to the holder of a participation by a transaction the terms of which fail to meet an arm's length standard, provided that the party granting the benefit suffered a corresponding adjustment of its taxable income.[9] Other income connected with substantial participations, such as the repayment of the nominal value of corporate shares, capital and appreciation gains, and any income that qualifies as a deductible expense in the hands of the payor[10] is not considered "dividend" income and therefore does not qualify for the tax relief.

3. Federal capital tax

The annual federal capital tax is levied upon the net equity, consisting of the paid-up share capital, contributed surplus (if any) and all other open reserves and retained earnings, as well as those hidden reserves that have been taxed as income. The federal capital tax is levied at a flat rate of 0.08 per cent.

C. Cantonal and communal income and capital taxes

As indicated above, each of the 26 Swiss cantons has its own tax law. The communal taxes are either governed by communal ordinances or by cantonal laws; they are usually assessed together with the cantonal taxes, often as a fraction thereof. Whereas the provisions of cantonal laws regarding ordinary corporate income and capital taxes are more or less similar to the respective federal provisions, the tax treatment of corporate entities performing special functions within an affiliated group[11] is very different under cantonal law as compared to federal law. The provisions of the cantonal tax laws regarding the principles of taxation (including the rules relating to holding and other base companies), taxable objects, tax periods as well as the procedural rules will have to be harmonized and brought in line with the THL by the year 2001. However, the cantons will continue to be free under the THL in the setting of their tax rates and tariffs as well as in providing for certain tax exemptions.

There is a wide variation in the ordinary corporate income tax rates of the cantons, which range from approximately 11 per cent to 35 per cent.[12] The actual cantonal and communal corporate income tax rates that apply in any particular case are in most of the cantons determined, within upper and lower limits, by the ratio of the corporation's taxable income to its equity. The additional combined cantonal/communal capital tax burden may range from 0.05 per cent up to 1 per cent.

Ordinary cantonal income and capital taxes are usually calculated in the same or a similar way as the respective federal taxes. The cantonal tax laws also provide for similar mechanisms as the DTL to relieve dividend income from (domestic or foreign) substantial participations from taxation. Some cantons[13] further provide for a comparable relief on such dividend income to individual shareholders resident in the same canton as the corporation distributing the dividend.

II. INCOME AND CAPITAL TAXATION OF HOLDING AND OTHER BASE COMPANIES

A. General remarks

Unlike the DTL, the cantonal tax laws provide for a considerable variety of additional tax privileges to specified categories of corporate taxpayers, such as holding companies and some other types of special purpose or base companies that are mainly active outside Switzerland.[14] These cantonal tax privileges are generally not only available to resident corporations, but also to branches (permanent establishments) of foreign corporate entities.

Notwithstanding the above, once the THL has been implemented into the cantonal tax laws, the special tax regimes offered by the cantons to special purpose or base companies will be limited to two different types, the holding company

7. The taxable net income for the purposes of calculating the participation deduction excludes the results generated by foreign permanent establishments, income from foreign real estate and the deduction of any losses carried forward from earlier taxable years.

8. Generally, the portion of financing costs attributable to a participation is determined by the ratio between the participation's book value and the total book value of all assets.

9. In case of constructive dividends or similar financial benefits received from a *foreign* participation, the qualification for the participation deduction is made subject to the additional alternative condition that either the Swiss tax authorities come to the conclusion that they, in lieu of the foreign tax authority, would have made essentially the same adjustment of the taxable income, or an agreement has been reached in a competent authority procedure under an international tax treaty.

10. Such as interest on loans granted to the company in which a participation is held.

11. In particular, holding companies and various types of base companies performing special activities such as international trading, group financing and all kinds of other services and functions within an affiliated group of companies.

12. Whereas federal taxes are deductible, cantonal/communal income and capital taxes may or may not be deductible depending upon the tax legislation of the relevant canton.

13. E.g. Nidwalden, Appenzell Innerrhoden.

14. Domiciliary, Mixed, Auxiliary, Administration and similar special purpose companies.

privilege and the administration company tax regime. (See below).

B. Holding companies

The tax laws of all the cantons provide for a special holding company tax privilege, under which a qualifying "pure" holding company is usually fully exempt from cantonal and communal income taxation. The exemption from income taxation does not only apply to dividends, but extends to interest, royalties, capital gains and any other income.[15] Furthermore, the cantonal holding company tax privileges generally provide for a substantially reduced annual capital tax. In some cantons[16], the capital tax on holding companies is levied only upon the paid-up nominal share capital. The special capital tax rates for holding companies may be as low as 0.042 per cent per annum and are, in some cantons, subject to negotiations with the local tax authorities.

The holding company privilege is also provided for under the THL. According to the THL, a holding company pays the annual capital tax: on the paid-up share capital and all open reserves as well as on those hidden reserves that would have been taxed as income, had the holding company been subject to income taxation.[17] The THL does not contain any rules that would prevent the cantons from further granting privileged capital tax rates to holding companies.

The test to qualify as a "pure" holding company varies from one canton to another. The THL provides that the cantons shall grant the holding company tax privilege to those corporations and cooperatives whose purpose as stated in their articles of incorporation is mainly the permanent administration of participations and which do not perform any business activity in Switzerland, provided further that either the total income of a holding company or the fair market value of its investments in the capital of other corporations represents at least two thirds of its total income or its total assets, respectively.[18] Under the THL, income derived by holding companies from real estate located in Switzerland shall be taxable at the ordinary corporate income tax rates. Deductions within the limits of a "usual" mortgage charge are to be admitted.[19]

Most of the cantons require that the participations be substantial as a prerequisite to qualifying for the holding company tax privilege.[20] The qualification criteria are often the same as for the purposes of the participation deduction under the DTL, i.e. the participation should either represent an interest of at least 20 per cent in the share capital of another corporation or a value of at least CHF 2 million. Although the THL does not contain any specific rule in this regard, it is the general view that, for the purposes of this requirement, the participations have to be taken into account at their fair market values.[21]

The main purpose of administering participations must not only be stated in the articles of incorporation, but also be a factual one. A distinction must further be made between those business activities which can be carried on in Switzerland without jeopardizing the tax privilege and those which cannot. As a rule, manufacturing, trading and service activities are prohibited. However, a holding company may perform activities or render services that are directly connected with the management of a group of affiliated companies. Hence, a holding company may, to a certain degree, provide debt financing to its subsidiaries and affiliates, hold and exploit intellectual property and provide other services, if such activities remain within the limits of a mere ancillary company purpose. In order to fulfil these functions a holding company may employ a limited number of staff and have its own infrastructure, such as an office with the necessary equipment.

C. Other cantonal special tax regimes (Domiciliary, Mixed, Auxiliary and Administration companies)

1. General

Many cantons try to attract corporate taxpayers with international operations by offering them advantageous local tax regimes. These cantons expect that in return for accepting much reduced cantonal tax revenues[22] the relevant entities will enhance their local services industry (banks, accountants, lawyers, etc.). It must again be emphasized that, at the federal taxation level, no special tax privileges for companies with mainly international operations are available; such companies are subject to the ordinary federal taxes on income and capital.

The cantonal tax privileges are generally offered to companies which have their seat (registered office) in Switzerland, but perform the bulk or all of their business activities outside Switzerland and therefore derive most of their income from foreign sources or at least from transactions with foreign parties. Such entities may benefit from a special cantonal tax status as a domiciliary, mixed, auxiliary, or administration company, depending upon the legislation of the canton in question. The privileged cantonal tax status is often not only available to resident corporations, cooperatives and even foundations, but also to Swiss branches (permanent establishments) of foreign legal entities or even foreign partnerships.

At present, the cantons still have full discretion in defining the conditions and features of these tax privileges in their laws; under the THL, however, such discretion will be limited to a significant degree insofar as the only admitted cantonal tax privilege will be the administration company regime as

15. Income derived from immovable property located within the territory of the canton may, however, be subject to normal taxation.
16. E.g. Zug and Schaffhausen.
17. Art. 29 THL.
18. The canton of Zug, which at present still has a very liberal holding company tax regime, requires alternatively that either at least 51 per cent of the assets consist of substantial participations, or 51 per cent of the income is derived from dividends received from such participations.
19. Art. 28 (2) THL.
20. No such requirement exists, however, under the existing tax laws of the cantons of Zurich, Basel-City, Lucerne, Schwyz, Obwalden and Grisons.
21. Some cantons only take the book values into account. A few cantons still accept a lower capital interest or a lower minimum value of the participations. Furthermore, a few cantons (Schaffhausen, Glarus, Schwyz, Valais) include certain long-term loans to affiliated companies in the participations.
22. These entities also contribute to federal direct tax revenues.

defined in Article 26 et seq. THL. The application of these cantonal tax privileges to a taxpayer must usually be negotiated with the cantonal tax authorities, who are generally ready to issue binding private letter rulings, if all relevant facts are disclosed.

2. Domiciliary companies

"Pure" domiciliary companies are usually fully exempt from cantonal income taxes[23] and pay only a reduced capital tax according to the same rules as apply to holding companies.

Pure domiciliary companies may be characterized as corporations which have their statutory seat (registered office or domicile) in Switzerland, but perform substantially all their commercial activities outside Switzerland. Accordingly, substantially all the income of a domiciliary company is derived from foreign sources. Most of those cantons which provide for a "pure" domiciliary company tax privilege do not allow the corporation to have any staff or operational office premises within Switzerland. However, management decisions made by the corporation's board of directors may be taken at board meetings held in Switzerland without jeopardizing the tax privilege.[24] Some cantons require that a domiciliary company be controlled by foreign resident shareholders. Domiciliary companies are not restricted in respect of their business activities carried on abroad and their staff employed and infrastructure maintained abroad.

The domiciliary company tax privilege is typically used for entities with foreign trading or agency activities (purchases and sales performed abroad) and for various types of services rendered to foreign parties, such as financing, management and exploitation of intellectual property, leasing, consultancy and similar services. The domiciliary company tax privilege can also be granted to those entities whose exclusive function and activity is the holding and management of their own movable assets, e.g. a portfolio of securities.

It should be noted that at the federal taxation level a pure domiciliary company (or branch meeting the respective criteria) pays the ordinary income taxes; it may, however, deduct up to 50 per cent of its gross profit as a lump-sum allowance for expenses incurred abroad without having to substantiate such expenses in detail. The remaining 50 per cent of the gross profit, after deduction of minor Swiss administration costs and taxes, must be reported as taxable income in Switzerland. If a domiciliary company claims an expense deduction which exceeds the 50 per cent limit, it has to provide full evidence and justification for all its expenses.

3. Mixed companies

The mixed company tax privilege is offered by a few cantons, such as Zug and Schwyz, as a substitute privilege for those Swiss entities or branches of foreign entities which have operations similar to a pure domiciliary company, but which need to maintain a certain infrastructure, (such as an office with employees) in Switzerland. Mixed companies may derive a small portion of their income, usually up to 20 per cent, from commercial activities within Switzerland; they are, however, not allowed to carry on any industrial or manufacturing activities. The laws of those cantons which provide for a mixed company tax status usually require that a mixed company be controlled by non-resident shareholders.

Normally mixed companies are subject to the ordinary cantonal and communal income taxes on all income from Swiss sources or commercial activities carried on within Switzerland. However, they are entitled to a partial exemption, usually 70-90 per cent, in respect of their income from foreign activities or foreign sources. Certain reliefs, such as the application of a reduced tax rate to a portion of the retained earnings, may also be available for capital tax purposes.

The mixed company tax privilege is predominantly used by international trading and sales companies with only limited or no commercial activities on the Swiss market that need to employ a certain number of staff in Switzerland.

4. Auxiliary companies

Several cantons offer the tax status of an auxiliary company to such entities which, although they may have an office and employ staff in Switzerland, do not carry on within Switzerland any commercial transactions or "genuine" business activities with or for independent third parties. Auxiliary companies typically perform mere subordinated service or auxiliary functions for foreign affiliated companies including the management of foreign subsidiaries or affiliated companies, the provision of debt financing and the rendering of marketing, publicity, research, technical assistance, accounting and various other services.

The exact conditions and features of the tax status of an auxiliary company vary from canton to canton and must be individually negotiated. As a rule, auxiliary companies benefit from a partial cantonal/communal tax exemption of their income from foreign sources, whereas they pay ordinary cantonal/communal income taxes on any income from Swiss sources. In the canton of Fribourg, the auxiliary company is fully exempt from income taxation on its income from foreign sources and on passive income from Swiss sources, while active income from Swiss sources (which must not exceed 20 per cent of the total income) is ordinarily taxed. Under the auxiliary company regime of the canton of Basel-Stadt, any income, including income from "subordinated" Swiss business activities (the volume of which must not exceed 10 per cent of the total income,) is taxed at a special rate that equals 10 per cent of the ordinary corporate income tax rate. However, a Basel-Stadt resident auxiliary company has to pay a minimum income tax even if it shows a net loss; the minimum taxable income corresponds to either 10 per cent of the total Swiss costs or one sixth of the total payroll expenses.

23. Except for taxes in relation to real property located in the canton, if the respective canton allows a domiciliary company to own real estate located in its territory.

24. Swiss corporate law requires that the majority of the members of the board of directors (*Verwaltungsrat*) of a Swiss corporation be Swiss Nationals resident in Switzerland. Similarly, at least one director (*Geschäftsführer*) of a limited liability company needs to be resident in Switzerland.

For federal tax purposes, a company whose activity essentially consists of providing services to foreign affiliated enterprises is required to show an arm's length net profit. Such intra-group services are generally deemed to produce a minimum taxable net profit of either 10 per cent of the total Swiss costs or one sixth of the total payroll expenses in Switzerland, unless the taxpayer can prove a bona fide loss. The same standard with regard to intra-group services is generally applied by the cantons for the assessment of cantonal/communal income taxes.

5. Administration companies

The administration company tax regime was first introduced by the canton of Zurich[25] and subsequently by a number of other cantons. This regime also served as the model for the only cantonal tax privilege (besides the holding company regime) provided for under the THL.[26]

The statutory provisions define the administration company as a corporate entity which only carries on administrative activities in Switzerland i.e. the company must not undertake any commercial business activity. Thus, an administration company is not allowed to actively appear in the (Swiss) market as a seller of goods or services or as a purchaser or manufacturer of goods. The admissible administrative activities include the mere administration and management of those assets which the company already owns or acquires without conducting any commercial activity in Switzerland, as well as auxiliary or servicing activities for the benefit of affiliated enterprises, such as performing research, rendering technical assistance or marketing advice, the management of patents, trademarks and other intellectual property, (re-)invoicing, debt collection, factoring, leasing, financing, accounting and other services. Other, genuine business activities may be conducted in Switzerland, if they are of minor and subordinate importance. The rendering of management services to affiliated companies is usually regarded to be a commercial and not a subordinate activity. Generally, no restrictions whatsoever apply with regard to commercial activities conducted outside Switzerland. It is further generally not required that the foreign business activities be carried on through branches (permanent establishments) maintained abroad.

An administration company can be legally structured as a Swiss corporate entity or as a branch (permanent establishment) of a foreign entity. The tax laws of e.g. the cantons of Zurich and Thurgau, do not require that the administration company be controlled by foreign-resident shareholders. Under the THL, the tax privilege is available to corporations, cooperatives and foundations, there is no requirement that the entity be controlled by foreign shareholders.

The typical cantonal/communal tax treatment of an administration company may be summarized as follows:

- Income from substantial participations[27] (open and constructive dividends) as well as any capital or book gains on participations are fully exempt from taxation.[28]
- Other income from Swiss sources is taxed at ordinary tax rates.
- Other income from foreign sources is partly exempt from taxation, the degree of the tax exemption depending upon the importance of the administrative activity conducted in Switzerland. The non-exempt portion of the foreign-source income is subject to tax at ordinary tax rates. According to the taxation practice of the cantons, the taxable portion may range from zero per cent to 40 per cent. The law of the canton of Zurich provides that a minimum of 10 per cent of the foreign-source income be subject to tax.

It is further provided that an administration company has to set off bona fide expenses, which are connected to a specific category of income, against such income. Financing costs and general administrative expenses must be allocated to the different categories of income. Capital losses on participations cannot be deducted, but have to be set off against tax free dividend income or capital gains on participations. Finally, the tax privilege is not applicable to those categories of income for which the taxpayer claims a relief from foreign withholding taxes pursuant to a Swiss tax treaty, if the respective treaty requires the ordinary taxation of such income in Switzerland not only at the federal, but also at the cantonal/communal level.[29]

The administration company is liable to capital taxes, under the THL, the taxable capital has to include the paid-up capital, open reserves and retained earnings, as well as those hidden reserves that, without application of the income tax privilege, would have been taxed as income.

D. Tax holidays

Foreign industrial or commercial enterprises moving into Switzerland may in a number of cantons be granted a partial or even a full exemption from the cantonal/communal and, in certain defined geographical areas of economic depression, also from the federal income and capital taxes for a maximum period of ten years. Such exemptions must be negotiated with the cantonal authorities and generally require that a substantial number of new jobs are created in a region with high unemployment.

III. FEDERAL WITHHOLDING TAX

A. Swiss domestic law

The Swiss federal government levies a withholding tax at a rate of 35 per cent on the gross amount of:

25. § 50bis Zurich Tax Code.
26. Art. 28 (3) THL.
27. Participations representing either 20 per cent or more of the capital stock of other corporations or a fair market value of at least CHF 2 million, cf. § 50bis Zurich Tax Code.
28. The tax law of the canton of Thurgau also exempts all income from the exclusive administration of the taxpayer's own movable assets, such as a portfolio of marketable securities; § 88 Thurgau Tax Code.
29. Cf. § 50bis(2) and (3) Zurich Tax Code.

- dividends, including constructive dividends[30] and liquidation dividends (i.e. the excess of the net liquidation proceeds over the nominal share capital) distributed by a Swiss corporation to its shareholders or persons actually or deemed to be related to the shareholders;
- 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' deposits held with a Swiss bank.

No federal withholding tax is levied, however, on interest paid in connection with straight loans as well as on rents, royalties, licence, management and technical assistance fees etc.[31] Furthermore, the repatriation of profits derived by a foreign corporation through its Swiss branch (permanent establishment) to the foreign head office is not subject to the federal withholding tax, unless the branch/permanent establishment qualifies as a "domestic enterprise" for withholding tax purposes. A branch of a foreign corporation qualifies as a domestic enterprise if (i) the foreign corporation is effectively managed in Switzerland and (ii) the foreign corporation, through its Swiss branch, conducts a commercial activity in Switzerland.

The withholding tax must be withheld by the payor of the taxable payment (or in-kind benefit) and charged to the recipient of such income.[32]

Swiss resident persons (individuals and corporate entities) are entitled to a full refund of the withholding tax, if they duly report the underlying income, are the beneficial owners and meet certain further conditions. Foreign resident persons, on the other hand, suffer the Swiss withholding tax as a final burden, unless they are entitled to partial or full relief under an applicable tax treaty between Switzerland and their country of residence.

B. Impact of double taxation treaties concluded by Switzerland

Switzerland has concluded bilateral tax treaties with more than 50 countries including the United States, Canada, Japan and most of the European countries. These tax treaties usually provide for a partial or even full relief from the Swiss withholding tax on outbound dividends and certain interest payments made to residents of the Contracting States. Whereas under many Swiss treaties a full relief is provided for interest payments, a full relief from the Swiss withholding tax on dividends is only provided for corporate recipients under the Swiss treaties with the Netherlands, Luxembourg, Sweden, Finland and Denmark, if certain conditions, depending upon the treaty in question, are met.[33]

The Swiss tax treaty with the Netherlands contains in its Article 9(2) an express anti-abuse clause, according to which full relief from the dividend withholding tax shall not be granted, if the relationship between the payor and the payee of a dividend has been established or maintained primarily for the purpose of obtaining such relief. Although the Swiss tax treaties with Luxembourg, Sweden, Denmark and Finland do not contain such explicit anti-abuse rules, it is the clear tendency of the FTA (Federal Tax Administration) to apply similar criteria to applicants from these countries seeking a full refund of the Swiss dividend withholding tax.

The focus of the FTA in regard to the entitlement of foreign shareholders of Swiss corporations to a full refund of the withholding tax lies undoubtedly on beneficial ownership. A corporate shareholder resident in a convenient treaty jurisdiction, which is controlled by residents of another, non-treaty jurisdiction and which cannot prove any "substance"[34] at its place of incorporation runs the risk of not being acknowledged as the beneficial owner of the Swiss shares.

IV. USE OF TAX TREATIES BY SWISS RESIDENT CORPORATIONS

As a rule, Swiss resident corporations, including holding companies and other entities enjoying cantonal tax privileges as domiciliary, mixed, auxiliary or administration companies may benefit from the Swiss double tax treaty network and, in particular, claim relief under such treaties from foreign taxes withheld on dividend, interest and royalty income. However where control is exercised by non-residents, certain conditions must be met in order to qualify for foreign withholding tax relief. These conditions are set forth in a unilateral Decree of the Federal Council concerning measures against the abuse of Swiss tax treaties, dated 14 December 1962. Similar anti-treaty abuse provisions are included in the Swiss tax treaties with Germany, France, Italy and Belgium. The most important conditions to be met are the following:

- *Capitalization.* A minimum equity capitalization of the Swiss corporation is required. Interest-bearing debt of the corporation may not exceed six times stockholders' equity. In addition, such debt shall not bear a higher than an arm's length rate of interest, the maximum rates of which are from time to time published by the FTA.
- *Use of income.* Not more than 50 per cent of the income[35] benefiting from foreign withholding tax relief under a

30. Constructive dividend situations include, *inter alia*, domiciliary companies which use more than 50 per cent of their gross profit for payments of any kind which they treat as expenses in their profit and loss account, as well as the providing of services to an affiliated person or company for a consideration which is less than 10 per cent of the total cost incurred in connection with such services.
31. Except in the case of excessive, not at-arm's-length amounts paid for such items, where the excessive portion of such payments is re-characterized as a constructive dividend, subject to the withholding tax.
32. This means in fact that the Swiss corporate entity, which is treated as the taxpayer and obligee of the withholding tax, must not bear the burden of the tax, but rather charge it on to the (direct) recipient of the taxable benefit. If the Swiss taxpayer fails to charge the withholding tax to the beneficiary, the latter can be regarded as having received a benefit net of the Swiss withholding tax, i.e. 65 per cent of the actually taxable benefit. Accordingly, the taxable amount can be grossed up to 100 per cent, which brings the effective withholding tax burden up to some 53.8 per cent.
33. Under the Swiss tax treaty with Denmark, not only Danish corporations holding a qualifying participation in the Swiss dividend payor, but also any Danish-resident individual shareholder can qualify for the full refund of the Swiss dividend withholding tax.
34. Such as an own office with the necessary infrastructure and a minimal staff and the presence of a commercial activity.
35. Typically dividend, interest or royalty income.

Swiss bilateral tax treaty shall be passed directly or indirectly to non-residents.[36]
- *Expense allocation.* Any expenses not related to the treaty-benefited foreign income must be covered by such other income.
- *Minimum distribution.* At least 25 per cent of the treaty-benefited income must be distributed by the Swiss resident corporation as a dividend, subject to the federal withholding tax.

In addition to these conditions, the Swiss tax treaties with Germany, France, Italy and Belgium require that treaty-benefited interest and royalty income be subject to full, ordinary Swiss taxation not only at the federal, but equally at the cantonal/communal level; otherwise, no treaty relief for such income shall be granted. In most of the Swiss cantons, corporations with cantonal tax privileges can elect to either pay full Swiss tax on interest and royalty income from these countries and to be granted the tax treaty relief or to renounce the tax treaty relief and enjoy the cantonal tax privilege. Far-reaching anti-treaty-shopping rules have reportedly been included in a new income tax treaty between Switzerland and the United States, which is expected to be signed in August 1996. The new Switzerland–United States income tax treaty will substantially limit the ability of foreign-controlled Swiss corporations to benefit from the treaty with respect to relief from US income taxes withheld at source.

V. FEDERAL STAMP DUTIES

A. Capital issuance stamp duty

Any contributions of cash or other assets to the capital of a joint stock corporation, limited liability company or cooperative corporation incorporated under Swiss law, whether or not made in exchange for an issue of shares, participation certificates or similar equity securities are subject to a federal stamp duty of 2 per cent of the net amount of the capital contribution. In the case of a contribution of non-cash assets, the tax is payable on the fair market value.

Exemptions from the capital issuance stamp duty apply in a number of situations:
- the initial contribution to the capital of a corporate entity incorporated in Switzerland in connection with its formation, if the net amount of the contribution does not exceed CHF 250,000;
- share issues in connection with transactions which qualify, for stamp duty purposes, as corporate reorganizations (mergers of corporate entities, merger-like transactions[37], spin-offs, certain corporate transformations);
- share issues in connection with the transfer of the corporate domicile (registered office) of a foreign corporation, which originally was incorporated abroad, into Switzerland, if the foreign law does not require a formal liquidation of the emigrating corporation.

In addition to the above exemptions, the contribution of assets to the Swiss branch of a foreign corporation is not subject to the capital issuance stamp duty, unless the branch is to be regarded as a domestic enterprise.[38]

Furthermore, the issuance of certain debt instruments (debenture or cash bonds, notes, money market instruments) by a Swiss debtor is subject to a special stamp duty at the rate of 0.12 per cent for each full or partial year of the maximum term (bonds, annuity bonds, mortgage bonds, debt register claims), 0.06 per cent (cash bonds, certificates of deposit), and 0.06 per cent prorated at $^1/_{360}$ of the tax rate per day in the case of money market papers.

B. Securities transfer stamp duty

The transfer of the title to certain debt or equity securities[39] issued by a Swiss or foreign issuer for a consideration is subject to the securities transfer stamp duty, if at least one of the parties to or an intermediary in the transaction is a Swiss securities dealer as defined in the Stamp Duty Law. The transfer stamp duty is measured by the amount of consideration paid in return for the securities transferred; the tax rates are 0.15 per cent for Swiss and 0.30 per cent for foreign securities. The term "securities dealer" includes professional securities traders, banks, brokers and similar financial institutions, as well as any corporation that holds, according to its last annual balance sheet, taxable securities in excess of CHF 10 million.[40] The securities dealer owes 50 per cent of the stamp duty for himself and another 50 per cent if the other party to the transaction is not a securities dealer.

The law provides that certain transactions be exempt from the securities transfer stamp duty, these include, *inter alia*, the transfer of Swiss or foreign equity securities in exchange for the issue of shares of a Swiss corporation and the issue of shares of a foreign corporation to a Swiss corporation, e.g. a holding company. All transactions that are subject to a capital issuance stamp duty are likewise exempt from the transfer stamp duty.

VI. VALUE ADDED TAX (VAT)

A. General

Effective 1 January 1995, Switzerland introduced a modern, mostly EU-compatible VAT system in replacement of the former sales tax, which was levied on the domestic turnover and

36. This condition applies not only to foreign-controlled, but also to any Swiss corporations.
37. For example, the contribution of shares representing qualifying majority interests in at least two active, Swiss or foreign corporations to the share capital of a Swiss holding company in connection with the formation or a capital increase of such holding company.
38. This is the case if the foreign corporation (i) is effectively managed in Switzerland and (ii) carries on a commercial activity within Switzerland.
39. Simple acknowledgments of debt in writing are not considered taxable instruments. Therefore, normal commercial loans, including those made between affiliated companies, are not subject to the transfer stamp duty.
40. Accordingly, most of the larger Swiss holding companies and other Swiss corporations qualify as securities dealers for stamp duty purposes.

importation of goods only, i.e. services remained untaxed. Until such time as a federal statute has been drafted and passed by the federal parliament, VAT is being levied on the authority of an Ordinance of the Swiss Federal Council. The tax is charged on the domestic supply and own use of goods and services by persons or enterprises whose relevant annual turnover amounts to at least CHF 75,000. It is also chargeable on the importation of goods and services into Switzerland.[41] The standard rate of Swiss VAT is at present 6.5 per cent; a special rate of 2 per cent applies to food, beverages and certain other products.

The turnover from certain categories of services is exempt from, or outside the scope of, VAT, in particular, capital-related payments such as interest and dividends. The receipt of payments of this kind does not cause a person or enterprise to become a taxpayer for VAT purposes and if a person or enterprise otherwise liable to Swiss VAT receives such payments, it will not be entitled to credits or deductions of input VAT suffered on services or goods purchased that are used to perform VAT-exempt activities.[42]

The taxable supply of a service includes, *inter alia*, the transfer of any intangible asset or a right for valuable consideration (especially, royalties). If a taxable supply of goods or services is made to a foreign recipient and consumed abroad, such supply is generally zero-rated, i.e. no Swiss VAT is due. Zero-rated supplies fully entitle the VAT taxpayer to deductions, credits or reimbursements, as the case may be, for input VAT suffered, including VAT payable upon the importation of goods or services from abroad.

If a foreign enterprise operates in Switzerland through a branch and if the operations of the Swiss branch are liable to Swiss VAT, the Swiss branch must register for Swiss VAT. The branch will then for VAT purposes, be regarded as an entity separate from the foreign head office (and any branches in other countries).

It should be noted that the definition of the place where a taxable service is rendered is not exactly the same under Swiss law as under the VAT legislations of the EU Member States. Under the Swiss VAT Ordinance the place of supply of services is generally defined as the place where the supplier has its registered office or permanent establishment and from which the service is rendered. In the absence of any such registered office or permanent establishment, the place of supply of a service is deemed to be the place at which the supplier is domiciled, or from which it carries out its activity.[43] Hence, if such services are provided by a Swiss resident company or a Swiss branch of a foreign company to a foreign customer, the services are deemed to be provided in Switzerland. However, notwithstanding a Swiss place of supply of a service, a zero per cent Swiss VAT rate may be applicable in many cases, if the service is considered to be used or consumed outside Switzerland.[44] The same may be true in regard to services imported from abroad, if they are considered to be used or exploited abroad.

B. VAT position of Swiss holding companies and other entities with cantonal tax privileges

Article 19(1)(d) of the VAT Ordinance excludes from the scope of VAT corporations, cooperatives and foundations with a cantonal tax privilege according to Article 28 THL, as well as Swiss permanent establishments of foreign enterprises with such a cantonal tax privilege. However the FTA only applies this provision, to pure holding and domiciliary companies which do not perform any commercial activity at their corporate seat in Switzerland. As soon as a resident entity or a permanent establishment of a foreign entity maintains a infrastructure (own office, staff) in Switzerland[45], it will not fall under the exclusion of Article 19(1)(d) of the VAT Ordinance.

As a consequence, pure holding and pure domiciliary companies suffer any input VAT as a final charge. On the other hand, an entity that conducts its activities through a certain physical presence in Switzerland will not fall under the exclusion of Article 19(1)(d). This is the case even where its income is derived exclusively from the export of goods or services, which are deemed to be consumed abroad. In these circumstances if the entity's sales of goods or services to foreign customers are zero-rated, it can claim a credit for its input VAT suffered, which may result in excess VAT credits and corresponding periodic VAT reimbursements to the taxpayer.

41. Even persons who are otherwise not subject to VAT independently owe VAT on the value of imported services, if such value in any year exceeds CHF 10,000.

42. A company other than a holding company, which makes taxable supplies of goods or services and, in addition, receives *dividend* income will not suffer a reduction of its right to credit or deduct input VAT. On the other hand, if a *holding company* (holding purpose stated in the Articles of Incorporation) derives e.g. royalty or services income which makes it subject to VAT, then its dividend income is treated as exempt turnover, which leads to a proportional reduction of the input VAT credit. Furthermore, the receipt of *interest* income by a VAT taxpayer leads to a reduction of the input VAT credit.

43. Art. 12 (1) VAT Ordinance.

44. The FTA has issued a special circular containing guidelines as to the determination of the place of use of various categories of services. Whereas services related to real estate are deemed to be used where the real estate is located, some other types of services are considered to be used where they are actually rendered (e.g. teaching, cultural, sports, artistic performance, safekeeping of things, appraisals of movable objects, etc.). A further category of services is deemed to be *supplied at the place of the recipient's place of business or domicile*. This category includes banking, publicity, consultancy, asset management, collecting, engineering (other than real estate related), research, legal, accountancy, auditing and fiduciary services, translation, EDP, information supply, assignment and granting of copyrights, patents, licences, trademarks, model and pattern rights, manufacturing rights etc., undertakings not to perform a professional activity or not to claim a right and making manpower available.

45. Which is, within certain limits, possible for mixed companies, auxiliary companies and administration companies as well as for holding companies.

OVERVIEW OF THE SWISS TAX SYSTEM

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I. FRAMEWORK OF THE SWISS TAX SYSTEM

A. Basic principles of tax legislation

As a result of Switzerland's confederate political structure, taxes are imposed at various levels. The Confederation, the 26 cantons and the more than 3,000 municipalities each have their own tax legislation. Furthermore, the cantons may also empower districts and other administrative subdivisions as well as church parishes to levy taxes. Since the municipalities, districts and churches mostly follow cantonal tax laws, the main distinction from a practical point of view is the one between federal taxes and cantonal/municipal taxes.

The Confederation finances most of its expenditure from indirect taxation, whilst the cantons and municipalities rely primarily on direct taxes. For the taxpayer, the burden of cantonal and municipal direct taxes is considerably higher than that of the direct federal tax. Overall, some 75 per cent of all taxes raised in Switzerland come from direct taxation, of which approximately 80 per cent constitute cantonal and municipal taxes. Most of the approximately 25 per cent of taxes coming from indirect taxation are levied by the Confederation.

At present, there are still major differences between the tax legislations in the various cantons. Due to the fact that a significant proportion of total taxes are raised at the cantonal/municipal level taxation in Switzerland varies considerably from one region to another. On 1 January 1993, a new law came into force which aims to harmonize the cantonal tax systems within the next few years. Although this will eliminate some of the more important discrepancies between the cantons, a number of cantons are expected to be able to maintain their comparatively favourable tax regimes. One of the instruments for doing so will be the determination of tax rates, since the cantons continue to be fully autonomous in this area.

B. Relationship between the taxpayers and the tax authorities

In comparison to the very exact and extensive tax legislations of many other states, the federal and cantonal tax legislation in Switzerland has been kept relatively brief and general, often leaving the taxpayers and the authorities a considerable scope for interpretation. This creates tax planning opportunities for the taxpayers and, more importantly, sometimes gives the tax authorities a competitive edge in their attempts to attract new taxpayers to their jurisdiction.

Obviously, the comparatively open tax legislation also carries the inherent risk of its rules being interpreted against the interest of the taxpayer in doubtful or unusual cases. However, since most departments of the cantonal and federal tax administrations are prepared to issue binding opinions (rulings) in advance, this risk can be eliminated in most cases. In fact, the cooperative and constructive attitude of the tax authorities is still one of the major advantages Switzerland has in the area of taxation.

II. TAXATION OF INDIVIDUALS

A. Personal income and wealth taxes

1. Tax liability and scope of taxation

As in other jurisdictions, the concept of residence is fundamental for the determination of an individual's tax liability and the scope of taxation. From a Swiss domestic point of view, residence is defined as the place where a person stays with the intention of settling permanently and which is thus the centre of his personal and business interests. An individual who stays in Switzerland for a certain minimum period of time and earns his living there, is subject to Swiss tax on his worldwide income. In addition, a person will be considered a resident for tax purposes if he or she remains in Switzerland for an extended period of usually more than three months, even if not engaged in a gainful activity.

An individual resident in Switzerland is in principle subject to unlimited tax on worldwide income (federal and cantonal/municipal income taxes) and net wealth (cantonal/municipal wealth taxes). Taxable income includes all earned income, whether received in cash or in kind, the rental value of owner-occupied houses as well as pensions and investment income. As an exception, capital gains on privately owned movable property such as securities are not subject to income taxes. Wealth taxes are basically levied on an individual's net assets. However, exposure to Swiss taxation does not extend to assets invested in and income derived from businesses, permanent establishments or real estate located abroad. Such assets and income are only relevant for the purpose of calculating the applicable tax rates.

Non-residents only pay Swiss taxes on certain types of Swiss source income such as income from real estate and from business activities in Switzerland and income from work performed in Switzerland for a Swiss employer. Directors' fees paid by a Swiss company to a non-resident are subject to Swiss income tax, which is normally deducted at source.

2. Taxation base and tax rates

For individuals, the tax year normally corresponds with the calendar year. The assessable wealth (cantonal/municipal wealth taxes) is the individual's net wealth at the beginning of the tax year. For federal tax purposes (federal income tax) as well as in most cantons (cantonal/municipal income taxes) the assessable income for any tax year is the average income of the two preceding years. A small number of cantonal tax laws provide for current taxes to be based on the previous or current year's income. Special rules apply in the first year of residence.

Married couples are normally assessed jointly, i.e. their income and wealth are aggregated ("family tax" concept). In order to minimize discrimination, different progressive tax rates apply for married and single persons. Another means of avoiding discrimination is higher deductible allowances (i.e. personal and family allowances) for married couples. Deductible items for both married couples and single persons include social security contributions, accident and health insurance premiums, certain non-reimbursed business expenses, interest payments, repair and maintenance costs of owner-occupied dwellings as well as certain charitable donations.

Individual income and wealth tax rates are generally progressive. In the major Swiss cities, the maximum marginal income tax rates (total of federal, cantonal/municipal and church taxes) for married couples range between approx. 25.5 per cent (Zug, for income exceeding CHF 250,000) and 48.5 per cent (Geneva, for income exceeding CHF 1,106,400). Within this range, (and in certain municipalities above or below it,) there are considerable variations. When determining the effective burden on an individual's income the fact must be taken into account that employment income (including income from sole proprietorships and partnerships) is also subject to social security contributions of 9.5 per cent to 13.1 per cent. Individual wealth tax rates range between approximately 0.5 per cent and 1.5 per cent.

B. Taxation of foreign nationals

1. Payroll tax for foreign employees

Contrary to the situation that prevails for Swiss nationals and permanent residents, whose taxes are assessed based on the self declaration in their annual or biannual tax returns, foreign nationals working in Switzerland for a Swiss employer initially have the income tax on their employment income directly deducted at source (payroll tax, source tax). If the individual's taxable income does not exceed a certain limit (presently CHF 120,000 p.a. in most cantons), the Swiss income tax liability is covered by the payroll taxes. If the limit is surpassed in any year, the regular assessment procedure applies and a tax return must be filed, whereby the source tax is credited against the final tax burden as calculated based on the tax return.

2. Lump-sum taxation

The federal tax legislation as well as a number of cantonal tax laws provide the possibility of so-called lump-sum taxation for foreign nationals who have their residence in Switzerland without working here. In order to qualify for this privileged tax regime, the individual concerned is required to have had his or her residence outside Switzerland for at least the period of ten years immediately prior to taking up residence in Switzerland.

Under the system of lump-sum taxation, the individual's taxable income is determined on the basis of the total expenses of living. These are defined as being at least five times the rental value of the individual's living accommodation in Switzerland or, if higher, equal to his or her income from Swiss real estate, mortgages, shares, bonds etc., plus any income remitted from foreign sources for which double taxation relief is obtained based on a treaty. In practice, the deemed taxable income is the result of discussions with the responsible cantonal tax authorities.

Since it is in general only possible to obtain a residence permit for non-employed persons who are older than 60 years of age, can demonstrate close ties to Switzerland and actually transfer their centre of vital interests to Switzerland, lump-sum taxation is usually reserved for individuals who decide to spend their retirement years in Switzerland.

C. Inheritance and gift taxes

Whereas the Confederation levies no inheritance or gift taxes, all cantons but one (Schwyz) impose an inheritance tax on the transfer of property to beneficiaries and all cantons but two (Lucerne and again Schwyz) levy taxes on donations. The tax rates differ between cantons. In general, they vary according to the value of the property inherited or donated and the relationship of the beneficiary to the deceased or donor. A number of cantons do not levy a tax if the recipient is the spouse or a direct descendant of the deceased or donor.

The inheritance and gift taxes are payable either by the recipient, by the personal representative of the deceased or by the donor. Non-residents are liable to inheritance or gift tax if the deceased or donor was a Swiss resident at the time the property is passed on, or if the property concerned is real estate located in Switzerland.

Switzerland has concluded inheritance tax treaties with Austria, Denmark, Germany, Finland, France, the Netherlands, Norway, Sweden, the United Kingdom and the United States.

III. TAXATION OF CORPORATIONS

A. Incorporation

Upon the incorporation of a joint stock company (AG, SA) or a limited liability company (GmbH, SARL), a stamp tax amounting to 2 per cent of the higher amount of the fair market value of the shares or of the registered capital is levied, if this value exceeds CHF 250,000. The stamp tax is also due on any capital increase.

However, under certain circumstances, stamp tax exempt incorporations or capital increases are possible. This is particularly the case in connection with corporate reorganizations (e.g. mergers, spin-offs). The exemption may also apply when a corporation is incorporated abroad and later transfers its legal domicile to Switzerland.

B. Corporate income and capital taxes

1. Tax liability and the scope of taxation

A corporation is resident if it has its legal domicile in Switzerland or if it is managed in Switzerland. Resident corporations are taxed on their worldwide income and capital, except for income and capital which is connected with a permanent establishment or with real estate abroad. For direct tax purposes, tax liability is linked to the individual corporation as a separate entity, which means that there is no group taxation.

Non-resident corporations are only taxed on their Swiss-source income and capital.

2. Corporate income taxes

For federal tax purposes as well as in most cantons for cantonal/municipal taxes, the tax year corresponds with the corporation's accounting year. In a smaller number of cantons which have not adapted this part of their tax legislation to the harmonization law, the tax year is the calendar year. However, for assessment purposes these cantons also base the tax assessments on the corporation's accounting year.

According to federal tax legislation and most cantonal tax laws, corporate income taxes are based on the current year's taxable income. A few cantons still base their assessments on the average profits of the two preceding years or on the previous year's income. Within the next four or five years, these cantons will be obliged to adjust their legislation to the current year assessment system.

Taxable profit is based on the accounting profit as adjusted for tax purposes. Usually, the following charges are tax deductible, provided they are recorded in the statutory books:

- Depreciation of assets up to certain predetermined rates. Any additional depreciation must be arguable from a business point of view. Examples of rates (for straight-line depreciation) are:

	Per cent
Commercial buildings	2
Commercial and industrial buildings	4
Machinery, patents, goodwill	20
Computer hardware and software	20
Motor vehicles	20
Small tools	22.5

  If depreciation is made on a declining balance basis, these rates may be doubled.
- The formation of a reserve of up to one third of the lower of the stocks' cost or market value.
- The formation of bad debt reserves of up to 5 per cent for domestic receivables and up to 10 per cent for foreign receivables. Any reserve exceeding these flat rates must be arguable from a business point of view.
- Taxes due for the accounting year the assessment is based on and for any previous years.
- In general, capital gains are treated as regular income for federal as well as for cantonal/municipal tax purposes. However, in some cantons capital gains from real estate are at least partly subject to a special capital gains tax. In order to prevent double taxation, such gains are deductible from the corporation's taxable income.

In addition to the deductions from taxable income, there is also relief for dividends received from qualifying participations. The participation reduction consists of a reduction of the amount of tax payable on the corporation's entire net income in the proportion of its net income from qualifying participations to its overall net income. Dividends qualify for the reduction if the recipient owns 20 per cent or more of the capital of the corporation paying the dividend or where the investment exceeds CHF 2,000,000.

Losses may be carried forward over a period of seven years (federal tax purposes and most cantons) or less (a minority of cantons). There are no loss carry-back provisions in Switzerland.

Federal and cantonal corporate income tax rates are mostly progressive and usually depend on the corporation's yield, i.e. on the ratio of income to average capital. The federal income tax rate ranges between 3.63 per cent and 9.8 per cent of net profit after tax. Cantonal/municipal taxes depend on the municipality in which the corporation is located and range between approximately 12 per cent and 35 per cent of profit after tax. Overall, the combined corporate income tax burden (federal, cantonal/municipal) amounts to between 18 per cent (Zug) and 37 per cent (Graubünden) of pre-tax profit. At the cantonal/municipal level special tax regimes with a reduced tax burden are available for certain types of companies (See below).

In federal tax law as well as in the majority of cantons there is no distinction between distributed and undistributed profits. As a result, profits distributed to individual shareholders are in general subject to the dual burden of corporate and individual income taxes.

3. Capital taxes

Capital taxes are levied on the corporation's tax adjusted net equity (share capital and taxable reserves) either at the beginning (a minority of cantons) or at the end (federal taxes, most cantons) of the accounting year concerned. The federal capital tax rate is 0.08 per cent, the rates in the cantons vary between approximately 0.05 per cent and 1 per cent. As in the area of income taxes, corporations with a special tax status (holding, domiciliary, mixed companies) are subject to privileged capital tax rates for cantonal/municipal tax purposes.

For foreign investors the capital taxes must be considered as a cost factor, since they are usually not creditable against any tax liabilities in the investor's state of residence (e.g. the United States).

C. Withholding tax

A 35 per cent withholding tax is levied on dividends (including deemed dividend distributions) as well as on interest payable on corporate securities such as bonds and debentures. It is also withheld on all interest credited by a bank to its clients, whether on current accounts, time deposits or savings accounts. However, the tax does not have to be withheld on interest on open accounts, intercompany accounts or straight mortgage interest. No withholding tax is levied on royalties.

The withholding tax will normally be fully refunded if the recipient of the dividend or interest payment is a resident of Switzerland. Where the recipient is located in a treaty state, refund is granted according to the treaty relief. The treaty rates on dividends generally range between zero per cent and 15 per cent and on interest between zero per cent and 10 per cent. In all other cases, no refund will be available.

D. Tax consequences of reorganizations

In order to reduce the fiscal obstacles to corporate reorganizations, there are special regulations in the Swiss tax laws (income taxes, stamp tax, withholding tax and VAT) which allow for certain types of reorganizations (mergers, spin-offs, divisions) to be carried out in a tax efficient manner. The provisions under which such reorganizations are possible are quite complex and care must be taken to structure reorganizations appropriately in order to have them qualify for the special exemptions. It is important to note that, unlike in the EU, there are currently no provisions for tax-free cross-border reorganizations.

E. Special statuses for cantonal and municipal taxes

Whereas for federal tax purposes all corporations are subject to the regular taxation rules, most cantons have introduced special tax statuses for corporations engaged in certain types of activities. These privileges can be characterized as follows:

Holding companies. The status of a holding company applies for corporations whose main purpose consists of owning and administering holdings in other corporations. This is mostly assumed to be the case if at least two thirds of the assets consist of participations or if at least two thirds of the total income is participation income. Some cantons have slightly different rules with regard to the balance sheet and income statement structure. On the cantonal/municipal level, holding companies are exempt from income taxes and subject to reduced capital taxes, whereas taxation at the federal level follows the regular rules. However, due to the participation reduction outlined above, many holding companies will pay minimal or no income taxes at the federal level either. In this context it is important to be aware that, as opposed to liquidation proceeds, capital gains from the disposal of shares do not qualify as participation income and are therefore subject to federal income taxes.

Domiciliary companies. A domiciliary company is a company that, apart from its registered office (which is merely a mailing address) and the Swiss director(s) who formally represent(s) the company, has no offices, personnel or activities of any sort in Switzerland. Its records, invoices etc. are prepared by third parties. In most instances, a domiciliary company has its head office with a fiduciary company, a lawyer or a bank which also administers the company. Domiciliary companies are totally exempt from cantonal/municipal income taxes and the cantonal/municipal capital taxes are levied at reduced rates. Federal taxes are imposed according to the regular rules.

Mixed domiciliary companies, etc. In addition to the holding and domiciliary companies, which are defined and taxed similarly in most cantons, there are also various cantonal specialities with regard to tax privileges, such as mixed domiciliary companies, administrative companies or auxiliary companies. These types of companies offer attractive opportunities for taylor-made solutions.

F. Incentives for newly established enterprises

In order to attract new enterprises and thus strengthen their regional economies, certain regions grant investment and tax incentives to newly established corporations. Incentives include tax holidays or reduced taxation for up to ten years at the cantonal/municipal level, interest subsidies, job-related subsidies or special guarantees. Incentives are available to both manufacturing and service companies.

IV. OTHER TAXES

A. Value added tax (VAT)

On 1 January 1995, a VAT system similar to the one operated in the EU Member States replaced the former sales tax regime. The standard rate for supplies of goods and services is 6.5 per cent, a reduced rate of 2 per cent applies to certain goods and services of basic necessity and there is a special rate of 3 per cent for hotel accommodation. Contrary to the direct taxation regime, the Swiss VAT legislation includes the concept of group taxation for group entities within Switzerland.

The present VAT regime is provisional and based on a government ordinance. Within the next two or three years this should be replaced by a VAT law, which is expected to solve some of the practical problems inherent in the current regulations.

B. Securities transfer tax

Apart from the stamp tax of 2 per cent on the issuance of share capital described above, there is also a stamp tax on the transfer of securities. The securities transfer tax is due on the transfer of securities, if one of the contracting parties or an intermediary is a securities dealer within the meaning of the Swiss stamp tax legislation. The tax rate amounts to 0.15 per cent for the transfer of Swiss securities and to 0.3 per cent for the transfer of foreign securities.

C. Taxes on immovable property

Whereas the Confederation imposes no special taxes on immovable property (land and buildings), there are four types of such taxes at the cantonal/municipal level. The most important of these from an economic viewpoint is the capital gains tax on immovable property. This tax is imposed on profits from the sale of immovable property held privately by individuals. In a number of cantons the tax is also levied on sales of business property held by individuals, partnerships or corporations. In the vast majority of cantons a non-recurrent transfer tax is payable on the transfer of immovable property.

In addition to the general net wealth taxation most cantons impose a special property tax on immovable property, which is usually under municipal jurisdiction. Finally, some cantons levy a minimal tax on immovable property owned by corporations. This tax only applies if it exceeds the regular taxes on income and capital or (in some cantons) the minimal tax on turnover.

V. INTERNATIONAL ASPECTS

A. Swiss unilateral rules

In Swiss unilateral tax legislation, the main instrument for avoiding international double taxation is the exemption of foreign assets invested in and income derived from businesses, permanent establishments or real estate located abroad. For individual as well as corporate tax purposes, such assets and income are only relevant for determining the applicable tax rates.

As a counter part to this foreign branch and real estate exemption, businesses, permanent establishments (defined based on the general definitions laid down in the OECD Model Convention) and real estate located in Switzerland are subject to Swiss taxation, regardless of whether they are owned by residents or non-residents. Foreign taxes paid on income which is taxable in Switzerland based on unilateral (and treaty) rules only result in a tax credit to the extent the relevant tax treaty provides for such a credit. In all other cases, the foreign taxes can be deducted from the tax base, without a tax credit being granted.

B. Tax treaties

Switzerland has a comprehensive network of income and capital tax treaties. Most of these treaties are within the framework of the OECD Model Convention. As in unilateral law, the Swiss treaties generally follow the exemption method, i.e. they exempt the income and assets allocated to the other state from Swiss taxation (although these may be taken into account when computing the progressive tax rates).

The full list of countries with which Switzerland currently (as per 1 January 1996) has a tax treaty is set out in the Appendix.

C. Anti-abuse legislation

In 1962, the Swiss federal government issued a decree designed to curtail abuses which had arisen under tax treaties between Switzerland and other countries. Where foreign source dividends, interest, royalties, etc. enter Switzerland in such a manner that a reduced withholding tax rate appears applicable under the provisions of one of its international income tax treaties, the transaction will be subject to scrutiny and certain conditions concerning financing, usage of earnings, coverage of expenses and the minimum dividend distribution must be met in order for the reduced treaty rate to be allowed. Similar provisions have been included in the treaties with Germany, France, Italy and Belgium.

Despite continued criticism of these regulations, mainly based on the observation that in general the states which should be protected by these measures have constructed effective obstacles to treaty abuse of their own since 1962, the responsible authorities show no signs of replacing or abolishing the provisions of the anti-abuse decree.

VI. COMPETITIVE ADVANTAGES OF THE SWISS TAX SYSTEM

Although Switzerland has been subject to increasing competition from other European jurisdictions with respect to its attractiveness as a business and tax location, the Swiss tax system still offers numerous advantages for both foreign and domestic investors. The most important of these can be summarized as follows:

- Due to the complete exemption from income taxes at the cantonal/municipal level and to the extensive tax reduction on participation income for federal tax purposes, the tax costs of operating a Swiss holding company are among the lowest in Europe. Furthermore, in the case of many countries Switzerland's comprehensive treaty network reduces the tax burden on dividend payments made to a Swiss holding company.
- The foreign branch exemptions stipulated in federal and cantonal/municipal tax laws allow a corporation to register in Switzerland and thus obtain access to the Swiss treaty network, without income and capital of foreign

operations (branches) being taxed in Switzerland. Even corporations with no activity in Switzerland can take advantage of this, although a certain, usually quite minor, headquarters allocation cannot be avoided.
- Within the scope of the various cantonal/municipal tax privileges a Swiss resident corporation or a Swiss finance branch of a foreign corporation can be used as an efficient vehicle for group financing and treasury activities.
- The use of domiciliary companies and mixed domiciliary companies offers opportunities for international trading operations which are still unequalled. In addition to the attractive tax aspect Switzerland's excellent communications and transportation infrastructure as well as the economy's relative security provide strong arguments for locating international trading companies in one of the Swiss cantons.
- Due to the special tax regimes for administrative and auxiliary companies, paired with the availability of highly educated labour possessing business and language skills, Switzerland is also well suited as a location for corporate headquarters and business support centres.
- Since individual taxation is favourable in many cantons, the transfer of employees to Switzerland is also beneficial. Furthermore, the standard of living, education, the access to cultural activities and other aspects of the infrastructure usually make Switzerland a pleasant place to live for the individuals concerned. For wealthy individuals wishing to spend their retirement years in Switzerland, the possibility of lump-sum taxation and the inheritance and gift tax regulations are noteworthy advantages.
- Finally, the traditionally constructive relationship between taxpayers and the tax authorities, combined with the widely used possibility of obtaining advance tax rulings in order to minimize future tax risks, must be considered one of the principal assets of the Swiss tax system.

APPENDIX

Swiss Tax Treaties

Antigua	France	Luxembourg	St. Lucia
Australia	The Gambia	Malaysia	Singapore
Austria	Germany	Malawi	South Africa
Barbados	Greece	Mexico	Spain
Belgium	Grenada	Montserrat	Sri Lanka
Belize	Hungary	Morocco	Sweden
Bulgaria	Iceland	Netherlands	Trinidad and Tobago
Canada	India	New Zealand	Tunisia
China	Indonesia	Norway	United Kingdom
Denmark*	Ireland	Pakistan	United States
Dominica	Italy	Poland	Virgin Islands
Ecuador	Ivory Coast	Portugal	Zambia
Egypt	Jamaica**	Romania	Zimbabwe
Falkland Islands	Japan	Russia***	
Finland	Korea (Rep.)	St. Christopher and Nevis	

* Including the Faroe Islands.

** The treaty with Jamaica is retroactive from 1 January 1995.

*** A new treaty with Russia has been concluded, which is not in force yet. The applicability of the old treaty with the former USSR to the FSU States has to be examined individually.

VAT ON CROSS-BORDER SERVICES

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This article is based on the current VAT Ordinance[1] (hereafter referred to as VATO), the draft of the VAT Law[2] as published on 10 September 1995, and the various brochures and circulars issued (prior to 30 April 1996) by the Federal Tax Administration.

I. INTRODUCTION

Although Swiss tax consultants are only beginning to get a grasp of all the implications of VAT, sales tax is not new to Switzerland. Before 1995, Switzerland had a sales tax system known as ICHA ("Impôt sur le chiffre d'affaires"). This was a single stage tax levied by registered wholesalers on the sale of goods. Services were, as a general rule, not taxable.

The Swiss VAT system was introduced by virtue of the VATO only thirteen months after the principle of VAT was accepted by referendum on 28 November 1993. The fact that the present VAT legislation has been issued in the form of an Ordinance from the Federal Council (i.e. the government) and not by a formal law enacted by the parliament is very unusual.

The principles of sales tax, the authorized period during which it may be levied, as well as its maximum rates are written into the Constitution. Any amendment of the Constitution requires the approval both of the people and the cantons. In 1993, when it appeared that a new sales tax was required to provide more revenue and that the period of validity of the ICHA was about to elapse,[3] it was proposed to replace the former ICHA by a VAT. However the Swiss Parliament did not have enough time to pass a formal VAT Law. Therefore the parliament temporarily delegated its authority to issue VAT legislation to the government.[4] Based on this authority, the general principles of VAT legislation were laid down in the transitional provisions of the Constitution and these were approved by referendum on 28 November 1993.[5] The Federal Council was therefore entitled to issue the VAT legislation. On 22 June 1994, the VATO was issued by the government. It came into force on 1 January 1995.

In December 1993, the Lower Chamber (*Nationalrat*) of the parliament instructed its Commission for Economic and Tax Matters to prepare the draft of the VAT Law. The commission published a draft version on 10 September 1995. Anyone interested in formulating remarks and/or proposing amendments had until the end of November 1995 to do so. The commission has not yet submitted its final draft to the Lower Chamber. After being approved by the Lower Chamber, the proposed legislation will be forwarded to the Upper Chamber (*Ständerat*) for approval. After adoption by both chambers, the VAT Law may still be challenged during the subsequent three month period by referendum.[6] The VAT Law is scheduled to enter into force on 1 January 1998. In the meantime, the VATO remains effective and the government may amend this at will.

Contrary to the old sales tax system, Swiss VAT is much the same as other European VAT systems, and a particular effort has been made to make it compatible with the Sixth EC Directive.

It is a multistage tax levied at every stage of production on the value added to taxable supplies. The amount of tax due by a VAT-registered person corresponds to the difference between the tax charged on the sale of goods or supply of services (output tax) and the tax payable on purchases (input tax). Taxable transactions include (i) the delivery of goods and the supply of services on Swiss territory, (ii) self supply, (iii) the acquisition of services from abroad and (iv) the import of goods.[7]

VAT is usually calculated on the basis of the consideration or price paid for the delivery of goods or the supply of services at a standard rate of 6.5 per cent.[8] However, certain goods and services, such as foodstuffs, medicine, books and newspapers, are taxed at the more favourable rate of 2 per cent.[9] In addition, after much discussion in parliament, a special rate

1. Federal Council, Ordonnance régissant la taxe sur la valeur ajoutée of 22 June 1994.
2. Lower Chamber of the parliament, Loi fédérale régissant la taxe sur la valeur ajoutée, projet pour la procédure de consultation selon décision de la Commission de l'économie et des redevances du Conseil national of 28 August 1995.
3. I.e. at the end of 1994.
4. Art. 8, para. 1 of the transitional provisions of the Constitution.
5. Art. 8, para. 2 of the transitional provisions of the Constitution.
6. I.e. if a referendum is requested and the majority of citizens vote against the legislation it will not come into force.
7. Arts. 4 and 66 VATO.
8. Art. 27, para. 1(b) VATO.
9. Art. 27, para. 1(a) VATO.

of 3 per cent will be introduced as of 1 October 1996 for accommodation services (hotel etc.) but not for regular meals. For social, economic or political reasons, some specific goods and services are exempt without credit.[10] Exempt services include medical treatment of all kinds, services in connection with social assistance, education, culture, insurance and certain banking operations, real estate, delivery of official stamps, operations connected to betting, and delivery of returnable containers.

Switzerland's VAT system follows the destination principle, whereby the delivery of goods and the supply of services are taxed in the country of consumption. The import of goods and services is therefore usually fully taxable. Conversely, exports are, in principle, zero rated i.e. exempt with credit.

Decisions rendered by the Federal Tax Administration may be challenged in court the final court of appeal being the Federal Tribunal (i.e. the Supreme Court). Such challenges to the Administration may be made for instance where it is considered that the VATO violates certain principles set down in the transitional provisions of the Constitution. For example, there is much controversy concerning the full deductibility of transportation, accommodation and meal expenses as input tax. The VATO restricts the deductibility to 50 per cent. It has been argued that the general VAT principles as mentioned in the transitional provisions of the Constitution do not provide for such a restriction. Although this issue has already been raised in court, the Federal Council has amended the VATO so that from 1 January 1996 transportation and accommodation expenses may be fully deductible. However, the 50 per cent restriction has been maintained for meal expenses.[11] There have been no amendments to the VATO concerning cross-border services for the time being, even though, as shall be demonstrated, the present legislation has been very much criticized.

When dealing with cross-border services, the following steps have to be taken into consideration. The first step consists in determining the nature of a particular transaction and whether it may be characterized as a taxable supply of services (Section II). Second, the place of supply has to be identified (Section III). Third, where the place of supply is in Switzerland, the obligation to register for VAT purposes has to be checked (Section IV). Only when these parameters have been clarified can the tax consequences of an import or export of services be determined and issues surrounding the recoverability of Swiss VAT be addressed (Sections V through VII). In view of some of the difficulties encountered with the implementation of the current rules on cross-border services, there have already been propositions for legislative changes. These are explained in Section VIII.

II. TAXABLE SERVICES

Taxable services are defined as all transactions which are not characterized as a delivery of goods.[12] In addition, the transfer of intangible assets and rights, regardless of whether or not they are represented by a document, and the obligation not to commit an action or of tolerating an action or situation are specifically characterized as services.[13]

Under this definition, any transaction which is not characterized as a delivery of goods is deemed to be a supply of services. The definition of delivery of goods is therefore all important in defining services.

Under the VATO, the definition of delivery of goods is broader than under the Sixth EC Directive. Indeed, goods are deemed to include all movable and immovable objects as well as electricity, gas, heat, cold and the like.[14] Furthermore, the Swiss definition of delivery of goods encompasses two additional types of operations: (1) the improvement of materials through examination, control, adjustments, etc., even if such goods are not altered, but merely examined, calibrated, adjusted, controlled in their function, or handled in any other manner,[15] as well as (2) the transfer of goods for limited use or exploitation, under for instance, a rental or lease agreement.[16] The fact that the Swiss definition of goods and, consequently of services, differs from the European Union definition may give rise to potential double taxation or absence of taxation when dealing with European Union countries.

Once it has been established that a given transaction is characterized as a supply of services, it is necessary to determine whether such services are taxable i.e. whether they are not excluded from the scope of Swiss VAT by virtue of Article 14 VATO (exemption without credit).

III. PLACE OF SUPPLY

In order to determine whether a particular transaction is deemed to be a cross-border service, it is necessary to establish the State from where the service is considered to have been supplied. It is only if the place of supply and the purchaser are in two different States that there is a cross-border transaction.

This feature is certainly the one which differs the most from the Sixth EC Directive. The general rule provides that the place of supply of services is deemed to be the place where the supplier has his business registration office or permanent establishment from which the service is rendered.[17] There are only three limited exceptions which concern: (1) services in connection with the preparation or coordination of work on immovable property which are considered as rendered at the place where the immovable property is located;[18] (2) transportation services which are deemed to be rendered in the country where the transport takes place[19] and (3) ancillary

10. Art. 14 VATO contains a list of 21 exempted types of goods and services.
11. Federal Council, Ordonnance of 18 September 1995 modifying *inter alia* Art. 30, para. 2 of the VATO.
12. Art. 6, para. 1 VATO.
13. Art. 6, para. 2 VATO.
14. Art. 5, para. 3 VATO.
15. Art. 5, para. 2(a) VATO.
16. Art. 5, para. 2(b) VATO.
17. Art. 12, para. 1 VATO.
18. Art. 12, para. 2(a) VATO.
19. Art. 12, para. 2(b) VATO.

transport services where the place of supply is in the country in which the activities are effectively carried out.[20]

There are however no rules similar to Article 9, paragraphs 2(c) & (e) of the Sixth EC Directive concerning the location of cultural, artistic, sporting, scientific, educational, entertainment and intangible services. Thus, even if rendered to persons outside Switzerland, such services are considered as being located within the country.

IV. TAXABLE PERSONS

As a rule, anyone who makes, in a regular and independent manner, taxable deliveries of goods and/or taxable supplies of services in Switzerland in excess of CHF 75,000 per year must register for VAT.[21] Although taxable supplies may exceed this threshold, there is no obligation to register if the turnover does not exceed CHF 250,000 and the annual VAT liability does not habitually exceed CHF 4,000.[22] In certain circumstances companies may incur large amounts of input tax but do not fulfil the above conditions to become a VAT taxpayer.[23] This is the case for corporations involved in international trade when goods are purchased and sold abroad without passing through Switzerland. In such cases it is possible to register on a voluntary basis[24] provided transactions abroad which would be considered as taxable if made in Switzerland exceed CHF 40,000 per year.

The VATO provides for a limited number of cases where entrepreneurs are under no obligation to register. For instance, farmers, foresters and horticulturists do not become VAT taxpayers provided they only deliver their own products. This rule also applies to cattle dealers. In addition, painters and sculptors can sell their own created works of art without becoming VAT taxpayers.[25]

A similar rule exists for companies and foundations which have been granted a special tax ruling for direct tax purposes.[26] This rule is supposed to enter into force only when the law for harmonization of the direct taxes will be applicable in all cantons, i.e. in the year 2001.

Non-resident legal entities and individuals are subject to the same registration rules as are resident companies and persons. If a non-resident is under an obligation to register for Swiss VAT purposes, it must designate a fiscal representative in Switzerland.[27]

When registering, the information required from the non-resident is as follows:[28]

- name, legal form, address, telephone number;
- extract of Commercial Registrar;
- type of activity;
- date of beginning of activity;
- number of employees (fixed and temporary);
- financial year;
- bank account number (in case of reimbursement of excess taxes); and
- gross income realized in previous year (in Switzerland and abroad).

The Swiss representative is responsible for all matters concerning Swiss VAT except the payment of the VAT. The responsibilities between a foreign entity and its Swiss representative should therefore be clearly defined. Usually the Federal Tax Administration requires that the name of the representative appears on all documentation (including invoices) which may have a Swiss VAT impact. In addition, all accounts and documents relevant to Swiss VAT must generally be held by the representative and be readily available to the Federal Tax Administration. The tax authorities usually request security by way of a bank guarantee for the tax expected to fall due. The amount of the guarantee is determined according to the forecasted annual turnover and usually represents one year's VAT (minimum CHF 5,000).

It should be noted that Swiss VAT registration does not automatically mean that a permanent establishment is created in Switzerland for corporate income tax purposes.[29] Indeed, the permanent establishment issue should be looked at separately in the light of Swiss corporate income tax law and any applicable international tax treaty.

V. EXPORT OF SERVICES

Based on the definition of the place of supply (see Section III) the Swiss suppliers are deemed, in most cases, to supply services in Switzerland. Therefore, the rule which governs exportations plays an important role. According to Article 15, paragraph 2(l) VATO, services are deemed to be exported, and therefore zero rated, when:

- the beneficiary has his place of business or residence abroad and,
- the services are utilized or exploited abroad.

The first of the two conditions can easily be evidenced, since the address on the invoice or on the contract shows where the beneficiary has his place of business or his residence, but the concept of "services utilized or exploited abroad" has given rise to much controversy.

For example, how is it possible to determine the place where taxable banking services are "utilized or exploited" when a foreign resident owning a bank account in Switzerland "utilizes" the income derived from his bank account to pay both the costs of his summer holidays in France and the mortgage interest of his chalet located in a Swiss ski resort? What are the means at the disposal of the Swiss banker to determine the place of utilization of the services he provides to foreign residents, in order to satisfy the double test of Article 15, para-

20. Art. 12, para. 2(c) VATO.
21. Art. 17, para. 1 VATO.
22. Art. 19, para. 1(a) VATO.
23. Here we leave aside the case of entities which supply non-taxable services.
24. Art. 20, para. 1(a) VATO.
25. Art. 19, paras. 1(b) & (c) VATO.
26. Art. 19, par 1(d) VATO.
27. Art. 59, para. 2 VATO.
28. Federal Tax Administration, Questionnaire pour l'enregistrement comme contribuable TVA, Form No. 798/4.95.
29. Art. 59, para. 2 VATO.

graph 2(l) VATO? The same uncertainty exists in the case of a Swiss advertising company organizing an advertising campaign in French and German newspapers on behalf of foreign clients when the newspapers are also distributed in Switzerland. Should there be separate invoices prepared in respect of the number of newspapers sold abroad and those sold in Switzerland? Countless examples can be given to illustrate this problem.

Due to the various criticisms concerning the applicability of Article 15, paragraph 2(l) VATO, the position of the Federal Tax Authorities has changed considerably during the last eighteen months. Three events in particular are worthy of note.

The issue of instructions and the brochure on banks and financial companies

In the autumn of 1994 the Federal Tax Administration issued a document[30] which gave some indications concerning the place where services could be deemed to be "utilized or exploited". At a first glance, the solution seemed straight forward and easy to apply. The Instructions introduced a rule whereby, "if the head office or the business establishments (company management etc.) are situated abroad, it is admitted that the use or exploitation is also abroad with the exception of:

- services rendered in relation to real estate property;
- services rendered in the hotel and restaurant sector;
- certain other services".[31]

According to the examples given, the general concept stated above was in fact to be interpreted in a very restrictive manner.[32] In an example referring to publicity services purchased by a foreign company from a Swiss agency,[33] the tax authorities not only required that the advertising campaign take place abroad, but also that the advertised products not be sold on the Swiss market in order to consider the services as exported. This double condition of "utilization" violates the concept of VAT.[34]

The Instructions expressly reserved the particular rules that could be mentioned in brochures issued by the tax authorities in various sectors of the economy. Between autumn 1994 and spring 1996, the Federal Tax Administration issued 28 brochures dealing with most economic sectors. But the only sector for which the tax authorities gave a precise criterion to determine the place where services could be deemed to be "utilized or exploited" by foreign beneficiaries, is the banking sector. In its brochure referring to banks and financial companies[35] issued in May 1995, the Federal Tax Administration indicated that when individuals have their domicile abroad, the services provided to them are also deemed to be "utilized or exploited" abroad, except for services in connection with real estate.[36] The same criterion, i.e. place of business or permanent establishment, is relevant both for corporations and partnerships.[37]

However, the banks and financial companies brochure provides for a very controversial exception with respect to services provided to offshore entities.[38] Indeed the tax administration wants to look through the legal entity to determine where the founders or the economic owners are resident. When the beneficial owners of an offshore structure are resident in Switzerland, the services must be fully taxed (i.e. they cannot be zero rated). Banks are in a position to verify who are the beneficial owners of an account by checking the so called formula A[39]. This document identifies by name and address the beneficial owners of the account opened under the name of domiciliary companies.

One aspect of the controversy concerns the offshore structures set up in Liechtenstein. Indeed, services rendered by Swiss VAT-registered taxpayers to legal entities in Liechtenstein are fully taxable since they are not considered as being exported, even if their beneficial owners are residing abroad (i.e. neither in Switzerland nor in Liechtenstein). One can argue that they should benefit from the "look through" process of the Swiss tax authorities. Therefore the services provided by Swiss banks to Liechtenstein offshore entities should be zero rated when the beneficial owners of those entities are not Swiss residents. Unfortunately the Swiss tax authorities do not agree with this point of view.

The customs legislation and turnover taxes in the Principality of Liechtenstein and Switzerland have been unified for many decades now. Regarding VAT, a treaty was signed between Switzerland and Liechtenstein on 28 October 1994, whereby Liechtenstein agreed to introduce a VAT legislation similar to that adopted in Switzerland[40]. Any later modification of the VATO must also be introduced into the Liechtenstein legislation[41]. According to an addendum to the treaty[42], the territory of each State is considered as encompassing the other's territory[43]. Except for VAT levied on the importation of goods into Liechtenstein, which remains the competence of the Swiss customs authorities as previously,[44] VAT on turnover generated in Liechtenstein is payable to the Liechtenstein authorities. This is particularly important with respect to services because, in the situation where the Swiss authorities were entitled to levy VAT on services supplied in the Principality they would have access

30. Federal Tax Administration, Instructions à l'usage des assujettis TVA, Bern, Fall 1994 (hereafter Instructions).
31. Instructions, para 559, at 66.
32. Instructions, paras. 560 to 565, at 66.
33. Instructions, paras. 563 and 564, at 66.
34. The mere fact that the recipient had its seat abroad was therefore not at all sufficient.
35. Federal Tax Administration, Banques et sociétés financières, brochure No. 610.507-3, Bern, May 1995 (hereafter Banques et sociétés financières).
36. Banques et sociétés financières, para. 2.2(b), no 1 at 7.
37. Banques et sociétés financières, para. 2.2(b), no 2 at 7.
38. Banques et sociétés financières, para. 6.5 at 22.
39. Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 92) Art. 4.
40. Traité entre la Confédération suisse et la Principauté de Liechtenstein relatif à la taxe sur la valeur ajoutée dans la Principauté de Liechtenstein, signed on 28 October 1994, entered into force on 1 January 1995, Art. 1, para. 1 (hereafter Traité).
41. Traité, Art. 1, para. 2.
42. Accord entre la Confédération suisse et la Principauté de Liechtenstein concernant la Traité relatif à la taxe sur la valeur ajoutée dans la Principauté de Liechtenstein signed on 28 November 1994 and entered into force on 1 January 1995, (hereafter Accord).
43. Accord, Art. 2.
44. Accord, Art. 5, para. 2.

to data concerning in particular services provided to foreign countries. Liechtenstein legal vehicles often used as offshore entities include the Foundation and Anstalt whose beneficial owners are generally neither resident in Switzerland nor Liechtenstein.

Bearing in mind the above rules for offshore entities, the solution adopted for trusts seems, by comparison, strangely simple. Services provided to a trust[45] are deemed to be exported if the trustee resides abroad. Apparently no other condition is required. The place where the beneficiary or the settlor resides is of no consequence. To guarantee that the trust is managed according to the law of a jurisdiction which has trust legislation one non-Swiss trustee is generally appointed. However, it is also normal to appoint one or several Swiss resident trustees. Although nothing is mentioned in the banks and financial companies brochure, when there are several trustees residing in Switzerland and abroad, apparently the majority of them must be foreign residents if services supplied to the trust are to be considered to be exported.

The July 1995 Guidelines

On 17 July 1995, the Federal Tax Administration issued new general guidelines on cross-border services.[46] There were three main issues: (1) services in the banking sector, (the above rules were confirmed), (2) services provided by lawyers, engineers dealing with patents and notary publics, (3) services rendered by fiduciary companies, chartered accountants and auditors. For these types of activity the principle of domicile applies. The Federal Tax Administration stated that the question of whether this practice would be extended to services in other fields would be decided upon at a later date. The circular also dealt with services provided in connection with real estate properties, the offshore "look through" rule, services rendered by executors and finally services supplied to international groups of companies. Where services are supplied to international group entities residing in Switzerland, the mere fact that those services are invoiced to a foreign group member is not considered to be sufficient to indicate an export of services. Indeed, the relevant element for taxation is the place where the services are effectively rendered. In the meantime the pressure on the tax authorities to extend the scope of the 17 July 1995 circular increased.

The October 1995 Guidelines

The third significant event occurred with the issue of the circular of 30 October 1995 which replaced that of 17 July 1995. This circular referred to the exemption of certain cross-border services,[47] in it the Federal Tax Administration adopted a much more favourable interpretation of Article 15, paragraph 2(l) VATO. The extension of the application of the principle of domicile has been strongly influenced by Article 9 of the Sixth EC Directive. The Federal Tax Administration specifically refers to the solution of the Sixth EC Directive. However, it should be stressed that the Swiss solution is basically completely different from the European one, since services are considered to be rendered where the supplier has his seat, permanent establishment or domicile, with the exceptions of services in connection with immovable properties, transportation and ancillary transport activities. In fact only in the case of exportation has the European solution helped the Federal Tax Administration to determine the place where the services could be deemed to be "utilized or exploited".

By comparison to the content of the 17 July 1995 circular, the principle of domicile has been extended. The new rules regarding the utilization of services are set out below.

The following services are deemed to be utilized where they are physically carried out;
- those relating to cultural, artistic, sporting, scientific, educational, entertainment or similar activities, including the activities of the organizers of such activities;
- those relating to storage in a bonded warehouse of goods, but this does not encompass the lease or rent as defined under Article 5, paragraph 2(b) VATO;
- those relating to pure expertise concerning movable tangible property, but not including other specific activities as described under Article 5, paragraph 2(a) VATO.[48]

On the other hand the services mentioned below are deemed to be utilized where the beneficiary has his seat, permanent establishment or domicile.
- those relating to advertising, provided they do not constitute delivery of goods;
- those of consultants, asset managers, debt collectors, engineers, lawyers, engineers dealing with patents, notary publics, chartered accountants, fiduciary, and other similar activities of translators in the legal, economic and technical fields as well as the data processing and the supplying of information;
- those concerning transfer and assignment of copyrights, patents, licences, trade marks and similar rights;
- those in connection with obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in this list;
- those concerning the supply of staff.

This circular was welcomed by taxpayers involved in the cross-border rendering of services. However, since it has been released ten months after the VATO entered into force, the question of retroactivity applies. The circular does not clearly address this issue, but strangely indicates that services in connection to advertising will only benefit from the above rule as of 1 January 1996. This distinction between various types of services constitutes a violation of the principle of equality of treatment.

45. Banques et sociétés financières, para 6.6 at 22.
46. Federal Tax Administration, Notice concernant l'exonération de certaines prestations de services fournies à l'étranger, No. 13, Bern, 17 July 1995.
47. Federal Tax Administration, Notice concernant l'exonération de certaines prestations de services fournies à l'étranger ou acquises de l'étranger, No. 13, Bern, 30 October 1995.
48. I.e. this excludes work undertaken regarding the examination, standardization, regulation, verification or handling etc. of goods.

VI. IMPORT OF SERVICES

When the place of supply of taxable services is abroad, there is an import of services when services are acquired by a Swiss resident if they are used or exploited in Switzerland.[49] The place of utilization is determined according to the 30 October 1995 circular described above. Unlike the import of goods, services are not subject to Swiss VAT at the point of entry, but must be declared by the purchaser if they are deemed to be used or utilized in Switzerland.

Imported services are taxed at ordinary rates. However, as per Article 18 VATO, there is no tax liability if the services received do not exceed CHF 10,000 per annum. The fact that the customer is otherwise registered for VAT is of no consequence for the application of this threshold. In other words, there is an equality of treatment between VAT registered and non-VAT registered persons with regards to the import of services.

If the services are rendered to a VAT registered taxpayer and such services are used in making taxable supplies, the VAT paid is immediately deductible,[50] as input tax. In the situation where the taxpayer has a portion of his turnover which is not taxable, the VAT can only be partially recovered. On the other hand, if services are rendered to entities or individuals which are not VAT-registered, the VAT must be paid on annual supplies in excess of CHF 10,000 and represents a final charge to them. The non VAT-registered persons must, at the end of the calendar year, declare to the tax authorities the imported services and pay the tax due.

VII. RECOVERY OF SWISS VAT BY NON-RESIDENTS

Under current legislation foreigners can recover the Swiss VAT paid on the acquisition of goods and services in Switzerland.[51] This possibility has been further enhanced by the Ordinance of 14 December 1994.[52] Included in this Ordinance is the possibility for foreign companies to request the reimbursement of tax which has been effectively charged to them on services rendered by Swiss VAT registered enterprises.

The conditions to be fulfilled in order to qualify for a recovery of Swiss VAT are as follows:[53]

- The services for which reimbursement is requested must be rendered to a person (corporate or individual) which has its head office or domicile abroad.
- The foreign beneficiary must not supply any goods or services in Switzerland.
- Proof must be given that the foreign beneficiary of the services is a foreign enterprise.
- The country in which the foreign enterprise has its head office or domicile must grant full reciprocity. Recently the reciprocity clause has been granted to the USA although this country has no VAT.
- The services for which the foreign enterprise claims reimbursement of the Swiss VAT must be used in order to supply goods or services which would be subject to Swiss VAT if rendered in Switzerland.
- The minimum VAT for which a reimbursement will be made is CHF 500 (per annum).
- The originals of invoices must fulfil the conditions of Article 28 VATO (i.e.: name and address as well as VAT registration number of the supplier etc.).[54]
- The foreign entity must designate a representative (individual or corporate) with a Swiss domicile or head office. The representative must be in possession of a written power of attorney.

A request for reimbursement must be filed with the Swiss Federal Tax Administration in Bern within six months after the end of the calendar year during which the services are rendered (i.e. before 30th June of the following year). Only one request can be filed per year. The competent authorities have prepared official forms for this purpose.

VIII. PROPOSED CHANGES IN THE LAW

The new VAT Law is scheduled to enter into force on 1 January 1998 at which date it will replace the current ordinance (see introduction). It is hoped that the new law will introduce some major changes to the taxation of cross-border services.

According to the draft VAT Law published as of 10 September 1995 there shall be no change to the present distinction between delivery of goods and supply of services. However, the rules concerning the place where services are considered to be rendered have been adjusted so as to follow the same basic pattern set out in Article 9 of the Sixth EC Directive. In order to avoid any unexpected cases of double taxation or absence of taxation resulting from cross-border services, a provision has been introduced which grants the Government the authority to determine the place where certain services are deemed to be rendered.

IX. CONCLUSION

Foreign suppliers of services who do not have any physical presence in Switzerland are not subject to Swiss VAT except

49. Art. 9 VATO.
50. I.e. in the same tax return.
51. Art. 81, para. C VATO.
52. Federal Council, Ordonnance régissant le remboursement de l'impôt à des destinataires dont le domicile ou le siège social est à l'étranger, 14 December 1994.
53. Federal Tax Administration, Explications concernant la demande de remboursement de la TVA à des destinataires ayants leur domicile ou leur siège social à l'étranger, Form No. 1221/4.95.
54. The further details required are:
- name and address of the VAT registered recipient of the supply (and not the name of the employee who receives the supply, for instance: meals or accommodation);
- date or period of the supply;
- description of the supply;
- consideration paid for the supply;
- amount of VAT due on the consideration, if the tax is included in the consideration, an indication of the rate is sufficient.

on services rendered in connection with immovable property, transportation and ancillary transport services. The Swiss resident beneficiaries are solely liable to settle the VAT due to the Swiss tax authorities.

With regard to the export of services by Swiss suppliers, one can regret that the Federal Council did not amend Article 15, paragraph 2(l) VATO, in order to provide taxpayers with greater certainty. This certainty is needed since whilst the Federal Tax Administration's current interpretation of the provision enables the taxpayer to determine whether in a particular case services are deemed to be exported it is nevertheless possible that the Adminstration will change their position at anytime.

Finally, the fact that Switzerland has adopted a different definition of goods and services to that applying in the European Union may give rise to the problems of either double taxation or non-taxation when transactions are entered into with entities from the European Union countries.

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THE TAXATION OF INVESTMENT FUNDS AND THEIR UNIT HOLDERS IN SWITZERLAND

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I. INTRODUCTION

A. Objectives

The objectives of this article are to:
- set out the main features of Swiss investment funds and related legal institutions;
- describe the federal tax regime applicable to investment funds and their unit holders; and
- examine and clarify the position regarding the refund of Swiss and foreign withholding tax.

B. Definitions

1. Investment funds and investment companies

The words "investment fund" usually cover various forms of professionally administered and publicly raised funds. In the following we distinguish between:
- the legal form;
- Swiss or foreign funds;
- distribution or cumulative funds;
- open and closed-end funds.

2. Investment funds or corporations

According to the legal structure collective investment is possible in two different forms: i.e. the "contractual form" and the "corporate form".

(a) *The contractual form*

Swiss investment funds are according to Article 2 paragraph 1 and Article 3 paragraph 1 and 2 Investment Fund Act (IFA) only subject to the IFA if they are administered by a collective investment contract. This means that the relationship between the investor and the fund management has a contractual nature. In Luxembourg such investment funds are called "Fonds communs de placement".

(b) *The corporate form*

Although only the contractually organized Swiss investment funds fall under the IFA, this does not mean that collective investment is not permitted on a corporate basis. Instead, Swiss civil law regulations will apply to such investment. Corporate funds may not use the description "investment fund" or any similar expression that might be misleading. Typical examples in Switzerland, are the different "Visions" of BZ Bank Zurich.

Corporately structured investment funds are common abroad. The most well known are the SICAV (*Sociétés d'Investissement à Capital Variable*) and (less importantly) the SICAF (*Sociétés d'Investissement à Capital Fixe*) in Luxembourg and France. The Luxembourg SICAV is a company in the open-end form; while SICAFs are closed-end investment companies with fixed share capital.[1] Besides the SICAV/SICAF, offshore companies also need to be mentioned when considering foreign corporate investment vehicles.[2]

3. Swiss and foreign investment funds

With regard to the applicability of the IFA a distinction should be made between Swiss and foreign investment funds. A fund is Swiss if the management and the administration of the fund are in Switzerland.[3] Administration is located in Switzerland if the fund practices its specific activities in Switzerland,[4] the bookkeeping is done in Switzerland and decisions on the contents of brochures and publications for the investor are made in Switzerland.[5]

A foreign investment fund is defined as a collective property administered by a fund management registered abroad either on the basis of a collective investment contract or another contract with similar effect.[6] In addition, the IFA defines as foreign investment funds companies registered and managed

1. Open-end and closed-end funds are discussed in detail see Sec. I.B.5.
2. For example accumulated investment vehicles of the Channel Islands (Jersey, Guernsey) and the Cayman Islands etc.
3. See Art. 9 para. 1 IFA in connection with Art. 44 para. 1(a) IFA and Art. 9 IFO; compare on the other hand also BGer 23 December 1981, in: *BGE* 107 Ib 363.
4. The fund management according to Art. 11 para. 1 IFA makes the decisions regarding the issuance of units, the composition of the fund, the repurchase price of the units and the distribution policy. It also must ensure that the fund complies with all the legal formalities.
5. See Art. 9 IFO.
6. Art. 44 para. 1(a) IFA.

abroad, where the investor has a right vis-à-vis the company or a related company to redeem his units.[7]

4. Distribution and cumulative funds

A distinction is made between distribution funds on the one hand and cumulative funds on the other. A fund qualifies as a distribution fund if at least 80 per cent of its profits are distributed[8] to its investors in accordance with the fund's regulations.[9] Alternatively, if less than 80 per cent of profits are so distributed the fund is classified as a cumulative fund.

5. Open and closed-end investment funds

With regard to the capital structure a distinction must be made between open-end and closed-end funds. An open-end fund exists if the investor may in principle at all times redeem his units; the fund being obliged to repurchase the units at intrinsic value at the expense of the fund's capital. Closed-end funds are those investment funds which have no repurchase obligation i.e. the fund management is not required to redeem the units. The characteristic feature of a closed-end fund is a fixed capital. Therefore the issue of new units is only possible if capital is increased.[10] As the investor can only sell his units in a closed-end fund on the open market, i.e. on the stock exchange or over the counter, his position is quite different from that of an investor in an open fund. The price, reflecting the value of a unit moves according to supply and demand; it need not be in line with intrinsic value.

According to Swiss law, closed-end funds are not considered to be investment funds. A certain mixed status is given in the case of an open-end mortgage fund, whereby the right to give notice according to Article 25 paragraph 1 IFA can be excluded by the fund regulations.[11]

II. LEGAL ASPECTS OF SWISS INVESTMENT FUNDS

A. Definition of an investment fund

An investment fund according to the IFA has the following characteristics:
- special purpose capital;
- a collective capital;
- funds raised as a result of public advertising;
- the owner of the fund's property is a Swiss fund management;
- there is a contractual relationship between investor and fund management;
- investment strategy is based on risk diversification;
- the investor has a right of termination at all times.[12]

B. Legal status of fund management and unit holder vis-à-vis the collective capital

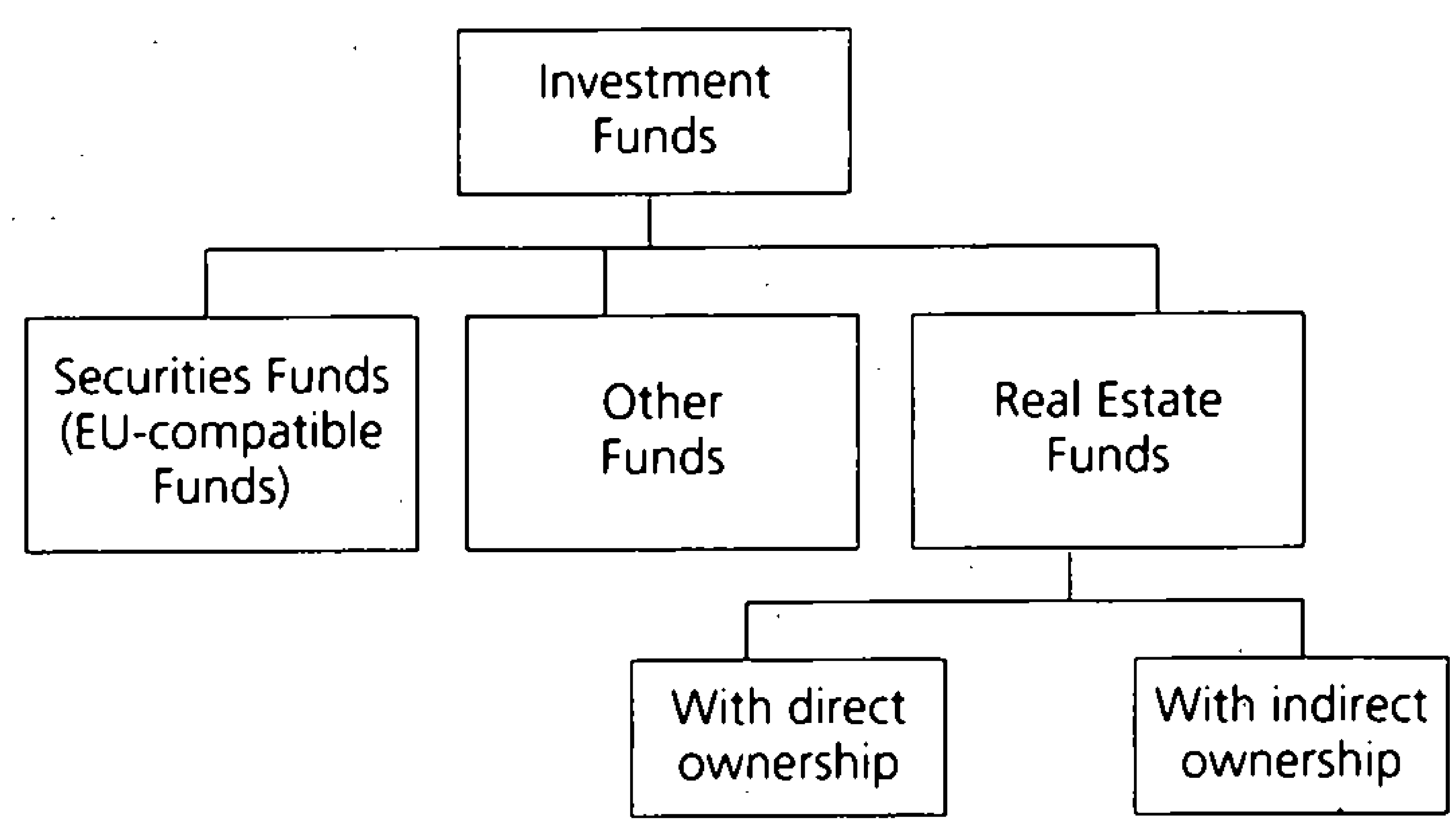
According to Article 23 paragraphs 1 & 2 IFA the investor simply acquires claims against the fund management on participating in the property and income of the investment fund. It is thereby clearly expressed that the investor only has obligatory rights to the payment of his part of the fund's income and property. The investor becomes creditor of the fund management. The fund management, however, does not owe him a fixed amount or a bond type of interest, but rather a fluctuating sum which will depend on the value of the fund.

Based on Article 6 paragraph 1 IFA the fund management is obligated by the collective investment contract to allow the investor to participate according to the number of units he holds and to manage the fund independently according to the rules of the fund regulation. According to Article 11 paragraph 1 and Article 12 paragraph 1 IFA the fund management manages the investment fund for the account of the investor independently and in their own name but in the interest of the investor. The fund management therefore functions in a fiduciary capacity on behalf of the investor.[13]

The rights of the investor must, according to the Investment Fund Act, and contrary to the old Act – no longer be fixed in the form of a document.[14] This, however, does not limit the trading of units since Article 23 paragraph 4 IFA gives each investor the right to ask for units in the form of securities.

C. The three fund categories of the Swiss Investment Fund Act

Today's IFA distinguishes between the EU compatible "securities funds" and the non EU-compatible "real estate funds" and "other funds".



7. Art. 44 para. 1(b) IFA.
8. If it is expressly stated in the fund regulations that income and capital gains are distributed, the fund is a distribution fund even if it does not make a distribution each year.
9. Pfund Walter Robert (1971), *The Federal Withholding Tax*, Part I, Basel, Art. 4 para. 1 c N 4.30.
10. Stadler Ralph (1990), "European Investment Law and the Swiss Investment Fund Act", Dissertation ZH, at 25.
11. See also Sec. II.D.
12. See Arts. 2 para. 1, 23 para. 1, 24 para. 1 and 25 para. 1 IFA.
13. Spori speaks in this connection about a "quasi fiduciary relationship", see Spori Peter, "Taxable Income Aspects of private Portfolio Investments", 59 *ASA* at 380.
14. See Message to IFA, at 236-7.

The fund's property which is to be separated from the fund management company's own capital may include movable as well as immovable assets. Real estate can either be property registered in the Land Register under the name of the fund management (remark "affiliated to the real estate investment fund")[15] or participations in and claims from real estate companies whose purpose it is to buy, sell, hire or lease their own property as long as two thirds of their capital and the votes are held by the investment fund.[16] The fund management ensures its financial commitment by keeping an appropriate part of the fund capital in short term fixed interest securities or funds.[17]

D. Termination of the collective investment contract

The investor has the right according to Article 24 paragraph 1 IFA to terminate the collective investment contract. Termination ends the contractual relationship between the fund management and the previous unit holder with immediate effect. If the unit holder terminates the collective investment contract the units must be redeemed at the expense of the fund capital and the investor is paid in cash.

If the valuation of a fund is difficult or where the fund suffers from restricted marketability the fund regulations may stipulate that termination can only be declared at certain times, subject to the proviso that it may be declared at least four times a year.[18] In justified exceptions the Federal Banking Commission can determine other dates for termination.[19] The right of the investor to redeem his units in the fund in principle at almost any time, qualifies the Swiss investment fund as an open-end fund.[20]

For real estate and mortgage funds special termination rules apply. According to Article 25 paragraph 1 IFA the right to termination in the case of a mortgage fund may be completely excluded by the fund's regulations: this exclusion must be set out in advertisements, in the fund's regulations and in the prospectus. By this rule a mortgage fund becomes in effect a closed-end fund. In the case of real estate funds, the investor has a right to terminate (Article 41 paragraph 2 IFA) at the end of the business year subject to a 12-month period of notice.

E. Liquidation of investment funds

There is a difference between the termination of a collective investment contract by the unit holder and the liquidation of the investment fund. With the termination of the contract only a part of the fund is dissolved and the relevant unit holder's interest in the fund is liquidated. In the case of a liquidation all collective investment contracts are affected; the dissolution therefore affects all unit holders.[21]

The investment fund is dissolved:[22]

- if it existed for an uncertain period of time,[23] through termination by the fund management or the depository bank;[24]
- if it had been concluded for a certain period of time, through lapse of time or if there is an important reason, at the request of the fund management or the depository bank or through order of the Federal Banking Commission;
- if by official order of the Federal Banking Commission the permission for business activity has been withdrawn from the fund management or the depository bank[25] and no new fund management or depository bank has been appointed.

III. OTHER INVESTMENT VEHICLES

Besides contractual funds various other legal forms are used which may be similar to Swiss investment funds. These are described below.

A. Pools of assets similar to investment funds

The Federal Council can declare pools of assets similar to investment funds to be subject to the rules of the Investment Fund Act. This is to prevent the undermining of the Act through contracting out the obligations it imposes. The Federal Council has made use of its competence and declared that multistage collective funds are also subject to the law. The Federal Banking Commission permits such funds, which are mainly "Master-Feeder" or "Hub and Spoke" constructions, only if their special structure does not in any way impair the interests of the investors.[26]

B. In-house funds

In-house funds fulfil three of the four necessary characteristics of an investment fund. They are special funds without legal personality, serving the purpose of a collective investment offered by banks. Similar to investment funds the investment policy also follows the rule of diversification of risk.[27] However, according to Article 4 paragraph 2 IFA the banks may not publicly advertise such in-house funds. The investor can at any time terminate the contract according to

15. Art. 36 para. 2(a) IFA.
16. Art. 36 para. 2(b) IFA. Co-ownership in real estate is permitted if the fund management has a major influence, Art. 36 para. 3 IFA.
17. Art. 36 para. 4 IFA.
18. Art. 24 para. 2 IFA in connection with Art. 25 para. 1 IFO.
19. Art. 24 para. 2 IFA in connection with Art. 25 para. 2 IFO.
20. See Sec. I.B.5.
21. See BGer 21 November 1969, in: *BGE* 95 I 589. The fund management is not permitted to terminate single collective investment contracts.
22. See Arts. 29 and 30 IFA.
23. This form of investment fund is the normal case.
24. The minimum period of notice for both the investment fund and the depository bank is one month; the period of notice must be mentioned according to Art. 7 para. 3(i) IFA in the fund regulations.
25. The Federal Banking Commission withdraws the granted authorization if the person with the authorization violates his contractual duties, Art. 57 para. 1 IFA.
26. Art. 2 para. 1 IFO. See also Art. 2 para. 3 IFO.
27. See Message to AFG, at 233 and 262.

Article 3 paragraph 3 Investment Fund Ordinance (IFO) and request a cash repayment.[28]

C. Investment club

A distinction must also be made between an investment fund and an investment club. The latter's purpose serves, according to the Federal Supreme Court, to familiarize its members with the trading of securities and to enable them without significant risk to participate in the buying of securities. For this purpose, according to the Federal Supreme Court, only individuals who would like to have personal involvement in the running of the club will be considered for membership.[29] The investment club is established by a small number of people in the form of a simple partnership. They determine the investment policy and make decisions jointly. Unlike investment funds an investment club does not fulfil the criteria of public advertising and the members invest the property themselves. An investment club is not subject to the rules of the Investment Fund Act.[30]

D. Fund-like corporations

Fund-like corporations are portfolio entities in the form of a limited company such as the "Visions" of BZ Bank Zurich.

The fund-like corporations are subject to the tax regime applicable to corporations. This means that at the time of foundation of such a company and upon any subsequent increase in its capital, stamp tax is levied. Such tax is due as soon as the increase of share capital is registered in the Register of Commerce.[31]

Regarding income and capital tax a distinction should be made between the cantonal/communal and federal level. Fund-like companies usually qualify as holding companies and thereby profit from the holding privilege. Therefore at the cantonal level no income or capital gains tax is levied,[32] the corporation merely being subject to a reduced capital tax.[33] The federal income tax system does not contain a holding privilege. On the other hand fund-like companies enjoy the benefits of the participation exemption. Therefore dividends are in effect not taxed and taxation is restricted to income from other sources[34] plus capital gains. Income tax is limited to 9.8 per cent.[35] Capital tax at the federal level is 0.08 per cent.[36]

As under the Stamp Tax Law (STL) fund-like corporations fall within the definition of securities dealers, they are subject to transaction tax.[37]

E. Investment foundations

Pension funds may utilize investment foundations as well as investment funds when investing their capital. (Investment foundations are also subject to federal supervision.)[38]

F. Luxembourg SICAV/SICAF and offshore companies

As mentioned above the SICAV and the SICAF are legal entities subject to Luxembourg law; the SICAV being an open-end and the SICAF a closed-end investment company.[39] The offshore companies of e.g. the Channel Islands and the Cayman Islands are also investment vehicles that fall to be treated as corporations. In our opinion all the mentioned companies are to be treated as legal entities and therefore taxed accordingly.[40] Correspondingly, the investors have to be taxed as shareholders.

IV. DISTRIBUTION FUNDS: TAXATION OF THE FUND AND THE UNIT HOLDERS

A. Taxation of the investment fund

1. The Swiss investment fund

The following description is in principle limited to securities funds and "other funds". Only brief mention will be made of real estate funds in this section.

Swiss investment funds have no legal existence and are therefore not subject to taxation. As a result and according to the federal, cantonal and communal tax systems the property of the investment fund together with its income is only taxed in the hands of the investor i.e. the investment fund is not itself subject to taxation.[41] In particular, although the fund management is, according to civil law, the owner of the investment property, the income thereof is not allocated to the fund management for tax purposes since it holds the fund property in a fiduciary capacity only.[42] Clearly the objective of the legislation is not to burden the unit holder with higher taxation than would have applied had he invested directly in the underlying assets of the fund.

28. As in the case of investment funds the bank's internal special property is also an open-end fund.
29. BGer 13 October 1972, in: *ASA* 42, at 415 = *BGE* 98 Ib 202.
30. For investment club see also Art. 60 para. 1 Withholding Tax Ordinance.
31. Art. 7(a) STL.
32. The tariff is reduced. The tax burden of the holding company varies from canton to canton between 0.05 per cent and 0.15 per cent of taxable capital. The basis on which capital tax is levied is different from canton to canton. Some cantons only take into account the paid-in original capital, others in addition include the reserves and deferred gains carried forward.
33. See e.g. § 50 para. 1 Income Tax Law ZH; Art 71 para. 1 Income Tax Law BE; Art. 76 para. 2 Income Tax Law SG. The income from Swiss real estate is taxed separately in some cases; the Tax Harmonization Law is planning by the year 2001 to tax Swiss real estate in future in all cantons at ordinary tariffs.
34. For example interest income.
35. See Art. 222 para. 3 Federal Direct Tax Law (DTL).
36. See Art. 78 para. 1 DTL.
37. See Art. 13 para. 3 STL.
38. Art. 56 para. 1 BVV 2.
39. See Sec. I.B.2(b).
40. See Sec. V.B.
41. Assuming the fund property consists of shares in Swiss stock companies and the investment fund is taxed, a threefold tax burden occurs: i.e. the stock company, the investment fund and the investor are all effectively taxed on the same income.
42. Compare this to Sec. II.B.

As an exception to the above treatment investment funds with real estate are subject to tax. They are treated according to Article 49 paragraph 2 of federal Direct Tax Law (DTL) like legal entities and are therefore taxed on their income. The income tax liability of the investment fund is calculated according to the rates applicable to individuals.[43] Based on Article 77 DTL, the investment fund is not subject to capital tax. According to Article 29 paragraph 2(c) of the federal tax law on harmonizing direct tax in the cantons and municipalities (THL), capital tax for real estate funds is levied according to the rules applicable to individuals.

Fund management companies and depository banks are securities dealers. If they are involved in the transfer of securities they have to account for transaction tax.[44] The tax amounts to 0.15 per cent for domestic certificates and 0.3 per cent for foreign certificates.[45] The transaction tax is part of the price of the investment.

The issuance of units of Swiss investment funds is neither subject to issuance tax[46] nor transaction tax.[47] However, the sales proceeds arising in respect of the transfer of ownership of the units is subject to transaction tax if one of the contracting parties or one of the intermediaries is a Swiss securities dealer.[48] The burden of the transaction tax due is as a rule shifted to the unit holder.

(a) *Investment funds with Swiss property*

As explained above, Swiss investment funds are neither subject to income tax nor property tax.[49] However, investments in Swiss securities are subject to Swiss withholding tax.[50] The rate is 35 per cent levied at source. The payer is subject to the tax but the burden is shifted to the investment fund. Capital gains distributed by investment funds by means of a separate coupon are tax free.[51]

(b) *Investment funds with foreign property*

Swiss investment funds, with the exception of those funds owning real estate, are in principle not subject to federal tax. The foreign countries in which the investment fund has property usually levy tax at source on dividends and interest. Issuance of foreign securities results neither in issuance tax[52] nor transaction tax[53] in Switzerland.

2. Foreign investment funds

Whether or not an investment fund is subject to taxation on its income and capital in the country of domicile will depend on the foreign tax legislation. If a fund is constituted on a contractual basis it is not subject to tax in Switzerland as it is not considered to be a legal entity.[54]

In contrast a foreign corporate investment fund, is according to Article 49 paragraph 3 (DTL) treated as if it were a Swiss legal entity. This means that such an investment fund in Switzerland will in principle be treated like a corporation. However, in the absence of a permanent establishment or ownership of real estate,[55] the Swiss tax authorities will not levy tax on the investment fund's income or capital. Furthermore, if an investment fund is taxed as a corporation the unit holders must be treated as shareholders.[56]

The fund management of a foreign investment fund is not resident in Switzerland; and can therefore not become a Swiss securities dealer. However, if a depository bank were to be resident in Switzerland it would be subject to taxation in respect of any transactions in securities it made on behalf of the foreign investment fund. This is because of its position as intermediary.[57]

The issuance of units of foreign investment funds as well as of shares of corporations that are treated as investment funds are not subject to issuance tax in Switzerland. However, the issuance is subject to transaction tax if one of the parties involved is a Swiss securities dealer.[58] Transaction tax is also levied under the same circumstances on secondary market transactions in shares of foreign investment funds.[59]

B. Taxation of unit holders

This article has so far focused on the tax situation of the investment fund. In the following section the taxation of investors will be discussed under the following broad headings:
- Swiss vs. foreign domiciled investors;
- private vs. business ownership of the units;
- participation in a Swiss or a foreign (contractually or corporate structured) investment fund;
- tax consequences relating to the period of ownership, the sale of units, the termination of the collective investment contract as well as the liquidation of the investment fund.

1. Investors domiciled in Switzerland

(a) *Swiss investment fund*

Income earned by the investment fund and distributed to the unit holder is subject to taxation in the hands of the latter according to Article 20 paragraph 1(e) DTL and Article 7

43. See Art. 72 DTL.
44. See Arts. 13, 15 and 17 STL.
45. See Art. 16 paras. 1(a) & (b) STL.
46. Art. 5 para. 1(b) STL was terminated with the 1991 revision.
47. See Art. 14 para. 1(a) STL.
48. See Art. 13 para. 1 in comparison to para. 2 and 3 STL.
49. Subject remains the investment fund with direct real estate in the sense of Art. 49 para. 2 DTL; see Sec. IV.A.1.
50. See Art. 4 para. 1 Withholding Tax Law (WTL).
51. See Art. 5 para. 1(b), Art. 10 para. 1, Art. 13 para. 1(a) WTL and Art. 28 Withholding Tax Ordinance.
52. See Art. 5 STL.
53. See Art. 14 para. 1(f) STL.
54. See Art. 3 and 4 DTL; Art. 49 para. 3 DTL finds no application for investment funds on a contractual basis. However, a foreign contractual investment fund with direct ownership of real estate falls in our opinion under Art. 49 para. 2 DTL and would be taxable on real estate in Switzerland (see Art. 51 para. 1(c) DTL) like other legal entities.
55. See Art. 51 para. 1(b) & (c) DTL. Foreign corporate investment funds with direct real estate are not considered.
56. See Hess Toni, "SICAV-Accumulation Fund: Critical appraisal of a change in practice of the Federal Tax Authorities", 49 *StR* (1994), at 234 et seq.
57. See Art. 13 para. 3 and Art. 17 STL.
58. See Art. 13 para. 2(b) STL; Art. 14 para. 1(a) STL refers only to share certificates of Swiss investment funds.
59. See Art. 13 STL.

paragraph 3 THL[60] in so far it does not represent a repayment of the unit's capital. Distributed capital gains are tax free if paid separately via a separate coupon[61] *and* the units are in private property. Even if this practice used to be criticized[62] it is in our opinion the correct treatment due to the fiduciary relationship[63] between the fund management and the investors. The motive of non-taxation of capital gains was originally a political one. The investor[64] who purchases units in an investment fund should be treated the same as if he had invested directly in the fund's underlying assets. Otherwise no-one would use investment funds.[65] If the units form part of the business assets, the distributed capital gain will be taxable on the investor based on Article 18 paragraph 2 DTL and Article 8 paragraph 1 THL.

The income distributed to the investors by the investment fund is subject to withholding tax based on Article 4 paragraph 1(c) of the withholding tax law (WTL). Withholding tax is levied on distributions to Swiss or foreign[66] investors except if they constitute capital gains or repayment of capital contributions.[67] Capital gains may only be distributed free of withholding tax if a separate coupon is used.[68]

If units are sold the relevant proceeds are seen as capital gains and no federal nor cantonal/communal taxes are levied unless the units form part of the business property of the seller. The same treatment applies if the investor sells his units to the fund management.[69]

Under the old law the termination of a collective investment contract resulted in taxation. With the circular letter dated 31 August 1979[70] the federal tax authorities introduced a change in the rules regarding termination of collective investment contracts and requested that the cantonal tax authorities treat the repayment to the investor after termination of the collective investment contract as the sale of units (i.e. therefore tax free). These instructions ensure that the repeated purchase and reissuance of units no longer cause the same income to be taxed several times. If the units belong to the business property of the investor the difference between sales proceeds and book value is subject to taxation.

There is a difference in tax treatment between the termination of a collective investment contract and the liquidation of a fund. This is entirely based on the reasons stated in Article 29 paragraph 1 IFA. If the units are held as private property, the liquidation proceeds, reduced by the cost of the investor's original investment and the capital gains component, are taxed as income.

(b) *Foreign contractual investment funds*

Reference may be made to Section IV.B.1(a) above.[71]
Withholding tax is only levied on distributed income if the foreign investment fund issues units in cooperation with a Swiss party[72] such as a Swiss depository bank.

(c) *Foreign corporate investment funds*

As practically all foreign corporate investment funds do not distribute their net profit, but instead accumulate it, they fall to be treated as accumulation funds (See below).

2. Non-Swiss domiciled investors

Foreign domiciled investors are neither subject to Swiss income nor to Swiss wealth tax. According to the rules of international tax law, movable assets and related income is only taxed at the place of residence of the investor. (As an exception movable business assets and related income is taxed at the place of business).

Distributions by Swiss investment funds are subject to Swiss withholding tax.[73] However, a special rule exists: according to Article 27 of the WTL, foreign investors have a general right to reclaim the withholding tax deducted from distributions if at least 80 per cent of the income is foreign sourced. Therefore and according to Article 34 of the Ordinance of the WTL the tax does not need to be deducted if a special bank affidavit confirms that the investor is not a Swiss tax resident.[74]

V. ACCUMULATION FUNDS: TAXATION OF FUNDS AND INVESTORS

A. Contractual accumulation funds

1. Taxation of the investment fund

The income tax rules applying to an accumulation fund are basically no different than those applying to the distribution fund. Comments made previously apply in this section as well.[75] For the time being, however, no withholding tax is levied due to the absence of distributions. We understand that the federal tax authorities are discussing whether withholding

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60. If the investor is not an individual but a legal entity, the distributed income is subject to profit tax and not income tax, see Arts. 57 et seq. DTL and Art. 24 THL.
61. See Art. 5 para. 1(b) WTL; if the share certificates were issued without coupons, capital gains and capital repayments are exempt from withholding tax if shown separately in the statement for the investor; Pfund, Art. 5 para. 1 b N 3.16 f.
62. See Höhn Ernst, *Tax Law*, 7.a., Bern/Stuttgart/Vienna 1993, § 16 N 64; Wassmer Carla, *The taxation of investment funds and their investors*, Bern/Stuttgart 1982, at 67-68. and 134-135 .
63. See Sec. II.B.
64. The Law refers originally to the small investor; today more institutional investors make use of the institution of investment funds.
65. See also Locher Peter, "Capital gains versus income in the Federal Tax Law", *Recht* (1990), at 120.
66. The non-levy of withholding tax in favour of a foreigner with an affidavit (see Art. 11 para. 2 WTL; Art. 34 of the respective ordinance) only becomes relevant if a Swiss investment fund deals mainly with foreign investments, i.e. at least 80 per cent of the fund income is foreign sourced; see Sec. IV.B.2.
67. See Art. 28 para. 1 Withholding Tax Ordinance; Art. 5 para. 1(b) WTL.
68. Stockar (*Case examples for stamp tax and withholding tax*, 2.A., Basel 1993, at 40) speaks in this respect of adverse concessions, that had to be given to Swiss investment funds.
69. The problem of a partial liquidation only affects a corporate investment fund. See accumulation funds in Secs. V.B.2(b). and V.B.2(c).
70. 48 *ASA* at 176-177.
71. Except foreign investment funds on a corporate basis; see Secs. V.B.2(b) and V.B.2(c).
72. See Art. 4 para. 1(c) WTL.
73. See *supra* note 72.
74. As a rule the fund management or the depository bank is the debtor.
75. Reference can be made to the comments under Sec. IV.

tax should be levied on the basis of an annual deemed distribution.

2. Taxation of the investor

(a) *Taxation during period of ownership*

In the circular letter of 23 November 1989 regarding the taxation of the non-distributed income of investment funds, the federal tax authorities stated that investors are subject to tax on non-distributed income by virtue of Article 21 paragraph 1(c) federal tax law.[76] Legally this practice is based on the fiduciary nature of the contract between fund management and investor. Such tax rules create considerable practical issues for the tax authorities. This is especially the case for investment funds which have their business year ending on 31 December. In the case of these funds, the split between taxable income and tax free capital gains is usually not yet known at the time when the federal tax authorities print the relevant list for the taxation of securities. This is a problem as the investor needs to know the income earned by his fund for his own tax declaration.

(b) *Taxation at sale/termination*

For the investor taxation is not only important during the period of ownership, but also in the following circumstances:
- the sale of investment fund units;
- the termination of the collective investment contract by the investor;
- the liquidation of the fund by the fund management.

The tax consequences of a sale etc. are similar to those applying to distribution funds (see above).[77] However, a special feature should be kept in mind. In the case of the liquidation of the investment fund the liquidation payment needs to be reduced for tax purposes by the investor's share in the original capital, by the reinvested capital gains component as well as by non-distributed income which was already taxed on the investor. Only the remaining excess is taxable income according to Article 20 paragraph 1(e) of the DTL, and Article 7 paragraph 3 of the THL.

Where the units were business assets of the taxpayer the difference between the liquidation proceeds and the book value of the units is considered to be taxable income within the meaning of Article 18 paragraph 2 DTL, and Article 8 paragraph 1 THL.

B. Accumulation funds in the form of a corporation: Example Luxembourg SICAV

1. Tax consequences for SICAV[78]

A SICAV is a foreign legal entity since it is a corporation under Luxembourg law. According to Article 49 paragraph 3 of the DTL, foreign legal entities are taxed the same way as the Swiss legal entities that they are most comparable to by reference to their legal and economic characteristics. As the SICAV shares many of the characteristics of a Swiss corporation in our opinion it should be taxed accordingly. However, this may only be the case if such legal entity has a permanent establishment in Switzerland. It is therefore important for Swiss banks offering these types of funds to carefully evaluate whether the criteria for such a permanent establishment have been fulfilled.

According to the circular letter of 6 May 1994 the federal tax authorities, however, are not willing to acknowledge the SICAV as a legal entity as they "are seen to be similar to a Swiss investment fund".

In Luxembourg a SICAV is according to Article 105 paragraph 1 of the investment law neither subject to income nor to wealth tax. According to paragraph 2 of this Article the distributions to the unit holders are free of withholding tax. Besides a registration fee at the time of establishment and taxation of the management company, SICAVs in Luxembourg are only subject to the so called *taxe d'abonnement* which is levied annually at 0.06 per cent on the net assets. (0.03 per cent for Money-Market Funds and for Funds-of-Funds; it is planned to reduce the rate of 0.03 per cent even further as of 1997).

2. Tax consequences for the Swiss resident investor

(a) *Taxation during period of ownership*

Up to the assessment year 1993 a Swiss investor was treated for federal tax purposes like a shareholder of a company which did not distribute any dividend. Consequently at the time of reinvestment, no tax was levied on the investor. Taxes were levied only when the reinvested income was distributed or, alternatively realized at the time of liquidation.

In their circular letter dated 6 May 1994[79] the federal tax authorities requested the cantonal tax authorities (when levying federal income tax) to apply the circular letter of 23 December 1989 regarding accumulation funds to the taxation of SICAVs. The undistributed income of a SICAV was taxed for the first time in the assessment year 1994. This specifically means that the Swiss resident investor should be taxed on the reinvested income credited to his account.[80]

These changes in the tax rules by the federal tax authorities are in our opinion, not correct for two reasons: first of all this practice violates Article 49 paragraph 3 of the DTL and Article 20 paragraph 2 of the THL which refers to comparable Swiss entities as explained above. Furthermore, the rule ignores the fact that there is no fiduciary relationship between investor and SICAV, but rather a corporate relationship. Therefore the taxation of the non-distributed income of a SICAV on the investor requires the revision of the DTL and the THL.[81] This conclusion not only applies to the SICAV

76. These regulations of the old federal tax law are in principle in accordance with Art. 20 of the new law.
77. See Sec. IV.B.
78. The following comments are also valid for SICAF and offshore companies of the Channel Islands and the Cayman Islands.
79. 63 *ASA* at 30-31.
80. 58 *ASA* at 348-349.
81. In detail see *supra* note 56 at 242 et seq.

and its investors, but also to all other non-distributing foreign legal entities.[82]

A SICAV is in the sense of the withholding tax law not a Swiss entity. The accumulated income therefore is not subject to Swiss withholding tax.

(b) *Taxation on the sale of shares*

Where the shares of a SICAV are disposed of we need to distinguish between redemption and sales to third parties.

According to Article 27 paragraph 1(b) of the Luxembourg investment law, a SICAV should at any time, and at the request of the shareholder redeem his shares. As a SICAV needs to be treated the same way as a corporation under Swiss tax law, such redemption of shares would qualify under certain conditions as a partial liquidation. In the case of an individual if such a partial liquidation is assumed, the tax consequences for Swiss investors will depend on whether the shares were part of the private or the business assets of the investor. If an investor holds shares in his private assets and sells them to the SICAV, he realizes taxable income based on the application of the nominal principle.[83] According to this principle the difference between sales proceeds and the nominal value of the shares is taxed. As SICAV shares have no nominal value the whole of the sale proceeds is considered a liquidation dividend and therefore taxable income. This would be the consequence for federal taxes and for the majority of the cantonal taxes as well. If the shares form part of the business assets of individuals, the difference between the sales proceeds and the book value of the investment is considered taxable income.

If, however, a SICAV is treated like an investment fund, as is required by the federal tax authorities in their circular letter of 6 May 1994, the redemption of shares by a SICAV will not result in taxable income for the private investor. However, if the shares form a part of the business assets of an individual, again the difference between sales proceeds and book value is taxable as income.

If an individual shareholder sells his shares which form part of his private assets on the stock exchange or over the counter, but not to the SICAV, the proceeds are considered to be capital and not subject to federal income tax nor to cantonal income tax. If the shares are part of the business assets of an investor, the difference between sales proceeds and book value constitutes taxable income.

(c) *Liquidation of a SICAV*

If it is accepted that a SICAV needs to be taxed in the same way as a Swiss corporation their investors are therefore taxed like shareholders. The tax consequences of the liquidation of a SICAV would then be as follows: if the shares are part of the private assets of an investor, the "liquidation" dividend will be treated as taxable income both for federal and cantonal taxes, if the cantons follow the nominal principle.[84] This means that reinvested capital gains will also be taxable upon distribution as with any other legal entity. The same holds for reinvested income which has not been subject to annual taxation. If the shares form part of business assets, the liquidation of the SICAV will result in the taxation of the difference between the liquidation proceeds and the book value.

If SICAVs are taxed as Swiss investment funds, which is the case at federal level and in most of the cantons, the liquidation proceeds reduced by the share in the original capital and the reinvested capital gains is subject to income tax (private assets). If SICAV shares form part of the business assets of the investor, the difference between the liquidation proceeds and the book value of the shares constitutes taxable business income.

VI. RECLAIM OF SWISS WITHHOLDING TAX

This section only applies to Swiss investment funds set up on a contractual basis (See above). The reason for this limitation is that fund-like corporations are taxed separately and follow the normal rules for reclaim. However, special rules are necessary for Swiss investment funds which are not subject to tax.

A. Reclaim of Swiss withholding tax on the fund's income

1. Reclaim by the fund

A Swiss investment fund has to deduct Swiss withholding tax upon distribution to the unit holders according to Article 4 paragraph 1(c) of the WTL. There is an exception upon distribution of capital gains. Furthermore, if at least 80 per cent of the fund's income is foreign sourced: distributions to non-Swiss resident unit holders can then be made free from Swiss withholding tax (see above).

As a result of these rules it is logical that the fund is entitled to reclaim Swiss withholding tax suffered on income from investments in Swiss securities and bank accounts. Due to the explained mechanism neither foreign unit holders nor Swiss unit holders can achieve an unjustified benefit by using a Swiss investment fund. Consequently there is no reason to prevent Swiss investment funds from reclaiming Swiss withholding tax. Technically the right to reclaim lies either with the fund management or the depository bank on behalf of the investors.[85]

The right to reclaim withholding tax is limited to three years after the end of the calendar year in which the taxable event occurred.[86] In connection with this limitation the tax authorities consider that a distribution fund becomes an accumulation fund if there are no distributions for more than two years.

82. I.e. they need to be treated the same way as a Swiss corporation according to Article 49 paragraph 3 DTL, and Article 20 paragraph 2 of the THL.
83. It is beyond the scope of this article to consider this problem in more detail.
84. As already mentioned under Sec. V.B.2(b) it is beyond the scope of this article to examine the correctness of the nominal value principle in more detail.
85. See Art. 26 WTL.
86. Art. 32 para 1 WTL.

In-house funds are subject to the same rules as defined in Article 9 of the WTL. Special rules regarding the bookkeeping treatment must be complied with in order to make this reclaim.

2. Reclaim by the unit holder

If the tax authorities apply a "fiduciary" concept to the taxation of Swiss accumulation funds it would be consistent to give the right of reclaim of withholding tax to the investor rather than the investment fund. This, however, is not provided for in the law as explained above. The investor therefore may not reclaim withholding tax.

It is interesting to note that the same reasoning is applied to SICAVs as well. As explained earlier, SICAVs are accorded the same tax treatment as Swiss investment funds. Following from this a Swiss resident investor in a SICAV fund is not entitled to reclaim Swiss withholding tax.[87] Due to the fact that the SICAV is not eligible for treaty benefits in Luxembourg, the SICAV is also prevented from reclaiming Swiss withholding tax. As a consequence a Swiss resident investor is subject to income tax on the non-distributed income of the SICAV, but forfeits the right to benefit from reclaiming Swiss withholding tax. In this respect he is therefore worse off than a Swiss resident investor in a Swiss investment fund.

B. Reclaim of Swiss withholding tax by unit holders on distributions by the fund

As previously explained a Swiss investment fund has to deduct Swiss withholding tax upon distribution to the unit holders. The Swiss resident unit holder can fully reclaim this withholding tax based on the declaration of the respective income in his tax return. A condition for the reclaim is that the investor should be resident in Switzerland at the date of the distribution and be the beneficial owner of the income. A reclaim is not possible in the case of tax evasion.[88]

The law specifically mentions the right to reclaim by the unit holders if at least 80 per cent of the fund's income is foreign sourced.[89] The 20 per cent tolerance recognizes the need for the fund to keep a certain percentage of its investment in liquid assets or tradable securities which may all suffer Swiss withholding tax. If an investment fund qualifies, the foreign investor will receive all distributions free of withholding tax. In addition, in this situation there is no need to distribute foreign source income any differently to Swiss source income.[90]

Foreign shareholders can reclaim Swiss withholding tax based on an applicable double taxation treaty. Seen from a Swiss perspective, fund distributions are equivalent to dividends and are therefore subject to the rules of the relevant treaty's dividend article.

It is interesting to note that the 80 per cent affidavit solution, as set out in the withholding tax law, is an exception to the general rule that non-Swiss residents can only reclaim Swiss withholding tax under a double taxation treaty.

VII. RECLAIM OF FOREIGN WITHHOLDING TAX

A. General comments

Regarding the reclaim of foreign withholding taxes the position is different to that applying to the reclaim of Swiss withholding tax. Firstly a reclaim by the Swiss investment fund is only permitted if provided for under a treaty or a related protocol and secondly reclaim is only possible for the benefit of a Swiss resident investor who is a beneficiary of the Swiss treaty.

This has two consequences. Firstly, the fund needs to distinguish between Swiss resident investors and foreign resident investors. This is done based on the statistics of the affidavit procedure.[91] Secondly, repayments of foreign withholding taxes must be accounted for separately as they can only be distributed to Swiss resident investors.

B. Double taxation treaties

A direct reference to the reclaim of withholding tax is only made in the UK treaty.[92] The treaty stipulates that the fund management of an approved investment fund of a contracting state is entitled to treaty benefits if the beneficial owners of dividends or income derived from the fund would be entitled to the treaty benefits as well. For the purpose of this article a Swiss investment fund is approved if it is subject to Article 2 IFA.

There are special protocols to the treaties in the case of five other countries[93] which effectively achieve the same result.

C. Formal criteria

It has already been mentioned that the benefits of treaty reclaims can only be distributed to Swiss investors and not to foreign investors. To facilitate the enforcement of this rule, special bookkeeping instructions exist. In essence the fund should record treaty benefits in a way that will allow it to make a clear distinction between the two groups of investors. There are special forms that need to be used for the reclaim of withholding tax.

87. Stockar Conrad and Hochreutener Hans Peter, *Practice of Federal Taxes*, Part II, Volume 2, Art. 26 Note 3.
88. See Art. 21 para 2 WTL and also Stockar Conrad, *Schweizer Treuhänder* (1986), at 60 et seq. and Pürro-Schwob Imogen, *Schweizer Treuhänder* (1994), at 606 et seq.
89. See Art. 27 WTL.
90. Pfund Walter Robert and Zwahlen Bernhard, *The Federal Withholding Tax*, Part II, Basel 1985, Art. 27 N 6.1.
91. Affidavit: see explanation in Sec. IV.B.2. Distributions to foreign resident investors are possible free of Swiss withholding tax if at least 80 per cent of the income of the fund is foreign sourced. This statistic is available for the closing day of the fund only.
92. United Kingdom–Switzerland double taxation treaty, dated 8 December 1977, Art. 27 para. 9.
93. Germany, France, the Netherlands, Austria and Sweden.

D. Refund of non-justified treaty benefits

According to internal practice and the rules of specific double taxation treaties certain countries reduce withholding tax on interest and dividends at source based on the Swiss address of the recipient. As a result a Swiss investment fund receives treaty benefits automatically even if the investors (or some of them), are not entitled to such benefits.[94] Typically withholding tax on dividends may only be say 15 per cent instead of the statutory rate of 30 per cent. As previously explained only Swiss resident investors are entitled to treaty benefits. The fund management therefore must refund the part of the treaty benefits which relate to foreign resident investors. Again the affidavit statistic is used for this purpose and the amounts in question are paid to the federal tax authorities.[95] The federal tax authorities will then reimburse the amounts to the countries involved.

As mentioned earlier a Swiss investor may not reclaim the Swiss withholding tax suffered by a Luxembourg SICAV and therefore the "SICAV investor" is worse off than the "Swiss investment fund investor". The reason for this negative consequence is the fact that a Luxembourg SICAV is not eligible for treaty benefits. The position is however different in respect of a direct reclaim of foreign withholding tax by a Swiss resident investor. If the undistributed income of a SICAV is taxed in the hands of a Swiss resident investor on the basis of a "fiduciary approach" he must have a right to enjoy treaty benefits as well. Therefore and assuming that the relevant data is available to the investor, he should be able to reclaim foreign withholding taxes under the Swiss treaties for his share in the fund's income. In the case of a large investment, for example by a Swiss pension fund, such reclaim may involve very substantial sums.

94. Reduced withholding rates at source apply in the case of Australia, Canada, Finland, Japan, New Zealand, Norway and the United States.
95. Forms 160 to 193.

APPENDIX

Survey in form of a tabular summary

A. Withholding tax and stamp tax

	Withholding tax on distributions	Withholding tax on redemption of units	Transaction tax on trading	Transaction tax on issue
Swiss income distribution funds	yes/no[1]	no[2]	yes	no
Swiss capital accumulation funds	–	yes[3]	yes	no
In-house funds of banks	yes/no[1]	no	–	no
Fonds communs de placement (Lux)	no	no	yes	yes
SICAV (Luxembourg)	no	no	yes	yes
Swiss companies limited by shares	yes	yes[4]	yes	no[5]
Off-shore companies	no	no	yes	no

1 Income is taxable; capital gains are not taxable if different coupons are used.
2 When a real estate fund is liquidated withholding taxes may become due.
3 Difference between redemption price and original investment and retained capital gains.
4 Difference between redemption price and nominal share capital.
5 Subject to stamp duty on issue.

cont. →

B. Federal tax for resident private investors in Switzerland

	Distrib. are taxable	A notional distribution is construed	Time at which tax liability arises	Tax free distribution of attributable capital	Redemption of units is taxable	Sale via stock exchange is taxable
Swiss income distribution funds	yes	-	due-date	yes	no	no
Swiss capital accumulation funds	-	yes	booking[1]	yes	no	no
In-house funds of banks	yes	-	due date	yes	no	-
Fonds communs de placement (FCP Lux)	yes	-	due date	yes	no	no
SICAV (Luxembourg)	-	yes[2]	booking	yes[3]	no[4]	no
Swiss company limited by shares	yes	no	due date	no	yes[5]	no
Offshore company	yes	no	due date	no	yes[5]	no

1 . This means the date of booking of the non-distributed income to capital account (or the retained income account) of the investor (normally the year-end of the fund).
2 As per circular letter of 6 May 1994 for federal income tax. According to the authors this letter violates the law.
3 This would be a logical assumption if circular letter of 6 May 1994 is followed. If this letter is not followed, a distribution of capital gains – same as companies – is not possible tax free.
4 According to the circular letter of 6 May 1994 this would be the logical conclusion. In the opinion of the authors the redemption of SICAV units, however, will be treated like shares; the question arises whether it is a partial liquidation.
5 Problem of direct partial liquidation.

CUMULATIVE INDEX – 1996

I. ARTICLES

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 41-44 of the January 1996 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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(B. 13.514)

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ASEAN

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Conference diary

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INTERNATIONAL

NON-DISCRIMINATION: A CONSIDERATION OF ARTICLE 24(5) OECD MODEL CONVENTION*

David Hughes
Research Associate and Editor, IBFD

I. INTRODUCTION

This paper deals with a question of great interest to many enterprises with "foreign" resident subsidiaries, where the subsidiary operates in a treaty country which has a non-discrimination article. The question is to what extent can these companies rely on the operation of such an article for protection?

The issue is very topical and is among the claims raised in the *Hoechst* and *Pirelli* litigation currently in progress (see section III below).

II. NON-DISCRIMINATION

A. Article 24(5)

Article 24 of the OECD Model Convention contains provisions prohibiting discrimination against non-nationals, or enterprises owned by non-residents. These provisions have been incorporated into many bilateral treaties. The type of discrimination this paper considers is discrimination against subsidiaries of non-resident parent companies. In this regard Article 24 paragraph 5 provides as follows:

> 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 that first-mentioned State are or may be subjected.

In understanding the scope of paragraph 5, it is vital to have regard to the OECD's commentary on that paragraph. In particular, paragraph 57 of the commentary states:

> This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

B. Similar enterprises

In determining whether discrimination has taken place, the first step must be to establish what constitutes a "similar enterprise" so that a comparison of tax treatment may be made. The tax authorities in the United Kingdom appear to have taken the view that comparison should be made with the way a subsidiary with a parent in a third state is treated. This view, however, appears somewhat at odds with both the OECD commentary and case law. The author therefore concurs with the opinion of most commentators which is that the appropriate benchmark is that of a subsidiary resident in the same country as its parent.

C. Case law

The case law underlines the distinction made in the OECD commentary between discrimination against the enterprise itself and discrimination against the owners of the enterprise's capital. Thus, cases decided in the Netherlands[1] and Sweden[2] have established that requiring the parent company to be a domestic corporation in order for subsidiaries resident in treaty countries to benefit from certain relieving provisions may contravene Article 24(5). For example in the Swedish case, despite a provision to the contrary in domestic law, the Swedish Supreme Administrative Court held that the transfer of stock for corporate reorganization purposes between group companies could take place without a charge to capital gains tax where the parent company was foreign, provided that the relevant treaty had an appropriate non-discrimination clause.[3]

D. General principles

From a consideration of the above, two key points emerge:
- enterprises owned by non-residents should be taxed similarly to enterprises owned by residents;
- the taxation relating to the non-resident owners of an enterprise need not be similar, i.e. each state would be entitled for example to impose a withholding tax on dividend payments, even though this tax only applied to non-resident shareholders.

The article will proceed by applying the above principles to the *Hoechst* and *Pirelli* litigation currently in progress before the courts.[4]

* The views expressed in this article do not necessarily reflect the views of either the IBFD or the IFA.

1. Decision of 23 December 1992, *BNB* 1993/71.
2. Decision RÅ 1987 ref. 158 of 19 November 1987 Regeringsrättens dom No. 2225-1987. See 38 *European Taxation* 12 (1988) at 401.
3. Here the clause was similar to Art. 24(5) OECD Model Treaty.
4. See section III. Although the EC issues undoubtedly will be decided by the EC Court, the bilateral treaty non-discrimination arguments may perhaps be determined by the UK Courts.

III. THE *HOECHST* LITIGATION

A. Facts

Hoechst UK Ltd and Pirelli UK Ltd both were compelled to account for advance corporation tax (ACT) upon the payments of dividends to their respective non-resident parent companies Hoechst AG and Pirelli SpA. This was notwithstanding that if the parent companies had been UK resident, the ACT liability could have been avoided by means of a group income election (see below).

Both companies have challenged the obligation to account for ACT on various grounds. This article will limit itself to considering the claims concerning the application of the relevant bilateral tax treaties' non-discrimination articles.[5]

In addition to the claims made by their subsidiaries, Hoechst AG and Pirelli SpA claimed a refund of the tax credit attaching to the dividend payments they had received from their UK subsidiaries.[6] This was on the basis that the tax credit provisions of Section 231 ICTA 1988, which deny the refund of tax credits to non-residents, breached the non-discrimination clauses of the relevant tax treaties.[7]

In order to consider the merits of these claims, it is necessary to briefly outline the key elements of the UK imputation system and in particular establish the true nature of ACT.

B. ACT

ACT is not as its name implies a payment made in advance of a company's corporation tax liability, rather it is a tax on corporate distributions.[8] It is payable subject to certain exceptions whenever a UK company pays a dividend to its shareholders.

1. Exceptions

No ACT is payable:
- in respect of a payment of a dividend where the payment is made under a group income election. This election may only be made between UK companies and their 51 per cent subsidiaries or between (UK resident) 51 per cent subsidiaries of the same UK Parent;[9]
- where the (grossed-up) dividend is covered by franked investment income (FII) in the hands of the paying company. FII is comprised of dividends plus tax credits received from other UK companies.

2. Uses

In the hands of the payer company ACT may be used to reduce the company's mainstream corporation tax (MCT) liability. In addition, any ACT in excess of the amount so offset (i.e. surplus ACT) may be carried back six years to obtain corporation tax refunds, or carried forward without time limit. It may also in certain situations be refunded but only to the receiving company.[10]

3. Taxation of shareholders

(a) Non-corporate

A non-corporate UK shareholder receiving a dividend from a UK company is entitled to a tax credit in respect of that dividend. He is then taxable upon the grossed-up dividend, but may offset the tax credit against any tax due. In cases where the taxpayer has a nil liability he may obtain a refund of the tax credit.

(b) Corporate

UK resident corporate shareholders holding shares in UK resident corporations are not taxable on dividends received from their shareholdings in such corporations. Instead the credits attaching to the dividends received may be used to cover the ACT liability arising on the company's own dividend payments.

Example

Co A Ltd receives a dividend of GBP 10,000 from XYZ Plc. Co A Ltd then pays a dividend of GBP 10,000 to its shareholders. No ACT is payable by Co A Ltd as the tax credit attaching to the dividend it receives from XYZ Plc covers its liability to account for ACT on the payment of its own dividend.

C. Tax credit

Section 231(2) ICTA 1988 in the case of UK companies provides entitlement to a payment of tax credit to certain categories of companies and to certain distributions.[11] Non-resident companies are therefore only entitled to the payment of a tax credit where provided for under a tax treaty.

5. The other claim is that the relevant provisions were discriminatory and contravened the EC Treaty's non-discrimination provision (Art. 6) and the freedom of establishment articles (Arts. 52 and 58).
6. In this respect their claims were mutually exclusive to those of their subsidiaries.
7. The other claim is that the relevant provisions were discriminatory and again contravened the EC Treaty's non-discrimination provision and freedom of establishment articles.
8. Sec. 14(1) ICTA 1988. ACT is payable on "distributions" (which expression includes dividends) as defined by Sec. 209 ICTA 1988.
9. Sec. 247 ICTA 1988.
10. Companies receiving Franked Investment Income may make an election to treat the income as taxable. A company with tax losses would therefore obtain a refund of the tax credit in this situation.
11. For a contrary view see M. Gammie and G. Brannan, "EC law strikes at the UK corporation tax – The death knell of UK imputation?" 8-9 *Intertax* (1995) at 392.

D. Analysis

In order to determine whether Hoechst UK Ltd and Pirelli UK Ltd have been discriminated against within the meaning of Article 24 paragraph 5, it is vital to determine the true nature of ACT to establish whether it effectively constitutes a tax on the enterprise or on the shareholders.

Comparison of ACT with corporation tax (CT)

	ACT	CT
Payable by reference to profits	No	Yes
Payable by reference to dividends	Yes	No
Calculated at what rate?	Normally the lower rate of income tax	CT rates
Repayable	Not to paying entity	Yes, subject to certain rules
Offsetable	Yes but only at the rate of ACT	No
Underlying rationale	An attempt to ensure that the tax representing the tax credit available to shareholders on receipt of a dividend is paid to the exchequer	A tax on profits

From the above it is clear that the nature of ACT is very different to that of corporation tax. This is not surprising when one considers the differing underlying rationales of the two taxes. Corporation tax is purely and simply a tax on corporate profits whilst ACT represents an attempt to ensure that tax corresponding to the tax credit available to shareholders on receipt of a dividend is paid over to the exchequer. ACT is therefore the mechanism underpinning the operation of the imputation system as it guarantees that the tax credit attaching to a dividend is matched by a payment of an identical amount of ACT. In this way ACT secures the cohesion of the UK imputation system, since without the requirement to account for ACT situations would inevitably arise whereby shareholders received dividends to which they were entitled to a tax credit, with no corporation tax being paid by the company paying the dividend, for instance because of the carry-back of losses.[12]

Reviewing the checklist it is possible to match the essential characteristics of the two taxes with their contrasting rationales.

Thus, the fact that corporation tax is only payable in a profits situation reflects that it is a profits tax. On the other hand, the fact that an ACT liability may arise in a loss making company reflects that ACT is a tax designed to ensure that the tax credit attaching to the dividend is anchored by a corresponding payment of tax regardless of whether or not the company has a corporation tax liability.

Similarly, while corporation tax is repayable subject to certain rules, ACT is never repayable to the payer, since to make a repayment would undermine the integrity of the imputation system. Finally although ACT is offsetable against the payer's corporation tax liability, it is only offsetable to the extent of a notional distribution of profits, calculated at the ACT rate, i.e. ACT is not offsetable at the corporation tax rate (see example below). This again emphasizes that ACT's primary function is to "protect" the tax credit and that its relationship with corporation tax is merely ancillary.

Example

Company X Ltd has profits of GBP 10,000,000 and ACT available of GBP 3,300,000.

	GBP	GBP
Profits	10,000,000	
CT @33%	3,300,000	
ACT set-off		
CT		3,300,000
Maximum set-off (lower of a) or b)) a) 10,000,000 x 20%[13] = 2,000,000 b) ACT available: 3,300,000		(2,000,000)
MCT payable		1,300,000

Even though Company X Ltd has sufficient ACT to cover its corporation tax liability it must pay GBP 1,300,000 MCT to the Revenue. The surplus ACT of GBP 1,300,000 must be carried forward.

Reviewing the above it seems clear that ACT falls to be treated as a tax on the owners of the enterprise and not as a tax on the enterprise itself. ACT is simply a collection mechanism (for the tax credit attaching to the dividend) facilitating the implementation of the imputation system.

Indeed the events triggering charges to ACT in Hoechst UK Ltd and Pirelli UK Ltd were the remittances of profits abroad. It is submitted that if ACT is seen to be a tax on shareholders, unfortunately the subsidiaries should fail in their claim of discrimination.

Support for this view comes from Klaus Vogel when he argues that the imputation provisions applied in Germany (admittedly different to the UK provisions) do not violate Art. 24(5) in particular since "Art. 24(6) {now Article 24(5)} does not forbid income accruing to them {the shareholders} to be taxed differently from corresponding income accruing to shareholders or partners resident in the same state as the enterprise."[14]

Turning to the claim for the repayment of the tax credit by Hoechst AG and Pirelli SpA it is feared that this claim must

12. Undoubtedly the UK Revenue would argue that to allow the shareholder a tax credit without ensuring that the company paid an equivalent amount of tax would undermine the operation of the entire imputation system.
13. I.e. the ACT rate.
14. K. Vogel, *Klaus Vogel on Double Taxation Conventions*, Kluwer.

also fail for the same reason. Indeed Hoechst AG's[15] claim would appear to be somewhat weaker than that of its subsidiary, perhaps falling at the first hurdle, i.e. reciprocity. This is a general requirement under international law, that places each state being party to a non-discrimination agreement under an equal obligation to comply with its terms. Failing compliance no reliance can be placed.[16] Since Germany is not willing to repay the German tax credit to a UK parent company, it seems rather one-sided that the United Kingdom should be asked to repay its tax credit to a German parent company. Indeed this argument has much force since it appears to be German treaty policy to deny the tax credit, in contrast to the United Kingdom's practice of negotiating mutual relief for tax credits.

15. In the case of Pirelli, although the new United Kingdom–Italy treaty does allow a refund of half the tax credit less a 5 percent withholding tax on the dividend plus half credit, the treaty in force at the time of the relevant dividend payment did not.
It is beyond the scope of this article to consider the question of reciprocity in connection with the Pirelli claims.

16. See J.G. O'Brien, 10 *Law and Policy in International Business* at 545 and 609 (1978). See also K. Vogel, *Klaus Vogel on Double Taxation Conventions*, Kluwer, at 1110.

IRELAND

IRISH INCENTIVES FOR INWARD INVESTMENT

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I. INTRODUCTION

Ireland has enjoyed indisputable success in attracting internationally mobile investment. This is due to a number of factors, geographic location, EU membership, a highly educated work force, language and strong links with the United States. Its active approach towards attracting foreign investment has its origins in the dramatic change of national economic policy in the late 1950s. Until then, from the attainment of independence from the United Kingdom in 1921, it had pursued a protectionist policy. National self-sufficiency and import substitution were earnestly pursued. Ireland adhered to this rustic ideal throughout the next three decades, but at the cost of declining standards of living. In 1921, Ireland had an income per capita level comparable to the Western European average, about half of the level prevailing in the United Kingdom. Until 1958, it steadily lost ground, with a GDP per capita of 60 per cent of the EEC average in that year.[1] It was then that the First Programme for Economic Expansion switched emphasis to an outward-looking, export-oriented policy which has been the cornerstone of the economic policy of successive governments ever since. Trade liberalization and the attraction of foreign investment were elevated to the status of national economic policy objectives. The instruments selected were a gradual reduction of tariff barriers, combined with a mixture of financial assistance to industry and a favourable corporate tax regime.

By introducing a corporate tax exemption for exports, Ireland became one of the first countries to use tax incentives to attract foreign investors. Local investors had equal access to these incentives but, having little experience of exporting, in reality had little practical prospect of utilizing them. With minor modifications, these export-oriented incentives operated successfully throughout the next three decades, so that by 1995, Ireland, with a GNP per capita of USD 12,200, was ranked 23rd by the World Bank out of 132 "large" economies. Foreign-owned companies accounted for 44 per cent of industrial employment and over 70 per cent[2] of total exports.

II. TAX INCENTIVES

A. Export sales relief

In 1956, exemption from tax on corporate profits derived from the export of goods manufactured in the State was introduced.[3] Initially, only 50 per cent exemption was available. This was extended to full exemption in 1957. The duration of the tax holiday was initially five years, extended by subsequent Finance Acts to ten[4] and then fifteen years,[5] with an additional five years of gradually tapering relief. Under pressure from the European Commission after Ireland's accession to the EEC in 1973, the government was unable to extend Export Sales Relief (ESR) beyond the expiry date of 5 April 1990 established by the 1969 Finance Act.

An almost identical relief was introduced[6] for licensed activities carried on within the Shannon Free Airport Zone. This relief was extended and modified in step with ESR, expiring on the same date.

ESR was available only in respect of profits from the sale of "goods",[7] and Shannon Relief available only to certified "exempted trading operations" carried on within the Shannon Airport Free Zone. In both cases, trading with local enterprises diluted the benefit of the exemption. Both definitions continue to be of fundamental importance today for purposes of the tax incentive that replaced ESR and Shannon exemption, the so-called "Manufacturing Relief".

B. Manufacturing relief: The 10 per cent tax rate

The normal rate of corporation tax payable in Ireland is currently 38 percent.[8] Since 1981, a lower rate of 10 per cent has been available, and has replaced the now-defunct Export Sales and Shannon Reliefs referred to above. The 10 per cent rate is available for three types of activity:

- "manufacturing", as defined in legislation;
- "relevant trading operations" carried on within the Shannon Airport Zone; and
- international financial services carried on in the Dublin Custom House Docks Area.

1. *The Economy of Ireland – Policy and Performance of a Small European Country*, Edited by J. W. O'Hagan - Gill & Macmillan 1995.
2. Shaping Our Future – A Strategy for Enterprise in Ireland in the 21st Century, *Forfás*, May 1996, at 72.
3. Sec. 10 Finance (Miscellaneous Provisions) Act, 1956.
4. Sec. 56, Finance Act 1958, which also extended the relief to book printing and exporting, fish production, and mushroom cultivation in the State.
5. The starting date for the tax holiday was extended by Sec. 28, Finance Act 1960 (to 6 April 1965), Sec. 33, Finance Act 1965 (to 6 April 1970) and Sec. 52, Finance Act 1969 (to 6 April 1975). The duration of the exemption was extended from five to ten years in 1958 and to fifteen in 1969.
6. Finance (Miscellaneous Provisions) Act 1958.
7. As defined in Sec. 10, Finance Act 1956, and extended by subsequent Finance Acts.
8. Sec. 1(1)(b), CTA 1976, as substituted by Sec. 54 Finance Act 1995. A reduced rate of 30 per cent for the first IEP 50,000 of profit was introduced by Sec. 44 Finance Act 1996.

The first of these can be carried on anywhere in Ireland, and the relief is available until 31 December 2010. The latter two are confined to geographically demarcated areas – Shannon on the west coast and the area around the Custom House Docks in Dublin, on the east coast. They are available only until 31 December 2005, under current legislation. To avoid the need for three parallel sets of legislation, the profits eligible for relief in the Shannon and Custom House Docks areas are deemed by legislation to relate to amounts receivable from the sale of "goods", which as will be seen below, is itself a highly evolved and significant term.

1. Manufacturing

Under Section 39(1) Finance Act 1990, "goods" means goods manufactured within the State in the course of a trade carried on by the company which, in relation to the relevant accounting period, is the company claiming relief in relation to the trade. Interestingly, the 10 per cent rate of tax is nowhere mentioned in law. Instead, Section 41(2) Finance Act 1980 provides that where a company which carries on a trade consisting of the manufacture of goods claims and proves as respects a relevant accounting period that, during that period, any amount was receivable in respect of the sale of goods, corporation tax payable by it, so far as it is referable to the income from the sale of those goods, shall be reduced by twenty-eight thirty eighths ($^{28}/_{38}$). With the current standard rate of corporation tax being 38 per cent, this has the effect of reducing the rate of tax to 10 per cent.

"Where there are two companies one of which manufactures goods and the other of which sells them in the course of its trade and one of the companies is a 90 per cent subsidiary of the other or both companies are 90 per cent subsidiaries of a third company any goods manufactured within the State by one of the companies shall, when sold in the course of its trade by the other company, be deemed to have been manufactured within the State by that other company."[9]

2. Manufacturing services

Where a company renders services consisting of the subjecting of commodities or materials belonging to another person to a process of manufacturing in the State, any amount receivable in respect of those services shall be deemed to be an amount receivable from the sale of goods.[10]

3. Meaning of the term "Manufactured"

This term is not defined in the legislation, and must be interpreted in the first place according to "its ordinary or colloquial meaning".[11] This does not include the making of a television advertisement,[12] the cooking of fish and chips[13] or the growing of dwarf chrysanthemums[14]. Nevertheless, in general the Irish courts have been liberal in their interpretation of the meaning of the term, and have regarded the ripening of bananas,[15] the pasteurization of milk,[16] the assembly of agricultural machinery,[17] the production of kitchen cloths and nappy liners,[18] the hatching of chickens in an incubator[19] and the secondary fermentation of beer[20] as all coming within the meaning of the term. However, these courtroom achievements by individual claimants were negated by Section 41(1)(c) Finance Act 1990, which added subsection (5) to Section 39 FA 1980. Under this:

- "goods shall not be regarded as manufactured if they are goods which result from a process which consists primarily of dividing (including cutting) purifying, drying, mixing, sorting, packaging, branding, testing or applying any other similar process to a product, produce or material for sale or distribution or any combination of such processes, or
- applying methods of preservation, pasteurization or maturation or other similar treatment to foodstuffs, or any combination of such processes, or cooking, baking or otherwise preparing food or drink for human consumption at or about the time it is prepared, or improving or altering any articles or material without imposing a change in their character or repairing, refurbishing, reconditioning, restoring or other similar processing of any articles or materials".

The apparently sweeping scope of this amendment is mitigated by the following considerations:
The key word is "primarily". This has led to some speculation among tax commentators – does milk that is pasteurized result from a process that consists primarily of pasteurization? Does food that is frozen with a view to extending its storage life result primarily from the freezing process? Some claim that this amendment leaves room for further litigation and several cases are currently under appeal in relation to borderline activities. However, a common-sense response to these questions would be that what is under consideration here are specific products – pasteurized milk and frozen food – and that these products certainly result from processes that consist primarily of pasteurization and freezing which differentiate them in the consumer's mind from their fresh equivalents. It is therefore unlikely the current litigation-in-progress will succeed.

Processes that include one or more of the above steps, but only as a subsidiary part of the overall process remain to be judged in accordance with the ordinary meaning of the word, as do processes not falling within these specific exclusions. In 1990, the tax authorities published a Statement of Practice which provides the current guidance as to the definition. This places emphasis on the substance of what happens in the process, i.e. on its economic and qualitative effects. Three aspects to a process are regarded as relevant: its mechanical

9. Sec. 39(1) FA 1980.
10. Sec. 39(2) FA 1980. This provision enables amongst others, "contract manufacturers" to claim entitlement to the relief.
11. Justice McCarthy in *Charles McCann Ltd. v. O'Cualachain* (1986) ITR Vol. III at 304.
12. *O'Cualachain v. Hunter Advertising* (1990) 2 IR 431.
13. *FCT v. Rochester* 50 CLR 225.
14. *Brosnan v. Leeside Nurseries* (1994) ITR 1060.
15. *Charles McCann Ltd. v. O'Cualachain* (1986) ITR Vol III at 304.
16. *Cronin (Inspector of Taxes) v. Strand Dairies Ltd* (1993) ITR Vol. III at 441.
17. *Irish Agricultural Machinery Ltd. v. O'Cualachain* (1990) 1 IR 535.
18. *O'Laochdha v. Johnson & Johnson (Ireland) Ltd.* (1991) 2 IR 287.
19. *Kelly v. Cobb Straffan Ireland Ltd.* 4 BITR 526.
20. *Hussey v. M.J. Gleeson & Co.* 4 BITR 533.

nature, its complexity and the involvement of skilled labour. The mechanical requirement is to differentiate it from natural processes, such as growth. It is necessary to have a combination of man and machine, with the latter application being of a material nature. In practice, the Irish rules have been proven to be less rigorous than those of some other jurisdictions.[21]

From 1980 to 1993, in response to lobbying and specific policy objectives, several non-manufacturing activities have been specifically granted the benefits available for manufacturing. As a result, amounts receivable from the conduct of the following activities are also treated as receivable from the sale of "goods".

- The production of fish on a fish farm within the State.[22]
- The repair of ships within the State.[23]
- Design and planning services the work on the rendering of which is carried out in the State in connection with chemical, civil, electrical or mechanical engineering works executed outside the territories of the Member States of the European Union.[24]
- "Computer services" defined as data processing and/or software development services, in the course of an undertaking in respect of which an employment grant was made by the Industrial Development Authority under Section 2 of the Industrial Development (No. 2) Act 1981.[25] From 6 April 1989, this definition was extended to include technical or consultancy services that relate to the above data processing and/or software development services.
- Qualifying shipping activities, i.e. the carriage of cargo or passengers in seagoing ships that are Irish owned or registered. Fishing activities qualify where the fish is subjected to a process of manufacture on board the qualifying ship, and to the letting or chartering of a qualifying ship for qualifying purposes. The transporting of supplies or personnel to a rig, platform, vessel or installation of any kind at sea involved in hydrocarbon exploration or development.[26]
- Income of "special trading houses".[27]
- Plant cultivation by micro propagation ("cloning").[28]
- Repair or maintenance of aircraft, aircraft engines or components within the State.[29]
- Film production, where the film is for exhibition to the public in cinemas or on television or for training or documentary purposes, provided not less than 75 per cent of the work on its production is carried out in the State.[30]
- The processing of meat in the State, excluding meat sold into an EU intervention agency.
- Fish processing carried on in the State.[31]
- Certain activities carried on by an agricultural or fishery society.[32]
- The remanufacture or repair of computer equipment or of subassemblies within the State, where such equipment or subassemblies were originally manufactured in the State by that company or a connected company.[33]
- The sale by an agricultural society to a certified qualifying company of milk purchased by it from its members.[34]
- Newspaper production in the State.[35]

With these extensions, the initial rigour of the definition has been considerably reduced.

C. Shannon Free Airport Zone

"Relevant trading operations" is the term used in respect of qualifying activities carried on within the Shannon Free Airport Zone, duly certified by the Minister for Finance. They must fall within one or more of the following listed activities:

- the repair or maintenance of aircraft;
- trading operations in respect of which the Minister of Finance is of the opinion, after consultation with the Minister of Transport, that they contribute to the use or development of the airport; or
- trading operations which are ancillary to the operations mentioned above or to any manufacturing trade qualifying under the "normal" rules.

The Minister may not certify any of the following:

- the rendering of services to embarking or disembarking aircraft passengers including hotel, catering, money-changing, or transport (other than air transport) services, or services in connection with the landing, departure, loading or unloading of aircraft;
- the operation of scheduled air transport services selling by retail; or
- the sale of consumable commodities for the fuelling of aircraft or for shipment as aircraft stores.

D. International financial services

This innovation, designed to assist the re-development of the docklands area of Dublin, was enacted in 1987, resulting in the creation of the International Financial Services Centre (IFSC). Access to the IFSC's 10 per cent rate of tax is controlled by the issue of licences by the Department of Finance, advised by the Certification Advisory Council. Licences are

21. However, a recent US tax case found in favour of a taxpayer with Irish Manufacturing operations. In the Bausch & Lomb case, reported in March 1996 (*Bausch & Lomb, Inc., et al. v. Comm'r*, T.C. Memo 1996-57 Tax Ct. Dkt. No. 13983-91) the IRS determined that the income from the sale of sunglasses by the company's two Controlled Foreign Corporations (CFCs), Bausch & Lomb Hong Kong and Bausch & Lomb Ireland, was includable in Bausch & Lomb's (B&L) gross income because it constituted Foreign Base Company Sales Income under Subpart F. B&L argued that the income was not FBCSI because the CFCs were manufacturers. The Tax Court agreed with B&L, finding that the foreign operations satisfied the facts and circumstances test of Reg. §1.954-3(A)(4)(iii). The Court found that the CFCs were engaged in a series of operations that were not minor, nominal, or insignificant. The Court reiterated that the assembly required trained and experienced personnel and a management staff to oversee the production operations.
22. Sec. 39(1)(A)(a) FA 1980.
23. Sec. 39(1)(B)(a) FA 1980.
24. Sec. 39(1)(C)(a) FA 1980.
25. Sec. 39(1)(CC) FA 1980.
26. Sec. 39(1)(CC1) FA 1980 as inserted and amended by Sec. 28, FA 1987, Sec. 40 FA 1988, Sec. 42 FA 1990.
27. Sec. 39(1)(CC2) FA 1980 as inserted by Sec. 29 FA 1987.
28. Sec. 39(1)(CC3) FA 1980 inserted by Sec. 31 FA 1987;
29. Sec. 39(1)(CC4) FA 1980 Sec. 41 FA 1990.
30. Sec. 39(1)(CC5) FA 1980, inserted by Sec. 41 FA 1990.
31. Sec. 41 FA 1990, Sec. 32 FA 1991 and Sec. 44 FA 1993.
32. Sec. 39(1)(CC8, 9 and 10) FA 1980 Sec. 47 FA 1992.
33. Sec. 39(1)(CC7) FA 1980 as inserted by Sec. 41(12)(b) FA 1990.
34. Sec. 46 FA 1992.
35. Sec. 39(1)(CC11) FA 1980, as inserted by Sec. 44(1)(c) FA 1993.

issued to operations that are carried on within the demarcated area and are seen as likely to contribute to the development of the area as an International Financial Services Centre, provided that they fall within one or more of the following classes of activities:

- the provision for persons not ordinarily resident in the State of services, in relation to transactions in foreign currencies, of a type normally provided by a bank in the ordinary course of its trade;
- the carrying on on behalf of persons not ordinarily resident in the State of international financial activities, including:
- global money management;
- international dealings in foreign currencies and in futures, options and similar financial assets which are denominated in foreign currencies;
- dealings in bonds, equities and similar instruments denominated in foreign currencies;
- insurance and related activities; or
- the management of investments and other activities of UCITS (Undertakings for Collective Investment in Transferable Securities);
- the provision for persons not ordinarily resident in the State of services of, or of facilities for, processing, control, accounting, communication, clearing, settlement, information storage in relation to financial activities;
- dealing in commodity futures or options on behalf of persons not ordinarily resident in the State;
- the development or supply of computer software for use in the provision to persons not ordinarily resident in the State of services or facilities for processing, control, accounting, communications, clearing, settlement or information storage in relation to financial services or for the reprocessing, analysing or similar treatment of information in relation to financial activities;[36] or
- trading activities similar to, or ancillary to, any of the above where the Minister of Finance is of the opinion that they contribute to the use of the area as an International Financial Services Centre.

By July 1996, there were 380 "active projects" established in the IFSC. These include captive finance companies, agency treasury companies, reinsurance companies, special purpose investment companies, fund managers and management companies. In addition to the reduced tax rate, there are several other attractions. Financial statements do not need to be prepared in Irish currency, and may instead be prepared in the company's functional currency. In these cases, the tax-adjusted profit is translated into Irish pounds at the average exchange rate for the period in question. In certain circumstances, companies may make tax payments in their functional currency. Under general rules, withholding tax imposed by a country with which Ireland has a double taxation agreement can be credited against Irish tax. In the case of IFSC-based companies, unilateral credit relief is also available for foreign withholding tax which cannot be relieved by tax treaties. Relief in both cases is limited to the amount of Irish tax payable on the income. In the area of VAT, concessions are also available which eliminate VAT on management fees of agency treasury companies and of IFSC companies offering custodial services.

E. Other investment incentives in Shannon and the IFSC

In both Shannon and the IFSC, tax depreciation is available on plant and machinery at rates of up to 100 percent. Losses created by tax depreciation can be offset against other 10 per cent taxable profits, with the exception of losses created in a leasing trade.

The property tax advantages of establishing in the IFSC include tax depreciation at rates of up to 100 per cent for construction costs on owner-occupied buildings, a double tax deduction for rental costs, and an exemption from property taxes for a limited period.

F. Foreign branch exemption

To encourage large international groups to establish regional operational headquarters in Ireland, a foreign branch exemption incentive was introduced in Section 29 of the 1995 Finance Act. Under this, the profits earned outside Ireland by branches of qualifying Irish resident companies are exempt from tax. To qualify, a company must have an investment plan approved in advance by the Minister for Finance. The plan must envisage the investment of substantial permanent capital in the State for the purpose of creating "substantial new employment" in the State in trading operations carried on, or to be carried on, in the State. The Minister will grant a certificate where, following consultation with the Minister for Enterprise and Employment, he is satisfied that the capital and employment targets will be met and that the maintenance of the employment so created in trading operations in the State will be dependent on the carrying on by the company of qualified foreign trading activities. These are defined as trading activities carried on by a qualifying company through a branch or agency outside the State in a territory specified in the certificate issued by the Minister. In the first year of operation of this incentive, two major US financial institutions are understood to have set up companies of this type.

G. Reductions in taxable base

1. Accelerated tax depreciation

Tax depreciation (i.e. capital allowances) is of much less importance since 1988, when the so-called "free depreciation" under which up to 100 per cent tax depreciation could be claimed at will, or the alternative 100 per cent first-year allowances were phased out. Now, this incentive is confined to Shannon-based and IFSC activities. These may claim 100

36. It would appear that the latter activities i.e. the "reprocessing..." may be carried out for resident as well as non-resident customers. Care must however be taken to ensure that work carried out for residents does not conflict with the terms of the relevant licence.

per cent first-year tax depreciation on new machinery and plant, or claim any lower rate they choose in each year that the machinery or plant is in use. For expenditure on buildings, first-year depreciation of 54 per cent of expenditure, with 4 per cent per annum thereafter, is available.

2. Quadruple deduction for incremental R&D expenditure

This incentive, introduced by Section 59 of the 1995 Finance Act and refined in the 1996 Finance Act, takes the form of a 400 per cent tax deduction for qualifying expenditure on research and development. It is confined to companies eligible for manufacturing relief, which means that increasing the deduction to four times the R&D expenditure, gives an incremental tax subsidy of only 30 per cent of qualifying expenditure.

The relief is available for a three-year period, and is available for increased R&D expenditure over the base year.

3. Non-tax incentives

For many investors, the Industrial Development Agency and the Shannon Free Airport Development Company offer capital grants, employment grants, training grants, and, in some smaller, usually indigenous start-up cases, equity participation and loan guarantees. These incentives are negotiated individually, with the level of grant varying widely. Employment creation is the main objective, with all grants being expressed on a per-job basis. A secondary factor influencing grant levels is the desirability of the investment and its perceived spin-off effects in creating opportunities for local suppliers.

III. FUTURE DEVELOPMENTS

As mentioned above, the 10 per cent rate of corporation tax expires at the end of 2005 for IFSC and Shannon activities and 2010 for manufacturing activities. Detailed consideration is being given to the corporate tax regime that will follow. Among the alternatives currently under consideration are:
- extension of the 10 per cent rate for existing qualifying activities beyond 2010, coupled with a progressive reduction in the standard corporate tax rate;
- the introduction of a single low rate of corporation tax for all companies;
- the introduction of a discretionary "ruling" system for particular sectors.

It is still too early to predict which of these options will be selected, but it is generally recognized that the long lead time and payback period associated with large-scale internationally-mobile manufacturing investment projects demands a decision by the Irish government on its tax incentives strategy for post 2010 during 1997 or 1998.

FRANCE

The French Perspective with Respect to Transfer Pricing Documentation and Transparency

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I. INTRODUCTION

In July 1995, the OECD[1] published transfer pricing guidelines for multinational enterprises and tax administrations.[2] These guidelines deal with the general principles relating to the determination of transfer prices between affiliated entities of a group. The guidelines are intended to be finalized and will be reviewed and examined regularly.[3]

The reason for these developments in transfer pricing is that it appeared necessary to give guidance to tax authorities and to taxpayers with respect to the determination of prices between affiliated entities. Indeed, while enterprises act on international markets, each state intends to maintain its fiscal sovereignty or in any case to maintain certain prerogatives.

Given that more than 60 per cent of the world market is realized by international enterprises, the determination of transfer prices is an essential exercise scrutinized by the states:
- each tax administration ensures that the prices fixed do not allow the transfer of a taxable base;
- the taxpayer must establish that he correctly determines his transfer pricing policy. The determination of the prices between enterprises belonging to one international group is usually carried out according to the desire to adopt the best economic policy for the group. However, the prices thus determined may also be influenced by tax considerations. This may lead to a shifting of the taxable base from those jurisdictions where the tax burdens are highest to those where the tax burden is lower. Alternatively, the profits of the enterprises may be transferred to those members of the group generating losses.

From experience, it appears that two intimately linked problems apply to both enterprises and tax administrations:
- which state has the right to tax the income earned when an enterprise operates in more than one jurisdiction? The answer to this question depends on the existence or otherwise of a permanent establishment[4] in the state where the foreign enterprise conducts its activities. The permanent establishment, a purely fiscal and not legal notion, is defined in all double tax treaties, which affords a conventional protection to taxpayers;
- if relations between two or more states are established between related parties, for instance between subsidiaries of one group or between companies and branches (the latter with fiscal autonomy), the allocation of income must be based on arm's length pricing.

These two points, especially the latter, are probably at least from a French perspective likely to be among the major themes of international tax law in the future.

In the following we will examine the French approach to transfer pricing issues, given the fact that in early April 1996, a new Act passed in France. This Act gives the French tax authorities (FTA) more powers to obtain information and documentation with respect to the relationships of a French company with its affiliated entities. The French Revenue is now entitled, subject to certain conditions, to ask the French company for an explanation of its transfer pricing policy. Correlatively, the statute of limitations has been extended, subject to certain conditions, to allow the tax authorities the necessary time to properly conduct its tax audit with respect to transfer prices, in the event the treaty exchange of information procedure is used.

II. ARM'S LENGTH PRICES

The OECD report on transfer pricing examines the question of transfer prices exclusively in an international context, the adjustment of a transfer price in one state giving rise to a corresponding adjustment in another state. It is essential to ensure that the same income is not taxable twice. An international consensus must therefore exist to reduce the risk of double taxation. The guidelines "also draw upon the discussion undertaken by the OECD on the proposed transfer pricing regulations (Article 482 of the American tax Code) of the United States". The OECD took the precaution of providing

1. The 25 member states of the OECD are: Germany, Australia, Austria, Belgium, Canada, Denmark, Spain, the United States, France, Finland, Greece, Ireland, Iceland, Italy, Japan, Luxembourg, Mexico, Norway, New Zealand, the Netherlands, Portugal, the United Kingdom, Sweden, Switzerland and Turkey.
2. These guidelines were approved by the Committee for fiscal affairs on the 27 June 1995 and by the Counsel of the OECD on 13 July 1995.
3. This happened in March 1996 for intangible assets.
4. See *The Taxation of Permanent Establishments* (Amsterdam: IBFD).

that these guidelines apply in a different context as they are intended to apply to a wider area than the US legislation.

The issue is the following:
- on the one hand, the enterprises must respect the legal and administrative obligations of each state in which they operate, bearing in mind that the rules are different from one state to another;
- on the other hand, the tax authorities must combine both their right to tax the income arising in that state and the need to avoid the double taxation of that same income.

A mechanism designed to eliminate double taxation, the mutual agreement procedure, is provided for by tax treaties. However, the states are only obliged to make their best efforts to arrive at a solution. They are under no obligation to actually reach such a solution. This difficulty comes in addition to the problem of the long time such a procedure takes[5] (from experience, about nine years in France!). At the European level, a multilateral agreement of 23 July 1990, in force since 1 January 1995 for an initial duration of five years, will allow the resolution of disputes arising from double taxation to be reduced to between three and six years. There is one notable difference with respect to the mutual agreement procedure: there is no longer a mere obligation to negotiate, but a certitude that a solution will be found. It remains to be seen how successful the new procedure will be in practice.

A. Principle: OECD rules

According to Article 9 of the OECD Model Treaty, transfer prices between affiliated enterprises must be at arm's length.

This arm's length principle must be applied intelligently as enterprises may use attractive prices, for instance during start up or penetration of the market. Its application may become complicated when the information necessary to determine or fix the transfer prices does not exist in one given state (in the case of a foreign jurisdiction) or when no comparables exist (for example where a product is manufactured in a state where there is no competition, or where an enterprise supplies services which are unique).[6]

The OECD commentaries do not give practical rules which are directly applicable to particular situations. Transfer prices must be determined taking into account the particular circumstances of each case.

Two categories of methods should be used:
- the methods based on the transactions, the comparable uncontrolled price, the resale price and the cost-plus method;
- the traditional benefits methods, profit splitting and transactional net margin method (this last method is new).

The Committee for Fiscal Affairs considers that there is no one best method and that international groups of companies can freely use other methods subject to the fact that these other methods must satisfy the arm's length principle set out in the guidelines. The arm's length principle only requires that several methods be used, where the case is exceptional or where no single method is satisfactory.

The guidelines result from a compromise between the member states of the OECD, and it is possible that certain states consider that the two transactional methods are equivalent to the traditional methods. Indeed, although the Committee for Fiscal Affairs seems to give priority to the traditional methods, it is possible that certain states will read in the approach they most favour.

However, the transactional methods should be, from a French perspective, considered as secondary to the other set of methods. I.e. they should only be used as a last resort.

The determination of transfer prices is not an exact science. As a result, even a taxpayer acting in good faith may make mistakes, and the tax administration may draw the wrong conclusions from a given situation. The tax inspectors should therefore not require an unrealistic amount of information. They must take into account the commercial appreciation of the taxpayer in relation to the principles of normal competition, such that the examination of the transfer prices be consistent with the realities of the business world. The tax administration must therefore firstly examine the transfer prices with regard to the method chosen by the taxpayer to determine its transfer prices.

B. French domestic rules with respect to transfer pricing

1. Article 57 of the Code Général des Impôts (CGI)

Under this article, profits indirectly transferred to foreign enterprises either by means of an increase or decrease of the sales price or the purchase price, or by any other means[7] are reintegrated into the paying entities taxable income in France. This provision applies to payments between related parties but the tax authorities do not have to give evidence that the parties are related if the transfer of profits is realized with enterprises established in a foreign jurisdiction benefiting from a privileged fiscal regime or in cases where the establishment itself is located in such a jurisdiction. In all other cases it is for the FTA to give evidence that the parties are related. It is also for the tax authorities to give evidence of the existence and the amount of the particular advantages granted to the foreign company.

In a statement of practice dated 31 August 1959 the FTA have indicated that in certain circumstances, the strict application of Article 57 may disturb the establishment or the management abroad of foreign entities whose purpose is to sell French products on foreign markets; accordingly, this may jeopardize the development of French exports. For this rea-

5. This results in a loss of time and a financial cost arising from dealing with the case, which is usually complex and occasionally random, as it is based on purely factual elements.
6. E.g. computerized management of transport reservations, or satellite services.
7. E.g. payment of excessive royalties with or without consideration, granting of interest free loans or reduced interest loans.

son, the FTA have specified that the tax inspectors must take into account the conditions of the functioning of the foreign affiliated entities. In particular, no challenge should occur if the French companies can justify that sales at a price only marginally above the cost price are supported by commercial reasons.

The FTA have to give evidence of the existence of a transfer of profits abroad. The French taxpayer may give contrary evidence to justify the transaction by showing that in reality it was driven by the market.

2. Evolution: Article L 13B of the Livre des Procédures Fiscales (LPF)

In order to implement with more efficiency Article 57 CGI, the so-called DDOEF of 12 April 1996 (Financial Act), has inserted a new provision as title L13B in the LPF. This article gives to the FTA more power to audit the cross border transactions performed by enterprises: it imposes an obligation of cooperation upon the enterprises with the tax inspectors. Furthermore the statute of limitations is extended in the event the FTA implement the treaty administrative assistance, in order to allow sufficient time for the conduct of the investigation.[8]

3. The new rules.

(a) Obligation of strengthened cooperation

If the FTA have collected evidence which suggests that an enterprise has indirectly transferred profits abroad within the meaning of Article 57, they are entitled to ask the enterprise for certain information and documentation. In particular, where, during a tax audit, the tax authorities have discovered things which suggest that an enterprise has indirectly transferred profits abroad, they are entitled to ask for information and documentation specifying:

- the nature of the relations between the French enterprise and the foreign affiliated enterprises or foreign group companies;
- the method of determination of the prices of the transactions whether industrial, commercial or financial, and the supporting items and the consideration received;
- the activities undertaken by the foreign entities;
- the fiscal regime of their foreign permanent establishment, subsidiaries or groupings which they control directly or indirectly.[9]

If the FTA have asked the tax authorities of another jurisdiction for the information on the basis of a relevant income tax treaty, then the statute of limitations is extended an additional five years from the date the other authorities reply. This is to permit a reassessment where the answer from the other state's administration is delayed.

(b) Procedure

The new transfer pricing information procedure has a wide scope. It is a specific procedure in the sense that it is independent from already existing procedures such as a request for information or justification under other provisions of the Procedure Act. But its utilization is strictly framed as Article L13B defines in detail:

- the conditions required to be satisfied before the FTA may send the request for information to the taxpayer;
- the scope of utilization;
- the formal conditions of the request;
- the proceedings.

Once the new procedure is engaged the taxpayer must comply: if the taxpayer fails to respond he is liable to a fine of FRF 50,000 (about USD 10,000).

Two conditions must be satisfied before the FTA may send a request: a tax audit must be in the process of being conducted and evidence must exist that suggests that a transfer of profits has taken place. Further to the reference to Article 57, the procedure of L13B applies to enterprises subject to tax in France which:

- are controlled or have control of enterprises situated abroad and which are likely to have shifted income abroad;
- are dependent on enterprises or a group having the control of enterprises established out of France and which have probably transferred profits abroad;
- are likely to have transferred profits to a foreign state or territory which benefits from a privileged fiscal regime.

The transfer of income may be realized by way of an increase in the purchase price, a reduction of sales price or by any other means.[10] The burden of proving the dependence element and the indirect transfer falls, from a strict reading of the new legislation upon the FTA. Article L13B does not operate a reversing of the burden of the evidence as the request for information depends on the existence of evidence suggesting the transfer of income.[11]

The new Act does not impose on the FTA any obligation to explain why they believe transfer pricing has taken place.[12] However the questions to the taxpayer must be specific. During the legislative debate, the Ministry of Finance refused to insert a provision which would have required the FTA to justify their request arguing that this would limit the scope of the request.

Form of the request. The request must be precise and must indicate:

- the nature of the activity or product;
- the state in question;
- the enterprise;
- the company or the grouping aimed at; and
- the amounts under scrutiny.

8. New Art. L188A of the LPF.
9. For these purposes control exists if more than 50 per cent of the subsidiary's share-capital or voting rights is owned directly or indirectly by the taxpayer.
10. I.e. payment of excessive royalties or without consideration, loan without interest, or at a reduced rate, forgiveness of debt.
11. This has been confirmed by the Ministry of Finance during the debate before the French Parliament.
12. I.e. the FTA is not obliged to specify to the French company in detail the information on which it bases its position.

The enterprise has to answer within a period which cannot be under two months and, which may be extended by one month, upon a reasonable request being made by the taxpayer.[13] The request must specify the penalty for failing to respond. Accordingly there are two possibilities:

1st case. The taxpayer provides its answer in due time. If the response is satisfactory to the FTA, the procedure of L13B is completed and the tax audit continues within standard rules.

If the answers are not satisfactory to the FTA, the latter sends to the French enterprise a formal request for additional information. The enterprise has a 30-day period to answer. If this further request is fully complied with, the procedure is terminated without any penalty. However, if the additional information is not provided this is regarded as an absence of response.

2nd case. The taxpayer does not respond to the request. The tax fine of FRF 50,000 (USD 10,000) is applied for each financial year specified in the request. It is independent from other penalties. This fine does not bar the enterprise from using the EC Competent authorities procedure.

Reassessment. If the French enterprise provides the requested information, the FTA may adjust the enterprises profits upwards, if the operation discloses an indirect transfer of profits.[14] Accordingly a reassessment is realized on the grounds of Article 57, within the standard procedure. The burden of proving arm's length pricing was not used, falls upon the FTA.

If the French company does not answer the request, the new Act provides that:

- the standard procedure must be used.[15] This point is highly significant: it translates the wish of the French Parliament to use standard proceedings and not the exceptional procedure usually in force in the case of fraud or absence of filing in due time. This is important because the rules governing the burden and the means of proof are not changed.[16]
- the taxable base may be estimated from the information the FTA have at their disposal.

Extension of the statute of limitations to five years. Under French standard rules, the statute of limitations is three years plus the current year for corporation tax. In the event of carried forward losses, the FTA are entitled to go back more than four years and audit their accuracy but they can only reassess four years. The standard four year rule is extended to five years within the procedure of the new Act if the FTA have implemented the treaty exchange of information procedure. This is to allow the FTA to reassess a transfer of profits where the foreign authority delays answering the request and the standard statute of limitations would otherwise have elapsed. In other words, due to the possible lengthiness of such a procedure, the statute of limitations is extended to five years if the FTA have asked for in time, information from the foreign competent authority.[17] The new Act (Article 188) distinguishes between two different categories of information:

- relationships of the taxpayer with an enterprise, a company or a grouping carrying out an activity or established abroad, where such relationships fall within the scope of Article 57 (transfer prices) or Article 209B (French CFC legislation);[18]
- assets, investments or income which were disposed of abroad by the taxpayer, or activities he may have performed.

The goal of this new article is not to reopen a period which is statute barred. The extension is only possible if the FTA's request was made in due time. The new Act requires the FTA to notify the taxpayer of the existence of the request at the time it is made and of the response of the foreign authorities. There is no obligation to give the content of the request. However from the case law, the FTA can reassess a taxpayer with respect to information taken from third parties if the taxpayer is put in a position to challenge them and to ask the transmitting of the documentation before the issuance of the notice of payment.

The FTA may reassess an enterprise until the end of the year following the response or at the latest until the fifth year following the one during which the taxation is due. This latter rule applies irrespective of whether the foreign authorities reply.

Let us take an example. A tax audit is undertaken in January 1997 for the years 1994, 1995 and 1996. A request is sent to a foreign Authority in March 1997.

1st case. The answer is received in 1997. The FTA are entitled until 31 December 1998, the year following the year of the response, to reassess the enterprise, even with respect to 1994 and 1995 (although these two years would be statute barred under standard rules);

2nd case. The foreign Administration does not answer or answers in 1999. The deadline expires at the end of 1999 for the year 1994.

The new rule cannot reduce the standard statute of limitations where it would expire after the limitation provided by the new Article 188 A. For instance, if the request sent in March 1997 is replied to in December 1997, the reassessment with respect to 1996 can be made until 31 December 1999 (standard statute of limitations).[19] Of course, if a specific statute of limitations is higher, it applies (for instance as far as registration duties are concerned: ten years where no declaration was made).

The extension of the statute of limitations is supposed to aim at any type of tax (and its audit). However, it allows the FTA to reassess only items included in the request.

13. I.e. the taxpayer has a *maximum* of three months to reply. This period includes the discretionary one month extension.
14. The information provided by the taxpayer may also be used to justify a reassessment with respect to taxes other than corporate income tax.
15. I.e. not the procedure under which the FTA reassess taxable income on their own without any discussion with the taxpayer.
16. This would be the case in the non-standard procedure.
17. Art. 188A LPF.
18. See 47 *Bulletin for International Fiscal Documentation* 4 (1993), at 214. In particular, by virtue of Article 209B, the administration may tax French Companies with respect to profits realized in foreign subsidiaries (or permanent establishments) benefiting from a privileged tax regime.
19. I.e. previously it could only have been made up until 31 December 1998.

Accordingly, the FTA are entitled to send to a taxpayer for the same period two notices of reassessment:

- one within the standard statute of limitations with respect to activities or income from French source or/and foreign activities or income which were not included in the request for international assistance;
- another one, within the specific deadline, including the reassessments based on the information contained in the reply to the request.

The penalties for late payment of corporation tax are not due beyond the standard statute of limitations. Accordingly, these penalties stop running on the last day of the month of the notice of reassessment within the standard period.

(c) *Experience*

From the recent tax audits performed by the FTA, the administration puts a great deal of emphasis on the transfer pricing policy of international groups; accordingly transfer pricing audits are increasing. The FTA request the completion of questionnaires, in which they ask for details of the percentage of gross margin of each product or service. In addition, they may examine the allocation of the profits among the various affiliated entities.

4. Case law

The French courts appear to be sensitive to the conditions of international markets. If a taxpayer has different prices from those which would normally be assumed to be the fair market ones and if he can justify that its approach was the sole realistic and sensible one as regards the circumstances, in particular imposed by competition, the judges may accept the policy of the taxpayer. Unfortunately the FTA appears far less sensitive to economic reality.

This may be illustrated by the following case law.

To give evidence that a decrease in sales price cannot be regarded as a transfer of profits abroad, a French company can explain that the decrease was necessary to strike a deal, as regards the market conditions and the competition (Court Case CE 13 April 1964 No. 56173).

In a Court Case of 30 March 1987, the FTA took the view that the remuneration of a top executive assigned to a Swiss subsidiary but whose salary was incurred by the French parent company was effectively a transfer of profits abroad. However the Court decided that the company had given evidence that this transfer was explained by the fact that it facilitated the conduct of an active foreign commercial policy, and insured the Swiss subsidiary continued to maintain and develop the products of the parent company.[20]

A company purchased pharmaceutical products from a Bermudan company which had previously been sold to the Bermudan company by a UK company. The French company was under the control of the UK company, which also controlled the company established in Bermuda. The FTA had challenged the prices fixed between the French and the Bermudan company as it appeared that a material margin was realized by the latter. The French company's arguments that no transfer of profits had occurred was accepted for the following reasons:

- the French company had established that the prices had been determined by virtue of the OECD rules;
- it was accepted that being part owned by a third party, the company was prevented from paying in excess of arm's length prices for its purchases; and
- the customs authorities had abandoned its legal action against the chairman regarding the valuation of goods (T.A. Lyon 25 April 1990 Fisons).

A recent case provides that the FTA are entitled to apply the mismanagement act concept to cross border transactions with respect to transfer pricing (Supreme Court 18 March 1994). Under this concept the FTA may challenge a transaction if it does not appear to have been implemented in a standard way i.e. no attempt being made to obtain a commercial consideration. However traditionally, Article 57 CGI is considered to prove a means of applying the mismanagement act concept.

A French company whose activities consisted of the distribution of cars manufactured by a German parent company had agreed to incur the warranty costs attached to the sale of cars, subject to a reduction of the importation prices. The FTA had noticed that during the years under scrutiny the decrease had no longer offset the warranty costs; accordingly they considered that this constituted a transfer of profits abroad. Such a reassessment was declared void by the Court of Appeal of Nancy (6 July 1995 No. 92.272). The Court indicated that the transfer of the costs of the warranty and the corresponding reduction of prices had led with other elements such as late payment, advertising expenses, and certain equipment costs to the determination of the importation price. In limiting its examination to the first two items, the administration did not prove that the transfer and the previous conditions were unjustifiably to the benefit of the German company.[21] The French company had in addition given evidence that it had achieved material margins during the audited financial years.

5. APA (advance pricing agreement)

An APA in relation to transfer pricing is an agreement which fixes the terms such as methods of calculation, elements of comparison, corrections to be used and hypotheses relating to the future determination of transfer prices to be applied to transactions between related enterprises over the course of a certain period. This procedure is requested by the taxpayer. The taxpayer (one or several associated enterprises) and one or several tax administrations then carry out negotiations.

The aim of an APA is to complement the traditional administrative judicial and contractual practices, relating to the resolution of transfer pricing disagreements. In practice, the APA appears more appropriate when traditional mechanisms are either shown to be difficult to put into place or are quite simply non-existent.

20. CE 30 March 1987 No. 52754, plen.
21. Neither does it differ from the conditions between unrelated parties.

France is reluctant to adopt such procedures;[22] this reluctance reflects French administrative culture, as institutionalized dialogue between the administration and taxpayers does not really exist at present in France.[23]

III. RECOMMENDATIONS: FOUR RULES AND TEN COMMANDMENTS

As far as France is concerned, transparency and documentation are, at least with respect to the French records, two key elements. The FTA have learned from the discussions they had within the OECD in connection with other administrations. For this reason and also as the French tax inspectors have not been educated within an international environment, the French based groups must maintain proper transfer pricing records. The following guidelines should be followed.

A. Four rules

1. Be active

The FTA are sensitive to the issue of transfer pricing, particularly further to its discussions with the OECD. These discussions have allowed the authorities to compare the practice and methods used by other countries and to estimate the quantum of revenue involved. Accordingly, enterprises must put into place procedures and review their methods when appropriate. This is all the more essential since with the introduction of L13B LPF the FTA now have the power to obtain information or to check the means and conditions of a transfer pricing policy. In practice, the FTA have asked some companies to fill in a questionnaire with targeted questions.

In view of the above, taxpayers must always be ready for a tax audit. The issue of transfer pricing involves far more than tax considerations, since economic and political aspects of companies may also determine transfer prices.

2. The exercise is not only French but international

Each state intends to keep its own fiscal sovereignty. It should therefore be kept in mind that the interests of each fiscal authority are conflicting and that within a state, the interests of customs and tax authorities are also opposed.

For this reason, the putting in place of a multinational's transfer pricing policy requires the intervention of experts sensitive to the different cultures and aware of the principles of several states. It is thus important to systematically examine the practices, and the law of each jurisdiction where the enterprise exercises its activity. It is also important to apply the OECD rules.

Although it is possible that the FTA will try during their audits to apply their own approach and practices, they should in the final analysis apply OECD rules. Indeed this has been confirmed orally by the representatives of the French Ministry of Finance. The expected publication of a statement of practice on transfer pricing should hopefully clarify matters.

3. Documentation

It is essential to keep records that may be shown to the tax authorities in the event of an audit or a challenge. The worse case scenario will be the one where the taxpayer cannot demonstrate that it has examined all available methods in order to choose the one which appears the most appropriate. Accordingly, enterprises must put into place comprehensive transfer pricing recording systems.[24] By experience, once this is done, then the exercise becomes simpler. The taxpayer must put himself into the position of being able to present a case before the courts; i.e. he must be able to show that his transfer pricing policy is both fair and carefully thought out.

Every taxpayer must ensure that its transfer prices are correctly calculated from a tax point of view, prior to being fixed. The taxpayer must therefore put into place all the rules appropriate to a complex and important decision: the tax administration is entitled to expect that the taxpayer produces all documents relating to the activity in question and that the transfer prices are fully justified. Furthermore, these documents[25] must be kept in order to be shown to the tax authorities in the course of a tax inspection.[26]

4. Be conscious of the sources of information available to the tax authorities

The FTA have at their disposal:

- their standard right to obtain communication of information;
- the tax treaty administrative assistance;
- their ability to cross-check the information given by the taxpayer with data obtained from another taxpayer;[27]
- the European VAT forms (which in certain situations trace the purchase price or sales price of goods: *vente en dépôt, vente en consignation*);
- information transmitted by the courts if a case is pending;
- central departments which collect general information on enterprises (newspapers...);
- listings and information from the customs authorities. In this respect, the taxpayers have to be cautious as normally they have opposing interests vis-à-vis tax rules and customs ones.[28] Cooperation between tax and customs authorities is now rather common;
- the possibility, in practice until now only used in exceptional cases, of visiting private houses and any premises without prior notice.

22. The FTA does however show some flexibility in exceptional cases of global trading by banks.
23. France does not yet have a proper rulings policy.
24. I.e. one that provides sufficient evidence to satisfy the FTA.
25. Including if possible documents relating to affiliated non-resident enterprises.
26. If no comparables are available, then it is recommendable to have undertaken economic studies, in the relevant field of activity.
27. I.e. they may use information on a given enterprise vis-à-vis another enterprise.
28. Taxpayers would like higher prices to show to the tax authorities (to reduce their income in the purchasing country) and lower prices to show to customs (thus reducing customs duties).

B. The ten commandments

1. Assess the situation

Normally enterprises have at their disposal documentation, agreements, memos, exchange of letters, notes, etc. However, in general this information is not centralized. It is necessary to centralize all this information to create and to regularly update a file on transfer pricing. It is also necessary to review this file at predetermined intervals or when otherwise appropriate.

One of the first tasks undertaken by an FTA audit is to make sure that assets or services are not being invoiced at different prices depending on whether the beneficiary is a third party or an affiliated company. This does not mean that any difference is forbidden, but it has to be fully justified.

2. Check the consistency

The transfer pricing policy (services and goods) must be consistently applied at the international level. This consistency gives greater weight to the taxpayer's arguments in the event of a tax audit. From experience it appears that the tax authorities of different states normally ask about the conditions under which the various entities of a group are invoiced. Furthermore the French courts are positively sensitive to the global consistency of a taxpayer's transfer pricing policy.

3. Support any change in the method

Any change of method must be supported by economics. Failing this, the tax authorities are likely to try to challenge either the old method (subject to the statute of limitations) or the new method.

4. Maintaining records

(a) General

All documentation must be kept to give evidence of the way the transfer pricing policy has been elaborated: memos, recommendations of outside counsels, minutes of meetings, professional journals etc. In the event of a challenge, the taxpayer will have to present his records before the courts. If he was prudent enough to maintain comprehensive, regularly updated records, he reduces the tax authorities likelihood of success. The French courts are very sensitive to the reasonableness of a taxpayer's course of action.

(b) Global arrangements

In certain international enterprises, a single transaction in consideration of a single price may include several services. This is known in general as a global arrangement. Accordingly, a transaction may be realized with the licensing of patents, formulas, technical services, administrative services etc. Such agreements do not include in general the sale of goods, even if the price of such goods includes accessory services. The tax authorities must make sure that the transfer price of the arrangement is compatible with the arm's length principle. Accordingly, the different items of the arrangement must be clearly identified.

5. Draft agreements

From experience, if a group puts agreements determining its different cross border payments into place, the French authorities are less likely to be able to successfully challenge the transfer price, provided of course documentation exists to support both the existence of the services and the need for such services by the beneficiary. A transfer pricing policy must be put in place irrespective of the profit or loss situation of the entities.[29] This does not prevent the taxpayer applying a certain flexibility during the start-up period for its (initially) loss-making subsidiaries.

For services, the taxpayer should draft several agreements if the withholding tax implications of the separate services rendered are different.

6. Be aware of foreign rules

The transfer pricing policy must be examined in detail and with prudence as each state's tax authorities have their own measures against fiscal evasion.[30] Of course, there are also procedures to avoid double taxation. However, such procedures take such a long time to implement that it is important to reduce the risk of a challenge to transfer prices from ever taking place.

7. Insure deductibility of the remuneration for services

As a general principle the deductibility of the payment for services follows the standard rules of the state of the debtor. Accordingly, the deduction of the remuneration for a service is allowed if at the time it was rendered, it was of use to the recipient of the service, even where the expected benefit does not in fact materialize.[31] In other words, the enterprise must give evidence that the service purchased was intended to give a real advantage and that therefore the expenditure was legitimately incurred.

As a general rule, expenses invoiced to French or foreign subsidiaries, may only be deducted if the following conditions are satisfied:
- the expenses must be incurred in the interest of the payer (they cannot correspond to head office expenses);
- they must not constitute assets;
- they must be supported by documentation;
- the services must be requested by the subsidiary and not imposed by the invoicing entity;
- the invoiced services cannot be grouped together with other services already invoiced separately;
- depending on the type of transaction, the remuneration may have to be reported in a specific form.[32]

29. Here, caution is needed since amending a group's transfer pricing policy to conform to this principle would create an additional risk as this could be regarded as a change of method.
30. Art. 57 CGI, Sec. 770 in the United Kingdom, Sec. 482 in the United States, the circular of 1983 in Germany.
31. This point is indicated in the OECD guidelines.
32. I.e. DAS 2 in France, for certain types of remuneration.

8. French debtor

According to Article 182B CGI, a withholding tax is generally due (except where provided otherwise by international treaties) on the sums paid by a debtor who carries on an activity in France to the benefit of a non-resident person or company,[33] in respect of the remuneration of all kinds of services supplied or used in France. The scope of this text is broader than the OECD one which only aims at *redevances* (i.e. royalties).

Generally, the withholding tax is reduced or eliminated by income tax treaties. Each situation must be individually examined particularly by reference to the wordings of the income tax treaties concerned and the formalities (generally simple but compulsory), which must be satisfied before the taxpayer may benefit from the elimination or reduction of the tax. According to the authors of the OECD report, a contribution to research expenses has a business profit nature, and is as such not subject to withholding tax. The remuneration must be separated according to the services rendered.[34]

9. Losses

If an affiliated company regularly suffers losses while the group as a whole is profit making, this would appear rather unusual as an independent entity would refuse to bear losses on a long term basis.[35] However, an affiliated company suffering losses may keep on its activities if the activity is profitable to the group as a whole. In this situation, the FTA would suspect arm's length prices were not being used. For instance, a group may for purely commercial reasons manufacture certain items at a loss. If the goods which are distributed generate a loss and are manufactured in one state, and to the extent that an independent enterprise would not agree to supply such goods on such terms, the enterprise in a loss position must receive additional remuneration for agreeing to supply the loss making goods.[36]

10. No offsetting

If an affiliated company undertakes a transaction for the benefit of another affiliated company and if the operation is either partially or totally deliberately offset by the latter, there is an intentional offset. This should be avoided as independent entities would separate the different services, regardless of the accounting rules.

C. Bases for the exchange of information procedure: Use in France of information received from a foreign tax administration

1. In France, Article L114 LPF provides that:

"The tax administration may exchange information with financial authorities of overseas territories and other territories of the French Republic which enjoy a specific tax regime, as well as with states which have concluded a tax mutual assistance treaty with France which provides for exchange of information with the French tax administration."

This procedure is also provided for by European Directive 77/799/CEE, of 19 December 1977, relating to the exchange of information between tax administrations of the Member States of the European Community.

2. Simultaneous tax audit

A simultaneous tax audit is an "audit carried out on the basis of an agreement by which two or several parties agree to audit simultaneously and independently each on its own territory, the tax situation of one or several taxpayers. This audit is in the common interest of the parties since they may later exchange the information learnt". Such mutual assistance does not in principle replace the competent authorities procedure. As a result, the exchanges of information under such a simultaneous audit must take place through the competent authorities which supposes that all safety measures provided for in this regard be respected.

The simultaneous audit in several states of various companies of an international group may be put into place by bilateral exchange of information procedures provided for by most tax treaties. A group of four states (the United States, France, Germany and the United Kingdom) has even agreed, on an informal basis, to carry out such audit without requiring that further international treaties be executed. These procedures fall in France within the jurisdiction of the DVNI (*Direction des Vérifications Nationales et Internationales*).

The multilateral treaty of the Council of Europe and of the OECD on mutual administrative assistance in tax matters also includes simultaneous tax audit in its Article 8. Furthermore, one should be aware that the members of various tax administrations often meet to plan and coordinate simultaneous tax audits.

These audits are also based on the European Directive of 19 December 1977 mentioned above. This directive deals with the harmonization of exchange of information procedures between tax administrations of the Member States of the European Community.

IV. REASSESSMENT AND ELIMINATION OF DOUBLE TAXATION

A. General

If the FTA challenges a taxpayer's transfer pricing policy, the following will apply. In their statement of practice dated 4 May 1973 (4 A-2-73),[37] they have indicated that the income further to a reassessment on the grounds of Article 57 CGI is determined:

33. Provided that person does not have a permanent professional installation in France.
34. Where the services have different natures, it may be appropriate to draft several agreements, depending on the necessity or not to levy a withholding tax.
35. I.e. eventually it would go out of business.
36. I.e. the amount an independent company would have charged for the supply of such goods.
37. The FTA are currently drafting a new statement of practice.

- either directly by increasing the French taxable income by the quantum of income abusively transferred abroad;
- or, in the event of insufficient information, by comparison with the taxable income of similar enterprises run under normal conditions.

These two methods of reassessment are known by the practitioners as the direct estimation method and as the ancillary estimation method respectively.

1. Direct estimation method

The reassessment is based, in principle, upon standard rules, i.e. from the specific items of the reassessed transaction. The ancillary method can be used only where there is insufficient information to use the direct method (Court case dated 23 November 1960). According to the direct method, the tax authorities need not make any comparison with other enterprises to determine the additional income since this is identifiable in the accounts of the enterprise (Court case dated 2 June 1976).

2. Ancillary method

If sufficient information is not available to determine the taxable income, the FTA are entitled to use a notional method derived from a comparison with independent enterprises carrying out their activities in the same field. For instance, in a Court case of 23 March 1953 the following method has been judged as valid: determining the business profits by applying to the turnover a ratio fixed by comparison with profits of similar enterprises operating under normal conditions.

B. Scope of the OECD commentaries

In principle, the OECD commentaries bind neither the courts nor the administrative authorities. However:
- they are a valuable reference point which the practitioner may use to elaborate a transfer pricing policy;
- the tax authorities of the member states pay special attention to these commentaries, which result in added protection for the taxpayer. These commentaries have often inspired tax authorities in the elaboration of their own anti-avoidance legislation designed to counteract international fiscal evasion;[38]
- the courts refer increasingly to the commentaries. Foreign case-law bears witness to this fact. In France, the judges also use the commentaries (see for example the decision of the Administrative Court of Lyon, Affair Fisons of 25 April 1990).

The FTA have indicated informally that they will respect the OECD commentaries. They have also announced that a statement of practice should be published within the following month on both Article 57 CGI[39] and Article L13B LPF.

C. Consequences of a reassessment

1. Primary adjustment

The primary adjustment is the adjustment of the taxable profit of a company which the first tax administration carries out when applying the arm's length principle. In the treaty reassessment procedure, the state which proposes the primary adjustment must show the other states that the reassessment is "justified in its principal and in its amount".

2. Corresponding adjustment

The corresponding adjustment is the adjustment of the tax liability of the related enterprise established in another state and carried out by the tax administration of that state. This adjustment reflects the primary adjustment carried out by the tax administration of the first state. Its purpose is to obtain a coherent allocation of the profits between the two states.

This is not obligatory as the tax administrations are not obliged to reach an agreement within the scope of the amicable procedure.

3. Secondary adjustment (dividend)

The primary adjustment and the corresponding adjustment modify the allocation of profits. However, they do not alter the fact that the excess of profits resulting from the adjustment does not correspond to the profit which should have been produced in arm's length conditions. In order to make the allocation of profits conform to the primary adjustment, most states reconstitute a transaction according to their own legislation by deeming the secondary transaction to be a distribution of dividends, or a contribution of capital, or a loan.

4. Grossing up

In France, a reassessment adds back to income the part regarded as transferred abroad and considers this sum to be a deemed dividend, subject to withholding tax depending on the wording of the relevant income tax treaty. If the withholding tax is applicable, the "dividend" is grossed up (Court Case Clappier 3 March 1996).

5. Procedure for eliminating double taxation

(a) Treaty law

The competent authorities procedure is a specific means of appeal relating to difficulties raised in the application of treaties to avoid double taxation. It is not a court procedure and is bilateral.

The French tax administration defined in its statement of practice of 4 March 1986 (14 F-1-86) the scope, the conditions for the use of and the praxis for this amicable procedure. The taxpayers have expressed their worries in relation to the

38. In particular, through general measures controlling transfer pricing, since transfer prices can be used for tax avoidance purposes.
39. Similar to Sec. 482 of the IRC or Sec. 770 ICTA 1988 for the United Kingdom.

competitive spirit of the tax administration which may mean that revenge measures may be used and their worries that their case may not be examined on its own merit but rather in the context of similar cases of other taxpayers.

(b) European agreement

A treaty relating to the elimination of double taxation in case of correction of the profits of associated enterprises was signed on 20 May 1990 (JOCE L 225/10). This treaty follows, according to Article 220 of the Treaty of Rome, the undertakings of the Member States to begin negotiations in order to ensure the elimination of double taxation. The treaty has been in force since 1st January 1995. It aims only at enterprises resident in Member States of the European Union. No experience has yet been obtained of this treaty, since it has only recently entered into force.

(c) Arbitration

Double taxation problems are in principle solved by virtue of the competent authorities procedure. However as mentioned above, this procedure does not guarantee a solution since it does not impose on the tax administrations an obligation to arrive at a solution. At the same time, commercial transactions including investments are becoming more and more international and as a result tax disputes are also increasingly international.

Certain states and certain jurisdictions have for these reasons put into place arbitration procedures:
– the free trade agreement between Canada and the United States;
– the North-American free trade area (NAFTA);
– GATT and the world trade organization which have put into place procedures and institutions for resolving disputes in the areas of international commerce;
– the tax arbitration treaty between the members of the European Community in force since 1st January 1995.

The OECD considers that it is necessary to further examine whether the "creation of an arbitration procedure with regards to taxation could not play a useful complementary role in international tax relations". The Committee for Fiscal Affairs decided to examine this question and in this regard to implement the principles of the July 1995 guidelines at an appropriate time.

V. CONCLUSION

In conclusion, enterprises should put into place a procedure to verify their transfer pricing policy, in order to be able to effectively counteract any attempt by the French tax administration to show that the policy they are using is not an arm's length one. Taxpayers who are not sufficiently prepared will find themselves in a situation which will be all the more disagreeable since:
– the determination of transfer prices is not an exact science, factual elements (and therefore records) will be essential. On the other hand, facts are always open to interpretation;
– if records are created at the time of the dispute, the peace of mind of the taxpayer disappears. Although it is obvious that the creation of centralized records imposes a financial cost, it is clear that such action is necessary since the taxpayer may at any time be called upon to justify its transfer pricing policy in France or in another state;
– French case-law has shown itself to be favourable to the taxpayer who justifies his choices, and is therefore in a position to supply records complying with the OECD rules.[40]

40. Decision of 25 April 1990 No. 86-10150 RJF 11/91; decision of the Conseil d'Etat of 6 July 1995 No. 92-272; decision of the Conseil d'Etat of 30 March 1987 No. 52-754.

CARIBBEAN

THE 1994 CARICOM DOUBLE TAXATION AGREEMENT: A NEW MODEL FOR REGIONAL INTEGRATION AND FISCAL COOPERATION

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I. INTRODUCTION

On 6 July 1994, eight governments from the member states of the Caribbean Community[1] signed a multilateral tax agreement.[2] The agreement which came into force on 1 January 1995,[3] replaces the 1973 treaty and has important implications for both extra-regional and regional investors and traders. This article highlights the main provisions of the new treaty and examines the progress of tax treaties and their impact on economic integration, business and trade trends.[4] It concludes with a discussion of the prospects for future fiscal cooperation within the CARICOM.

The CARICOM treaty is derived in part from the objectives of the Treaty of Chaguaramas that created the Caribbean Common Market and Community.[5] The Treaty of Chaguaramas essentially established, subject to a number of important exceptions, free trade in goods and services and the free movement of capital within the area bounded by the common external tariff. The treaty's main objective is to facilitate the harmonization of economic policies.[6] Other objectives of CARICOM are to promote regional investment, national and regional entrepreneurship, joint development of the region's resources, and the undertaking of high priority regional projects.[7]

Measures to achieve fiscal harmonization within the Community include apart from the conclusion of double taxation agreements, arrangements for the granting of fiscal incentives to the manufacturing sector and the establishment of an organization of tax administrators.[8]

II. THE 1973 MULTILATERAL TAX AGREEMENT

In June-July 1973, the members of CARICOM concluded a unique tax agreement.[9] Similar to the OECD and the UN Model treaties its purpose was to encourage international trade and investment and prevent fiscal evasion with respect to taxes on income and profits.[10] Unfortunately, the agreement was ignored by most tax professionals. For all practical purposes, the 1973 Agreement has been superseded by the 1994 Multilateral Tax Agreement. Nevertheless, an understanding of the salient provisions of the old treaty greatly facilitates an evaluation of the 1994 Agreement.[11]

One unique feature of the 1973 Agreement was that it was between the more developed countries (MDCs) within CARICOM, which were designated in Schedule 1 as Barbados, Guyana, Jamaica, and Trinidad and Tobago, and the less

1. A ninth government, the government of Trinidad and Tobago, signed on 19 August 1994.
2. The CARICOM members are Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago. At the initial signing Barbados did not sign, but has since signed and ratified.
3. Effective date 1 January 1995 (with respect to Belize and Trinidad and Tobago).
4. For a useful overview of the economic and other major trends in CARICOM, see Report of the West Indian Commission, "Time for Action" (1993).
5. For the text of the Treaty of Chaguaramas, see 12 *International Legal Mat.* at 1035. For a discussion of the effect of CARICOM membership on the legal systems of the Member States, see F. Phillips, (1985), *West Indian Constitutions: Post Independence Reform* at 331-333.
6. For background on CARICOM from the perspective of the mini-states, see Adlish Brown, "Caribbean Mini-States and the Caribbean Common Market: The Case of Antigua", *Size Self Determination and International Relations: The Caribbean* (Vaughan A. Lewis, Ed.), (1976), at 123, and 130-38.
7. For background on the economic policy of CARICOM countries, see Jacqueline Anne Braveboy-Wagner, (1989), *The Caribbean in World Affairs – The Foreign Policies of English-Speaking States* at 67-104.
8. For an early discussion of fiscal cooperation within CARICOM, see World Bank, (1978), *The Commonwealth Caribbean: The Integration Experience* at 54-58.
9. Agreement Between the Governments of Barbados, Guyana, Jamaica and Trinidad and Tobago on the One Hand and Antigua, Belize, Dominica, Grenada, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia and St. Vincent on the Other Hand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Profits and for the Encouragement of International Trade and Investment.
10. For a useful discussion of the CARICOM tax treaty, see the paper given by Mr Panniah Karalasingham, "An Examination of the Permanent Establishment and Residence in the CARICOM and other Treaties", prepared for the seminar on the CARICOM Tax Treaty and Tax Issues within CARICOM (2-3 Nov. 1990) sponsored by the International Fiscal Association, Barbados Chapter in association with the Caribbean Law Institute (unpublished).
11. For an earlier discussion of the 1973 Agreement, see B. Zagaris, "IFA Barbados Branch Considers CARICOM Tax Treaty and Tax Issues", 45 *International Bulletin for Fiscal Documentation* 4 (1991) at 186-89.

developed countries (LDCs) within CARICOM, which were listed as Antigua, Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent, St. Kitts, Nevis and Anguilla.

The reduced withholding rates of 10 per cent in the case of interest and 5 per cent in the case of royalties only applied to the more developed countries within CARICOM. The less developed countries had the right to tax these amounts according to their own laws. For dividends, varying reduced withholding rates applied to three of the more developed countries. The less developed countries were permitted to apply the rate of tax chargeable in respect of the profits or income of the company paying the dividend. The fact that reduced withholding rates did not apply when capital flowed from the more developed countries to the less developed countries was a fatal flaw, acting as a disincentive to invest in the LDCs. In addition, the erroneous classification of Guyana as a more developed country when it quickly became in terms of its GNP a less developed country, undermined the application of the treaty.[12]

III. THE 1994 MULTILATERAL TAX AGREEMENT

A. Basis of taxation

On 7 July 1992, the CARICOM Secretariat circulated for comments the proposed CARICOM Double Taxation Agreement for investment and trade among CARICOM members (referred to hereafter as the 1994 Agreement) to replace the 1973 double tax convention. The treaty was signed on 6 July 1994 at a heads of government meeting in Barbados.[13] It is based closely on the principle of source-taxation contained in the Andean Group Conventions for the Avoidance of Double Taxation.[14] These Conventions apply both internally among Andean members and externally in tax treaties between Andean and non-Andean members. The reason why CARICOM adopted the source taxation model in preference to the more popular residence-based OECD Model was that source taxation has the advantage of simplicity.

B. Comparison

A major difference between the 1973 and 1994 Agreements is that as mentioned above the 1973 Agreement was between what were previously referred to as MDCs[15] and LDCs.[16] The treaty did not apply bilaterally between MDCs. Under the 1994 Agreement however, transactions between MDCs are now covered. Hence, a multinational company from outside the region that wants to process fruit from Trinidad and Tobago in Barbados for sale throughout CARICOM utilizing technology from outside the region, may use the treaty to eliminate or reduce double taxation on its CARICOM operations.[17]

Another major difference between the 1994 Agreement and the 1973 Agreement is that the 1994 one is based on the Andean model which as mentioned above adopts the source or territoriality principle of taxation. For instance, Article 5 of the current agreement provides (subject to certain exceptions) that, irrespective of the nationality or state of residence of a pèrson, income of whatever nature derived by such person will be taxable only by the member state in which the income arises.[18]

C. Main provisions

Dividends. In the 1994 Agreement, the withholding rate of tax on ordinary dividends is zero per cent irrespective of the percentage of equity owned by the recipient. The rate of tax on dividends from preference shares may not exceed 15 per cent of the gross dividend.[19]

Interest and royalties. For interest and royalties arising in one treaty country and paid to a resident of another treaty country, the maximum allowable rate of tax cannot exceed 15 per cent of the gross amount of the interest[20] or royalties.[21]

Entitlement to treaty benefits. The agreement does not require that the recipient be the beneficial owner in order to qualify for the reduced withholding rates. In addition, the treaty does not have a limitation on benefits provision.

Management Fees. Following the source-based model of tax treaties, the payment of management fees arising in a host country and paid to a resident of the home country are to be taxed in the source (i.e. the host) country. The rate of tax may not exceed 15 per cent of the management fees.[22] Management fees are defined as payments to a person for, or in respect of, the provision of industrial or commercial advice or for management or technical services or similar services or facilities. Payments for independent professional services are expressly excluded.[23]

Directors Fees. An article on directors' fees and similar payments, provides that where the payment was derived by a resident of a treaty country in his capacity as a member of the

12. For an earlier discussion of the 1973 Agreement, see B. Zagaris, "Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options", 47 *Bulletin for International Fiscal Documentation* 3 (1993) at 129 and 136-38.
13. Agreement among the Governments of the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment, signed on 6 July 1994.
14. Andean Group Dec. No. 14, adopted by the Commission of the Cartagena Agreement, 16 November 1971; entered into force, 1 January 1981.
15. E.g. Barbados, Guyana, Jamaica and Trinidad and Tobago.
16. E.g. Antigua and Barbuda, Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent, St. Kitts, Nevis and Anguilla.
17. Trinidad and Tobago and Barbados are covered. Such transactions would not have been covered by the 1973 Agreement as it did not apply to transactions where both countries were MDCs.
18. For a useful discussion of the agreement and its application to Barbados, see Lynette V. Eastmond, "What Do We Tell Investors Now?" 2 *Barbados B. Newsletter* (March 1995) at 7-10.
19. 1994 Agreement, Art. 11.
20. 1994 Agreement, Art. 12.
21. 1994 Agreement, Art. 13.
22. 1994 Agreement, Art. 14.
23. 1994 Agreement, Arts. 14 and 16. The latter article provides for the taxation of independent professional services.

board of directors of a company that is a resident of another treaty country it may only be taxed in the treaty country of which the payer is a resident.[24]

Other points. The agreement has a standard exchange of information article.[25] Finally the agreement provides for future accession by a CARICOM member through depositing with the CARICOM Secretariat an instrument of accession specifying the taxes to which the agreement will apply in respect of that state.[26]

IV. PROSPECTS FOR FURTHER TAX COOPERATION WITHIN THE CARICOM

The 1994 Multilateral Tax Agreement is only a small step towards tax cooperation within the CARICOM. Several potential new directions of fiscal cooperation are possible in the near future.

A. Harmonization of tax law

Tax harmonization would greatly enhance the effectiveness of the 1994 Agreement. One method to achieve harmonization would be to revise the Treaty of Chaguaramas and give the CARICOM institutions more authority to promulgate tax laws designed to facilitate and encourage investment flows. Such an approach would emulate the authority of the European Union to enact tax laws. This may be unrealistic at present unless CARICOM is restructured and a political consensus is achieved on this issue. Given the comparatively low level of integration within CARICOM it may be politically premature for the members to cede such authority over taxation matters.

Notwithstanding the above, some tax harmonization is occurring indirectly through the provision of *technical assistance* by the International Monetary Fund. This technical assistance which either requires or strongly recommends certain tax policy adjustments, is tied to the advancement of structural adjustment loans. Since many of the CARICOM countries have availed of such loans and received similar technical advice, they have acted similarly in the design and implementation of tax policy.

The Inter-American Center for Tax Administrators (CIAT) and the Inter-American Development Bank have also periodically provided assistance on selective tax policy and implementation issues.

B. Model tax treaties and/or common tax treaty negotiations with extra-regional states

Another alternative for facilitating and encouraging investment within the CARICOM, as well as for reducing tax evasion would be for the CARICOM to prepare model double tax convention(s) for use by CARICOM members with countries outside the region.

To be viable, it is important for any new model to be based on generally accepted tax treaty policy. Thus the OECD Model Convention or at least a model emulating a mix of the OECD and the UN Model Convention would have to be used. In this regard, in the context of European integration, Member States have concluded standard income tax treaties that reflect the OECD Models. Indeed EU tax policy is gradually interacting with and superseding the tax treaties of individual Member States, to the extent that the treaties may conflict with the Treaty of Rome and its amendments.

Recently the Organization of Eastern Caribbean States has conducted parallel[27] negotiations of a Mutual Legal Assistance in Criminal Matters Treaty with the United States. Such an approach could also be adopted by CARICOM in negotiating income tax treaties with the United States and other countries.

C. Tax Administration and Enforcement Assistance (TIEA)

In order to prevent tax evasion and raise revenue, CARICOM members may want to consider concluding an expanded and modern version of a multilateral convention on mutual assistance in tax matters. The Council of Europe/OECD Convention is the best model[28] that can be adopted to CARICOM purposes.[29] In addition to serving as a multilateral treaty such a convention could also be used as a prototype for bilateral TIEAs between interested CARICOM members. Clearly, a multilateral mutual assistance treaty that embraces, *inter alia*, assistance in administration and information, service of documents and assistance in collection would be of great value. However, such a treaty may be controversial because of the relative immaturity and fragility of CARICOM's institutions, and the political influence of the region's principal taxpayers.[30] Nevertheless, the ability to earn revenue, the fairness and integrity of the tax systems, and of course the nexus between the tax systems and investment depend on the ability to administer the tax laws. Since each of the CARICOM members exhibits at least some weakness in its tax administration, a potentially critical component in the CARICOM convention could and should be the provision of assistance for national tax administrations. CARICOM has had as one of its goals the provision, regionally, of the necessary assistance. However, unfortunately lack of resources has meant that little progress has been made in this area.

The relationship between budget and trade deficits, political and economic stability and overall development has interest-

24. 1994 Agreement, Art. 17.
25. 1994 Agreement, Art. 24.
26. 1994 Agreement, Art. 29.
27. I.e. simultaneous but separate negotiations.
28. Alternatively, the CIAT model tax information exchange convention could be adopted for CARICOM purposes.
29. Convention on Mutual Administrative Assistance in Tax Matters, opened for signature 25 Jan. 1988, I.L.M. 1160 (1988), reprinted in R. Rhoades and M. Langer, 5 *Income Taxation of Foreign Related Transactions*, (1989) Ch. 85.
30. These taxpayers of course have an interest in minimizing their own tax liabilities.

ed some developed countries and international financial organizations. In particular, the Inter-American Development Bank has discussed with CARICOM the provision of regional resources for tax administration and training. Other key players are CIAT,[31] the International Monetary Fund, and major donor countries, such as the United States, Canada, Germany, and Spain.[32] To date the European countries have been the most far-sighted and innovative in providing tax assistance to regional bodies. However, when donors such as the US Government have offered assistance in tax administration and enforcement on a regional basis, governments of the Organization of East Caribbean States (OECS) have declined the offer, because they have been unwilling to surrender national control of their revenue collections.

One trend within the international financial organizations, such as the World Bank, has been to emphasize the need for tax compliance in order to maximize local tax revenues as a condition to benefit from structural adjustment programmes. Recent examples of these programmes can be seen in Mexico and Argentina. The technical assistance given to Mexico for tax administration has been a major success. Assuming CARICOM members want to undertake a regional programme of tax administration in the context of a regional convention, the tax information exchange and implementation conventions between the United States and its territories can be considered good models to follow.

D. Agreement on the harmonization of fiscal incentives to industry

Another convention on taxes vis-à-vis countries outside of CARICOM is the Agreement on the Harmonization of Fiscal Incentives to Industry. This convention was concluded in 1973 on the formation of CARICOM. It was intended to promote the balanced and harmonious development of CARICOM through regulating and harmonizing incentives to industry. It covers several important types of tax: relief from tonnage tax and customs duties on plant; equipment, machinery, spare parts and raw materials; relief from tax on export profits; depreciation allowances; carry-forward of losses; dividends and other distributions; and interest. Although the purpose is laudable, i.e. to coordinate fiscal incentives so that CARICOM members do not have highly divergent regimes aimed at attracting foreign investment,[33] this convention has fallen into disuse and is not observed. Indeed, it appears that its provisions may already conflict in some cases with national legislation, actual investment concessions to individual projects, double tax treaties, and bilateral investment treaties. Pressure too exists from multilateral development banks[34] and governments outside CARICOM for CARICOM members to liberalize their treatment of foreign investment (e.g. the Enterprise for Americas initiative), any such liberalization would again be in breach of the treaty. In view of the above perceived problems it would be necessary to substantially amend the treaty if it is intended to use it to facilitate greater inward investment into the region.

V. SUMMARY AND CONCLUSION

The 1994 Tax Agreement has a broader coverage than the 1973 Tax Agreement, especially insofar as it covers transactions between the MDCs. In addition, its low withholding rates (zero for dividends) together with the absence of a limitation on benefits provision provides enhanced incentives for inward investment into the CARICOM.

Clearly, the 1994 Tax Agreement is only the first of many measures that will be required within CARICOM in order to stimulate investment and generate more revenue. Additional pressure will be exerted on CARICOM governments to modernize their treatment of investments from other countries both within and outside of CARICOM. The explosion of free trade in the region and major tax reforms by countries such as Mexico have brought about significant changes in tax policies and the negotiation of wide tax treaty networks.[35] Indeed, the success of Mexico in negotiating tax treaties and initiating an international tax office to deal with international tax issues following its successful implementation of a tax enforcement programme has led the way for the rest of the Americas.

31. For a discussion of the CIAT model TIEA, see B. Zagaris, "CIAT Adopts Model Tax Information Exchange Agreement", 6 *International Enforcement Law Report* (Mar. 1990) at 105.
32. For papers on the tax administration programme of CIAT, see *Planning and Control in Tax Administration,* Monographs and Studies 39, 1987, International Bureau of Fiscal Documentation.
33. The overlap of tax and investment regimes is becoming more central to the evolution of economic integration and free trade organizations.
34. E.g. the International Monetary Fund, the World Bank and the Inter-American Development Bank.
35. For a discussion of the tax impact of non-tax treaties on CARICOM, see B. Zagaris, *supra* note 12, at 136.

DENMARK

The Taxation of Interest Free Loans Involving Corporations

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I. INTRODUCTION

From the 1980s onwards the Danish courts have to a very large degree influenced the development of Denmark's transfer pricing regime. The attitude of the courts has led the tax authorities to become very reluctant to raise transfer pricing cases, particularly because it is they who must discharge the burden of proof.

Notwithstanding the above, the tax authorities have had notable success before the High Court in the area of intra-group loans and loans between a company and its main shareholder in both instances where an arm's length interest rate has not been charged. In these cases the tax authorities impute deemed interest. Arguments over the legality of this course of action are now coming before the Supreme Court.

The tax authorities' approach to loans to related parties bearing a lower than arm's length rate of interest[1] is highly controversial. The more aggressive attitude taken by the authorities in recent years has added to this controversy. Without doubt, the reason for the hardening in the authorities attitude reflects their desire to fight tax avoidance. Nevertheless, doubts remain about the correctness of their approach, particularly in the context of national rules but also in the context of EC-rules. Not surprisingly the administrative practice has been strongly criticized by writers on taxation.

According to the Danish Constitution, no taxation can take place unless specifically authorized by the legislation. Some tax experts have claimed that no such authority exists in respect of the taxation of loans bearing a lower than arm's length rate of interest. If this is correct the tax authorities have not been acting in accordance with the law.

In the government's legislative programme for the Parliamentary session 1995/96 it appears that a working body has been appointed by the Ministry of Taxation in order to prepare a Bill concerning the tax treatment of interest free or low interest loans. However, to date no Bill has yet been presented to the Danish Parliament.

II. TAX TREATMENT

The tax authorities apply the following treatment to an interest free loan:

The lender is taxed on deemed yearly interest computed by reference to the Danish Central Bank's rate[2] at the time of granting the loan plus 4 per cent (hereafter "the official rate").

The borrower is regarded as having received a subsidy and is therefore taxed on the benefit of receiving an interest free or low interest loan. However, as the borrower may deduct the deemed interest it will have no additional tax to pay.

The above approach has been more or less consistently applied to intra group loans and to loans between a main shareholder and a company.

III. AUTHORITY

Section 4 of the National Income Tax Act (ITA), states that taxable income may either take the form of money or money's worth (i.e. assets). In addition, the receipt of any form of advance of economic value is also taxable. According to the wording of Section 4 ITA, the borrower is no doubt taxable on the value of the imputed interest. On the other hand it has been questioned whether the borrower is entitled to any deduction as it does not actually pay interest on the loan.

However, the wording of Section 4 ITA does not support the taxation of the lender on the income which the lender might have obtained by demanding an arm's length rate of interest. Neither is there any support for taxation of the deemed interest elsewhere in the Act.

Writers on taxation argue that income that the taxpayer has neither obtained nor realized and to which it has no legal claim, should not be taxed.

However, in spite of this very clear starting point practice has been more extensive. The legal foundation for transfer pricing adjustments in Denmark is based on Section 12 of the Corporate Income Tax Act (CITA). This provision only applies where a foreign enterprise controls a Danish compa-

1. This expression includes interest free loans.
2. The rate is 3.25 per cent as of 1 May 1996

ny. Furthermore, taxation of the interest free loan is not imposed under this provision as both the tax authorities and the High Court refer to Section 4 ITA.

IV. GENERAL CONDITIONS

To make an adjustment the following three conditions must be fulfilled:

- There must be a relationship between the parties.[3]
- The interest free (or low interest) loan is unusual and not commercially justified. Here it is the taxpayer who has the burden of proof and has to prove that the granting of the loan was commercially justified and due to business reasons. It is not the actual granting of the loan which is required to be for business reasons, rather it is the granting of the loan without (or with a low rate of) interest.[4]
- The unusual conditions are due to the parties being related parties.

V. PRACTICE

A. Loans from a company to a main shareholder

The following applies only where the shareholder is an individual.[5] According to Section 115 of the Danish Public Companies Act (PCA) a company is prohibited from granting loans to shareholders. This rule was introduced in 1982, before that time such loans were commonly used for tax avoidance.[6]

In the circular 1978-31 concerning main shareholders the tax authorities stated that the company was to be taxed on deemed interest equal to the official rate on the loan. In addition, the main shareholder would be taxed on the hidden distribution which would be deemed to be a notional dividend, or alternatively additional salary if the shareholder was employed by the company. The shareholder was in both cases granted a deduction.

Today a loan to the main shareholder will be governed by Section 115 PCA. However, credit relationships arising on the basis of amounts due in the normal course of business according to usual company terms and conditions are not affected by the provision. Therefore, "loans" from a company to a main shareholder may still be made.

B. Loans from a subsidiary to a parent company

Loans to a parent company are permitted under Section 115 a PCA.[7] However, in the opinion of the Danish Commerce and Companies Agency, the provision in Section 115 a PCA concerning loans to parent companies only applies to loans to Danish parent companies. Thus, it is the opinion of the Agency, that loans may not be made to foreign parent companies. Under the rules governing loans to shareholders foreign groups are thus not entitled to transfer cash resources from Danish subsidiaries to a foreign parent company. The Agency has stated that this is their guideline interpretation of the Act,[8] however the final decision rests with the courts. The question has been raised as to whether this interpretation can be maintained in relation to parent companies in other EU countries. However this question has not yet been brought before the courts.

The tax treatment of such loans will follow the above mentioned rules. The lender, i.e. the subsidiary, will be taxed on deemed interest calculated at the official rate and the parent company will be admitted a deduction for this interest.

Furthermore, the parent company will be taxable on the benefit which is regarded as a hidden distribution. However, a Danish parent company receiving a dividend from a Danish subsidiary in which it holds at least 25 per cent of the share capital, is exempt from tax on the dividend provided it has held the shares either for the entire fiscal year in which the dividend is received or the parent company has held the qualifying amount of shares for a continuous period of at least two years.

If the subsidiary is domiciled outside Denmark, the tax exemption is extended to dividends received from a foreign subsidiary subject to the additional requirement that the parent company shows that the dividends are 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 the rules applying in Denmark.

If the dividends are exempt under these rules[9] the net result is that even if the subsidiary is taxed on the deemed interest, the parent company is admitted an equal deduction. This correction is in accordance with the general transfer pricing principles set out in Section 12 CITA.[10]

Taking the two companies as one unit the taxation of the subsidiary and the deduction in the parent company cancel each other out. Accordingly, in general the tax authorities have no fiscal interest in making adjustments in the case of a Danish group of companies.

The tax authorities may however have an interest in making an adjustment in the following cases:

- where the parent company has tax losses which it would otherwise be prevented from using by application of the five-year rule;[11]

3. As is always the case the burden of proof falls on the tax authorities.
4. It is often very difficult to argue that an interest free loan is commercially justifiable.
5. The question of correction in connection with interest free loans is a classical way of presenting the problem involving a main shareholder connection.
6. This could occur in the case of interest free loans since income was effectively extracted from the company tax free.
7. Therefore, as a general rule loans to shareholders as mentioned in Sec. 115 do not affect the granting of loans within a group as such.
8. Credit relationships arising on the basis of amounts due in the normal course of business according to usual company terms and conditions are not affected by the provision.
9. Sec. 13 CITA.
10. I.e. consisting of an increase equal to the fixed interest with the lender and a subsequent reduction with the borrower.
11. Tax losses may be carried forward for five years and may be offset against taxable income during the same period.

- if the conditions for the parent company to receive the dividend tax exempt are not fulfilled;
- if the parent company is situated abroad.[12]

If the subsidiary is situated abroad, the authorities are not interested in making an adjustment as it will mean that the Danish parent would get a deduction for the deemed interest.

C. Loans from a main (individual) shareholder to a company

With reference to a number of cases most of which concerned insufficient remuneration being paid to the main shareholder and where the National Tax Tribunal assumed that it was not possible to tax deemed interest, the authorities sent out a circular in 1975, circular 1975-437. In this circular it was stated that correction should only take place if adequate fees, rents or interest had not been paid by the company, and if this distorted the company's income. This circular was regarded in such a way that taxation of the deemed interest on the main shareholder should not be the general rule.

The circular of 15 December 1992 (1992-14) stipulated that the cases of deemed interest and rent in connection with main-shareholder relationships should be passed to the local tax authorities. In this connection it was mentioned that no changes were to be made to the current practice.

The general opinion was that the practice as provided for in the 1975 circular, meant that deemed interest on a loan from the main shareholder to the company, was limited to cases of distortion of income, and that taxation was reserved for cases where income was moved to a company in order to utilize its tax losses.

However, the circular did not prevent the National Tax Tribunal from applying the deemed interest provisions to a case where the loan was not made in a tax loss situation[13]. Apparently, the tax authorities place a wider interpretation on the word "distortion" than initially thought. From 1992 it is clearly stated in the guideline from the Assessment Board that when a shareholder has granted his company an interest free loan deemed interest would be imputed. However, the National Tax Tribunal seems to stick to the practice stated in the 1975 circular.[14].

The National Tax Tribunal only seems to apply the deemed interest provision to shareholder balances if there is distortion of income. It does not apply these provisions if there are bona fide commercial reasons for making the interest free loan.

The Tribunal's position is very probably the reason for the Board of Assessment setting out its point of view concerning deemed interest attributed to main shareholders. Circular 1995-24 stated that if a main shareholder grants a loan to his company and no interest is allocated or the interest is below an arm's length rate a correction shall take place.

The correction may only be made if in the circumstances of the case the interest free loan is not commercially justified. In these cases the shareholder will be taxed on deemed yearly interest computed at the official rate. However, a lower interest rate may be used if the company proves that the market interest rate for the company is below this rate.

It is further stated that normally there are no grounds for altering the income of the company as the deemed interest is completely offset by the interest deduction.

The 1995 circular specifically provides that deemed interest should only run from 1 January 1996 in cases where the said circular extended the application of the current practice. This may imply that the authorities have realized that up until 1996 the guidelines stated in the 1975 circular and as they have appeared in the National Tax Tribunal's practice apply.

However, the definition of commercial justification or distortion of income is unclear, and at the moment several lawsuits are pending in which main shareholders claim that they are being taxed on deemed interest to a wider extent than the circular from 1975 anticipated, and that practice has been tightened with retroactive effect. In one of the cases (TfS 1994.813 ØL) judgement has been passed in favour of the Ministry of Taxation in particular it was held that no such tightening had occurred. In the case of TfS 1995.800 the High Court states in the grounds of the judgement that taxation will take place according to Section 4 ITA, and despite the wording of the guideline from the Board of Assessment. The case is now pending before the Supreme Court.

D. Loans from a parent company to a subsidiary

From the above it appears that in the case of a Danish group of companies, the tax authorities are reluctant to make adjustments where the subsidiary has granted an interest free loan to its parent company. In contrast, if it is the parent company who granted an interest free or low interest loan to the subsidiary, the tax authorities take a different view.

The circulars concerning main shareholders have been interpreted so that they only apply to loans between an individual and a company i.e. they do not apply to intra group loans. It is expressly stated in the guideline from the Board of Assessment, that the limited rules in TS circular 1992-14 will not apply between a parent company and a subsidiary or among sister companies. The same must apply to TS circular 1995-24.

Even though a parent company's loan to a subsidiary is not governed by the 1975 circular, its tax treatment parallels that which applies to loans from an individual main shareholder. The tax authorities adopt the fiction that the subsidiary has received a taxable subsidy which is completely offset by a corresponding interest deduction. The tax liability will end up with the parent company which is regarded as having received taxable income computed by reference to the official interest rate and made a corresponding subsidy to the subsidiary which is not deductible.

12. I.e. the Danish subsidiary would be taxed on the deemed interest.
13. TfS 1993.103.
14. TfS 1993.249, TfS 1993.261, TfS 1994.136.

This fiction is made irrespective of whether the companies are jointly taxed. A Danish holding company may elect to be jointly taxed with its wholly owned subsidiaries. Both Danish and foreign subsidiaries may be eligible for joint taxation regardless of the domicile of the subsidiary.

It has been claimed that the adjustment in this situation can be made by virtue of Section 12 CITA, or the general transfer pricing principle. However, I do not agree as the main element in the transfer pricing principle is not available. Transfer pricing will normally mean redistribution and not an increase of the total income. It is only the income of the lender which is raised and no equal reduction is granted to the other party. Further, the taxpayers have claimed that the taxation is in conflict with Directive 69/335/EEC of 17 July 1969 on capital duty. In connection with bringing some of the decisions before the Supreme Court preliminary questions have been asked in the case TfS 1995.800 to the Court of Justice of the European Communities (ECJ). As the Directive specifies the transactions which shall be subject to capital duty it is claimed that the Directive prevents taxation of other transactions, including loans.

In the case in question in 1984 a parent company granted its subsidiary an interest free loan of DKK 27,500,000. In the middle of 1987 the loan was reduced to approximately DKK 8,500,000. The tax authorities increased the income of the parent company by an amount of deemed interest computed by reference to the official interest rate on the average loan outstanding for the period.

According to Article 10 of the Directive no taxes or duties other than capital duty must be collected on the transactions mentioned in Article 4 (loans or other payments etc.). The question is, however, whether the word "taxes" in Article 10 should be interpreted as only indirect taxes in the form of duties or whether direct taxes are also covered by the Directive.

One of the arguments put forward by the Ministry of Taxation was that it is the parent company which is taxed and that the Directive only governs the taxation of the subsidiary. However from an economic viewpoint it does not matter which company pays the tax.[15]

Oral hearing was held in the ECJ on 20 March 1996, but as yet the Court has not answered the questions raised although the Advocate General of the ECJ on 7 May 1996 proposed to rule in favour of the tax authorities. If the ECJ agrees with the opinions of the authorities and the Advocate General because the taxation is imposed on the parent company, further tax questions will arise on other points and further preliminary questions must be expected.

If transactions take place within groups and assets are transferred from one company to another group company the tax authorities may be of the opinion that there are assets which are not paid for or the correct prices are not paid. Accordingly, the tax authorities may increase the income of the subsidiary if it is the parent company which has transferred assets to the subsidiary. If the tax authorities do so it may be questioned whether the taxation is in accordance with the Directive 69/335/EEC.

E. Loans between sister companies

According to the commentaries of the Public Companies Act even though two companies are controlled by the same shareholder, lending from one company to the other, will not be governed by Section 115 unless the intention of granting the loan is to bypass the lending restrictions set out in Section 115 of the Act.

The same rules regarding deemed interest will apply as for a loan from a parent company to a subsidiary.[16]

It has been argued that an alternative method of deeming interest should be used between two sister companies owned by the same parent if one of the sister companies paid a dividend to the parent company and the parent company then granted a loan to the other subsidiary. In this model the deemed interest and its taxation should take place with the parent company and not the sister company. However, the authorities do not follow this approach.

In practice a number of cases have been raised concerning low interest rate loans between sister companies where the tax authorities have claimed that the proper interest rate should be the official rate. In several of the cases the lower interest was acknowledged as the market or arm's length interest rate.[17]

VI. EXCEPTIONS

The tax authorities have not always been successful in attacking interest free and low interest loans: Apart from the cases mentioned above in Section V.C, no taxation will take place if the borrower is insolvent.[18] However, relief may only be temporary since the lender is taxed on the deemed interest for the whole period if the borrower becomes solvent again. This outcome is perhaps more an expression of the fact that deemed interest income is not to be taxed before it can be paid. The mere risk of insolvency is not sufficient to avoid interest being deemed.[19]

Another example where the National Income Tax Tribunal did not agree that the deemed interest provisions should apply was a case, where a special subsidy was granted under Swedish rules.[20] According to Swedish court practice and book-keeping practice no interest should be paid on the loan. The National Income Tax Tribunal was of the opinion that the condition did not derive from common interest in the group, but from normal market conditions. However, the Danish tax authorities have brought the case before the High Court. The opinion of the Danish tax authorities is that the treatment of the subsidy according to Swedish law and practice can be disregarded.

15. I.e. the economic impact on the group as a whole is the same.
16. TfS 1985.439.
17. U.1963.880, TfS 1986.156, TfS 1996.69.
18. TfS 1993.249, TfS 1993.261, TfS 1994.191
19. TfS 1995.798
20. TfS 1994.162

If the courts rule in favour of the Danish tax authorities, conflicts of law will arise with cross border transactions if other countries have rules according to which loans between parent companies and subsidiaries must either be interest free or low interest.

Finally, in practice it has been accepted that if the company has taken over a personally owned firm (including its debtors) from the shareholder and the shareholder's outstanding amount is a loan, no interest is to be imposed on the outstanding amount due to the shareholder.[21].

VII. THE ARM'S LENGTH INTEREST RATE

The tax authorities are evidently of the opinion that the interest rate shall be the central bank's rate at the date of granting the loan plus 4 per cent. This standard correction does not take into account the actual market situation and the group involved. The central bank's rate is not the market interest rate. Furthermore, the surplus of 4 per cent is a purely arbitrary figure.

The central bank's rate is now as low as 3.25 per cent, but in 1993 the rate was 11.5 per cent, which gives an interest rate of 15.5 per cent. This interest rate has nothing to do with the arm's length interest rate. Furthermore it seems to actually contradict the arm's length principle, since the correction does not consider the individual circumstances of each taxpayer.

In the new circular dated 31 December 1995 (1995-24) the Board of Assessment has decided that if a shareholder grants a loan to a wholly owned company and either the loan is interest free, or a below arm's length rate of interest is charged a correction shall take place. The correction may only be made if in the circumstances of the case the terms of the loan are not commercially justified. In these instances the shareholder will be taxed on the deemed yearly interest computed at the official rate. However, a lower interest rate may be used if the company proves that the market interest rate for the company is below this rate. The last clause is probably due to the National Tax Tribunal's practice according to which the use of a lower interest rate than the official rate[22] has been allowed in several cases.

The courts also seem to be prepared to accept that a lower interest rate may, depending on the circumstances, apply. In the case published in TfS 1995.798 the court mentioned that if the taxpayer had requested, the High Court would have used a lower interest rate than the one the authorities claimed was the normal interest rate. However, the High Court decided not to rule in favour of the taxpayer due to the way the claim was made and the case conducted. This judgement has also been brought before the Supreme Court.

As a general rule it will be necessary when granting the loan to compare it with loans of the same type. It should be possible to use the interest rate equal to the rate, which the group usually has to pay to its bank. The question is whether it also may be possible to use the interest rate earned by the company on its deposits. As it is the creditor who is taxable it might be argued that the interest should be the same interest which the creditor would have obtained at the bank. However, in practice the tax authorities do not accept this argument.

VIII. REWRITING THE TRANSACTION

The question arises as to whether it is possible to avoid the taxation if the parties later accept that interest should be paid. However, in practice the tax authorities will not accept the rewriting of the transaction. The authorities refer to the fact that interest free loans are so unusual that the taxpayer should have known that interest should have been allocated.[23].

IX. CONCLUSION

Even though the taxation of deemed interest is regarded as being unfair to taxpayers particularly since they have not realized any income, the High Court has approved this taxation. This may lead to arbitrary taxation especially in the context of cross border transactions. In order to avoid future problems it is always advisable to consider whether an interest free loan can be commercially justified and if not, what rate of interest need be applied to avoid intervention by the authorities.

21. TfS 1994.884
22. TfS 1986.156, TfS 1990.83, TfS 1992.107, TfS 1995.528 and TfS 1996.69.
23. TfS 1995.210, TfS 1995.285, TfS 1995.305, TfS 1996.103

INTERNATIONAL

The Compliance Costs of Taxation

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I. INTRODUCTION

Tax compliance research is an important research area for policy making. Notwithstanding this, studies on the compliance costs of taxation have until lately attracted only a few academic researchers. Possible reasons are the high financial costs and the length of time involved in conducting surveys of taxpayers and analysing the ensuing data. Since the costs, in terms of time and money, are high, the quality of output also needs to be high for such research to be worthwhile.

Fortunately in recent years there has been an upsurge in interest among academic researchers in the compliance costs of taxation. The new studies attempt to estimate and quantify the magnitude of the tax compliance costs. Studies have been published on New Zealand (Sandford and Hasseldine 1992), United States (Slemrod 1988), Canada (Vaillancourt 1989), Australia (Pope et al. 1993) and Singapore (Ariff et al. 1995). One of the earlier studies on compliance costs was done in 1935 in the United States by Haig. A number of studies also looked at the compliance costs associated with various aspects of taxation. Examples of these are Pope and Chen (1993) on personal income tax, Pope, Fayle and Chen (1993a) and Vaillancourt (1989) on employment related tax, and Pope, Fayle and Chen (1993b) on wholesale sales tax. Indeed this paper limits its scope to corporate tax compliance costs.

The paper provides a brief overview of the research on compliance costs. The second section delineates the meaning of compliance costs while section three highlights the significance of such costs and section four proposes further areas for future research.

II. WHAT ARE COMPLIANCE COSTS?

Compliance costs have been defined by Sandford et al. (1989) as costs incurred by taxpayers or third parties, notably businesses, in meeting the requirements imposed upon them by a given tax structure (excluding payment of the tax itself and any distortion costs arising from it). Compliance costs are the "hidden costs of taxation" i.e. the private sector's costs of complying with a tax system, over and above the actual taxes imposed (Green 1994). In addition, compliance costs also refer to the administrative or collection costs incurred by the government in collecting tax revenue. These costs, however, have been identified in government reports. Compliance costs consist of two components – computational costs and planning costs.

Computational costs that are unavoidable can be termed *basic or pure compliance* costs. These are largely computational and routine in nature. An example would be costs associated with the preparation of an income tax return. Other computational costs relate to tax objections, tax queries and appeals. These costs can be termed *advisory* costs. Compliance costs are affected by the underlying simplicity (or otherwise) of a tax system and the degree of certainty that characterizes that system. The simplification of a tax system should lead to a reduction in pure compliance costs, especially where simplicity means self-assessment. Uncertainty, however, could lead to higher advisory costs. Taxpayers would either pay for professional advice to prepare their tax returns or could end up having to argue with the Inland Revenue Board.

Planning costs are avoidable and discretionary in theory, but in practice would be undertaken by any reasonable person or company. Compliance costs incurred within the company have been termed internal compliance costs and those incurred outside the company (mainly professional fees) are known as external compliance costs.

III. SIGNIFICANCE OF COMPLIANCE COSTS

Wallschutzky and Gibson (1994) noted that the Australian Tax Office (ATO) has been concerned with the general issue of compliance costs for all taxpayers. However, senior ATO staff have expressed doubts about the validity of the methods used in the study conducted by Pope (1989) and Pope et al. (1990). The findings of a project jointly funded by the ATO and the Department of Industry Technology and Commerce suggest that while compliance costs are important, far too much has been made of them and of the problem of complying with government regulations. Nevertheless compliance costs should not be overlooked. Today international competition for foreign investment is fierce. National tax regimes are often in direct competition since tax payable may be a key factor in determining the location of investments. Compliance costs are another expense to consider. These can be significant, as was suggested by Heiji to be the case in Vietnam (see below).

A study conducted by Sue Green, as reported by Greene and Maddalena (1994), found that tax experts believe an overly complex tax system and deficiencies in the legislative process conspire to create unacceptably high tax compliance costs. These findings are supported by Holmes and Russell (1994) in their paper on the underlying Foreign Tax Credit (UFTC) regime in New Zealand. UFTC, applying to foreign dividends received on or after September 1993, 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 Foreign Dividend Withholding Payments (FDWP). Holmes and Russell concluded that 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 in which a New Zealand resident does not have a controlling interest, may make it preferable to simply pay FDWP. This highlights a situation whereby compliance costs and complications could lead to a reduction in the attractiveness and utility of tax incentives.

In a speech given at a seminar held in May 1994 on international tax planning, David Elvidge, Director of Taxation at Barclays Bank UK said that as a worldwide taxation regime, unitary taxation is in practice impossible as worldwide unitary regimes would potentially involve multinationals in paying away more of their profits in tax compliance costs than they would pay in taxes.(Elvidge 1994). This highlights the importance of reducing compliance costs. Compliance costs are at times high due to specific regulations, as Holmes and Russell noted was the case with New Zealand's UFTC regime. Another example was highlighted by Barlas (1994) in the United States where a study from the Tax Foundation found that 45 per cent of the cost of complying with federal law results from rules relating to accounting for foreign source income. Furthermore, Malaysia repealed its 1984 Share Transfer Tax Act within five years of its introduction in part because it learned that such complex laws could result in mistakes being made in favour of either the taxpayer or the government (Kasipillai and Shanmugam 1995). The above demonstrates the importance of researching compliance costs in relation to specific tax rulings.

A favourable tax regime can lose its advantage if the costs of complying with the tax regime dilute the tax benefits of operating in a particular location. Gitte Heiji (1995 at 24) acknowledged the importance of compliance costs, particularly with respect to Vietnam which he described as one of the most favourable tax regimes in the Asian region. He however concluded that "it may be useful for those investing in Vietnam not to be easily persuaded by the corporate tax incentives and holidays, but instead to look at the overall level of taxes and the costs of meeting these liabilities". These costs, including actual payments of professional fees and "hidden" fees as well as time spent overcoming bureaucratic difficulties and legislative ambiguities, need to be taken into account in any assessment of whether Vietnam's tax regime compares favourably with other countries in the region who are competing for foreign investment dollars.

IV. DIRECTIONS FOR FUTURE RESEARCH

Goonetilleke (1994) defined best practice in tax compliance as a function of compliance cost (min) and reasonable care (max) and tax payable (min):[1]

Best practice = W_1 Cost of compliance $_{min}$ + W_2 Reasonable care $_{max}$ + W_3 Tax payable $_{min}$

Where W_1, W_2 and W_3 are the weights to be applied to the components.

He conceded that compliance costs per dollar of turnover is not an appropriate measure for compliance costs as it varies with the size of the organization. A more appropriate measure needs to be identified. Research to date, however, has been using the turnover measure.

Several studies have attempted to estimate and quantify the magnitude of tax compliance costs at the levels of both the individual and the firm for various countries. These studies compare countries on the basis of their compliance costs per dollar of turnover. Pope et al. found that compliance costs per AUD 100 of turnover in Australia was AUD 2 for companies with turnover of up to AUD 5 million, decreasing to about four cents per AUD 100 of turnover for companies with a turnover of AUD 100 million and above. Sandford et al. (1989) and Ariff et al. (1995) also found that costs of compliance per dollar of turnover is higher for the smaller companies in the UK and Singapore respectively. Researchers in compliance costs use cost per dollar of turnover as a measure for comparison. All have found that compliance costs contain a large fixed cost element i.e. cost per dollar of turnover decreases even though in absolute terms such cost is higher for larger companies. This is, of course, expected. Cost per dollar of turnover is a measure relating compliance costs to firm size, where turnover is the proxy for size. Compliance costs, however, are more related to the tax policies than turnover.[2]

The surveys in tax compliance cost research are often detailed and provide substantial information. Researchers ought to calculate the compliance costs per dollar of gross profit and test whether there is any significant difference between the profit related measure and the size related measure. Pure computational costs should remain static as, even if the firm is not paying tax, it has to comply with filling returns. Advisory and planning costs, on the other hand, should show a positive relationship with the quantum of the "potential" tax liability. This potential liability is a direct function of the profit level. Firms which have a low exposure to tax will incur less voluntary planning costs than firms with

1. (1) Best practice = Cost $_{min}$ + Quality $_{max}$
The cost from the taxpayers' point of view is the cost of compliance.
(2) Quality → f (Reasonable care, Tax payable)
Maximum quality will be achieved when
(3) Quality $_{max}$ = Reasonable care $_{max}$ + Tax payable $_{min}$
Combining (1) and (3)
(4) = W_1 Cost of compliance $_{min}$ + W_2 Reasonable care $_{max}$ +
W_3 Tax payable $_{min}$

2. The income tax liability is related to profitability levels. Of course the Sales tax or VAT are directly related to the turnover, in which case cost per dollar of turnover as a measure of tax compliance cost is appropriate.

high exposure. The profits level and tax rate determine the potential exposure to taxation.

Higher compliance costs leading to lower tax payable can be considered good practice provided the increase in compliance costs is less than the reduction in tax liability (see Goonetilleke above). This is the basic rationale or justification for tax planning. Surprisingly no research has been carried out to test if the presumed correlation exists. A starting point could be to compare planning costs per dollar of turnover with the tax liability per dollar of turnover. There is a need to test the hypothesis that tax planning can reduce future tax liability in amounts greater than tax planning costs i.e. the efficiency of tax planning.

Pope et al. (1993) and Ariff et al. (1995) compared mean computational costs based on the size of firms and broke this down into its internal and external components. Both studies were based on mail questionnaire surveys and both identified advisory costs but neither attempted to analyse computational costs into pure compliance and advisory computational costs. Advisory costs can be a measure for the uncertainty inherent in tax laws. The relationship between new laws and advisory costs can be tested.

Both studies accepted that a questionnaire survey might not lead to very accurate results and suggested longitudinal studies be undertaken to identify the effects of simplification on compliance costs since declining costs will infer that the tax system is becoming simpler. The longitudinal study however should look at advisory as well as pure compliance costs. It is only the pure compliance costs that can be reduced by simplifying the tax system. Simplification could lead to higher advisory costs due to uncertainty (see Sue Green 1994). An interesting point for research would be the relationship between advisory and pure compliance costs and whether the two are inversely related. Simplicity of tax laws and regulations would lead to a reduction in pure compliance costs, especially where a system of self-assessment is imposed. Oversimplification, however, has the potential danger of creating uncertainty. Tax assessment is generally not black and white, there are grey areas. Uncertainty could lead to higher advisory costs. Pope (1992) recognizes compliance costs as one measure of the complexity of any tax system, with high costs implying a complex tax regime. Pope (1989, at 130-131) recognized the difficulty and the lack of research into objectively measuring the complexity of tax legislation. He argued that the public's perception of complexity was an important indicator. Researchers can include the taxpayer's perception of complexity in their surveys. This type of survey data can help determine whether the tax authorities have shifted some of the costs associated with a more complex system away from its own administrative costs onto the taxpayers in the form of higher compliance costs, particularly in the transition to self assessment.

It would be interesting to perform an empirical study to test this hypothesis. The introduction of self assessment can be used as the proxy for simplicity. Then we can test if there is any correlation between the introduction of self assessment and reduction in compliance costs. Pure compliance costs should decline and we should test the effect on advisory costs. The effect on advisory costs would be lagged as self assessment would mean more tax appeals and objections (if the tax system is ambiguous). The data should be tested for at least a seven-year period. If both pure and advisory costs are reduced then the system has become more simple and certain. A word of caution however, Sue Green (1994, at 79) commented on self assessment, "In the end, some of these taxpayers will decide to pay for professional advice while others will inadvertently fall foul of the new interest and penalty provisions. In both cases, their compliance costs will increase."

There has been some research conducted on audit fees and management advisory services (e.g. Rashad 1990, Simonic 1984). This type of research will benefit from the magnitude of data collected in tax compliance research. The relationship, if any, between audit fees and tax planning costs can be tested to identify any significant differences where the audit firm is providing the tax planning advice. Anecdotal evidence suggests that in cases where the audit firm provides the tax planning advice tax planning fees can have an impact on audit fees.

The differences in tax compliance costs between private and public companies has not been researched. This will provide evidence as to whether tax compliance is an added long term cost of privatization. Most compliance cost research (e.g. Pope, Ariff et al.) does not attempt to break down compliance costs into costs associated with complying with various rulings or sources of income. Another interesting aspect to research would be the compliance costs of obtaining tax incentives. Tax incentives are designed to attract investment by offering firms the inducement of a lower tax liability. If the compliance costs associated with the tax incentives are high it would reduce after tax profits and dilute the benefits obtainable under the incentives. This was highlighted in a survey of 114 tax practitioners in New Zealand by Tooley and Tan (1994) on the effectiveness of tax reform measures introduced in New Zealand. The respondents believed that the complexities of the tax measures had wiped out the benefits gained from the reforms.

The industry effect also has not been empirically tested. This is surprising as tax regulations do effect different industries differently. Pope (1994) identified six phases in the development of the compliance costs of taxation as a policy area. The fifth phase being "effective policy measures" where compliance costs are reduced at "grass roots" level. This phase involves targeting specific groups. Pope argues that Australia has not yet reached this phase but instead has entered phase four i.e. "policy recognition". Research into how compliance costs effect individual industrial sectors would be necessary if Australia is to move to the fifth phase.

V. CONCLUSION

The issue of tax compliance costs presents researchers with substantial research opportunities. Tax compliance is an important area that has gained significance in recent years. It is hoped that interest in this area will grow, thus triggering research endeavours on the more relevant and insightful aspects. It is also propitious that policy makers accord the issue of tax compliance costs its deserved attention.

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Pope, J., 1992, "The Compliance Costs of Taxation in Australia: An Economic and Policy Perspective", School of Economics and Finance, Curtin University of Technology, *Working paper 92.07*.

Pope, J. and Chen, D. L., 1993, "Determinants of the Time Taken to Deal with Personal Income Tax Affairs in Australia", Department of Economics, The University of Western Australia, *Discussion Paper 93.11*.

Pope, J. Fayle, R., and Chen, D. L., 1993a, *The Compliance Costs of Employment-Related Taxation*, (Sydney: Australian Tax Research Foundation).

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Simonic, D. A., 1984, "Auditing, Consulting and Auditor Independence" 22 *Journal of Accounting Research* 2, (Autumn 1984).

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Tooley, S., and Tan, L. M., 1994, "Simplification – What do Practitioners Think?" 73 *Chartered Accountants of New Zealand (ANZ)*, 5 (June 1994).

Vaillancourt, F., 1989, *The Administrative and Compliance Costs of the Personal Income Tax and Payroll Tax System in Canada, 1986* (Toronto, Canadian Tax Foundation).

Wallschutzky, I., and Gibson, B., 1994, "Taxing Small Business", 64 *Australian Accountant (AAA)*, 2 (March 1994).

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 41-44 of the January 1996 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

Australia

1996 Australian taxation law. 6th Edition.
North Ryde, CCH Australia Limited. 1996, pp. 1580. ISBN: 1 86264 766 5.
The book explains the essential principles of Australia's main federal and state taxes, focusing particularly on income tax. It provides a comprehensive and practical-oriented analysis of relevant legislation and case law. Includes capital gains tax, fringe benefits tax, the imputation system of company taxation, the taxation of retirement payments and superannuation funds, and the international aspects of Australia's income tax.
(B. 58.182)

Deutsch, R.L.; Gates, S.J.; Gibson, M.M.; a.o.
Australian tax handbook 1996. 1st Edition.
North Ryde, Australian Tax Practice, 13-15 Lyon park Road, North Ryde, NSW., Australia. 1996, pp. 1850. ISSN: 1325 7935.
Handbook covering all legislation in force as of 31 December 1995. The book includes the following subjects: Australian tax, system, income tax, capital gains tax, deductions, accounting and auditing, international taxation, fringe benefits tax, tax planning. A notably new feature of the handbook is a newly designed tax calendar which should provide practitioners with a quick reference of the various parts, divisions and sections of the Income Tax Assessment Act.
(B. 58.164)

Cambodia

Lee Fook Hong.
Investment and tax planning considerations for foreign investors in Cambodia.
Singapore, Lee Fook Hong & Co. 1995, pp. 55.
(B. 58.176)

EUROPE

Baltic States

Conditions for direct foreign investments in the Baltic States. Editors Peter M. van der Hoek and Hans van Miltenburg.
Aldershot, Avebury Ashgate Publishing Limited, Gower House, Croft Road, Aldershot, Hants GU11 3HR, England. 1996, pp. 210. GBP 38.50. ISBN: 1 85972 295 4.
The first part of the book contains descriptions of the situations in the three Baltic states (Estonia, Latvia and Lithuania) in respect of history, natural resources, political system, economic situation, international relations, including treaties, industry and trade, finance and banking and main legislation. The second part focuses on the conditions for direct investment by including topics as the legal framework, the labour market, monetary and fiscal policy and privatization.
(B. 115.253)

Belgium

Fiscolex 1996. 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; Diegem, Ced Samsom. 1996, pp. 963. ISBN: 90 5334 408 X.
1996 Update of the Income Tax Code together with the executory measures and the Tax Code assimilated with income taxes together with the executory measures. This edition is up-to-date as at 31 January 1996.
(B. 115.317)

Czech Republic

International banking: Czech Republic. 2nd Edition.
Prague, Price Waterhouse, Office Centre Vinohrady, Rímská 15, 12147 Praha 2, Czech Republic. 1996, pp. 47.
Second edition of a booklet intended to provide a basic insight into the structure of the banking industry in the Czech Republic. It describes the legal, accounting and tax framework within the industry, outlining the requirements and procedures for setting up a new banking operation.
(B. 115.401)

Business law guide to the Czech Republic. Prepared by Jennie Mills of Norton Rose, Price Waterhouse.
Bicester, CCH Editions Limited. 1994, pp. 329. GBP 65. ISBN: 0 86325 370 9.
The guide provides a comprehensive and practical survey of Czech business law, tax and accounting regulations. In addition to a general introduction and an outline of the political, economic and legal system, the guide includes coverage of the following topics: foreign investment, joint venture, privatization, real property, environmental legislation, accounting and taxation, bankruptcy, law on securities, banking, import and export, intellectual property, employment. The book is of practical help for anyone doing business, or planning to do business in the Czech Republic.
(B. 115.416)

Estonia

Investment guide for Estonia.
Paris, Organisation for Economic Co-operation and Development. 1996, pp. 165. ISBN: 92 64 14806 X.
Guide designed to assist those interested in doing business in Estonia, providing detailed background information about the country, and outlining the current legal and regulatory framework for foreign investment. It includes a list of investment opportunities and brief information on accounting and taxation aspects.
(B. 115.361)

France

Miechielse, G.; David, C.; Theisen, Manuel R.; Wenz, M.; Tiley, J.
Tax treatment of financial instruments. A survey of France, Germany, the Netherlands and the United Kingdom.
The Hague, Kluwer Law International. 1996. Series on International taxation, No. 14, pp. 344. NLG 240.62. ISBN: 90 6544 666 4.
A general overview of the tax treatment of the various financial instruments in four important EU Member States: France, Germany, the Netherlands and the United Kingdom. The book shows clearly the most important tax differences and outlines the points on which EC harmonization is not only the most imperative, but also the most difficult to realize. This publication is ideal for consultants and students in international law.
(B. 115.356)

Retraites d'entreprise. Juridique – fiscal – social – comptable – financier. A jour au 1er février 1995.
Levallois, Editions Francis Lefebvre. 1995, pp. 871. FRF 421. ISBN: 2 85115 273 4.
The book is divided into five chapters. Chapter 1 explains the regime of compulsory pension schemes; Chapter 2 deals with rules applicable to complementary (a supplementary) pension

schemes; Chapter 3 summarizes the tax regime applicable to pension schemes; Chapter 4 sets out the rules to be followed by a company wishing to install a complementary pension scheme for its employees; Chapter 5 summarizes the accounting aspects of both compulsory and complementary pension schemes. Further aspects such as the legal aspects, and the financial and investment aspects are also examined.
(B. 115.364)

Financement des entreprises. Sources de financement en France. 1995-1996. A jour au 1er mai 1995.
Levallois, Editions Francis Lefebvre. 1995, pp. 623. FRF 380. ISBN: 2 85115 282 3.
Summary of the different ways of financing a company on both a long term and a short term basis. The book gives details regarding the financing of a company depending on the situation of the company concerned, such as: financing at the moment of the creation of the company; financing of investments made; financing of research and innovations; financing of companies experiencing difficulties, etc.
(B. 115.365)

Germany

Frotscher, Gerrit.
Kommentar zum Körperschaftsteuergesetz. Leitfaden zum Körperschaftsteuererklärung 1995.
Freiburg, Rudolf Haufe Verlag GmbH. 1996, pp. 260. ISBN: 3 448 03411 8.
Commentary to the Corporate Income Tax Law. Guide to the 1995 corporate tax return.
(B. 115.368)

Zitzmann, G.; Spanke, E.
Zulagen für Investitionen in den neuen Bundesländern. 5. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 253. DEM 35.90. ISBN: 3 08 364085 4.
Updated fifth edition of book on German investment incentives applicable in the new Länder.
(B. 115.377)

Miechielse, G.; David, C.; Theisen, Manuel R.; Wenz, M.; Tiley, J.
Tax treatment of financial instruments. A survey of France, Germany, the Netherlands and the United Kingdom.
The Hague, Kluwer Law International. 1996. Series on International taxation, No. 14, pp. 344. NLG 240.62. ISBN: 90 6544 666 4.
A general overview of the tax treatment of the various financial instruments in four important EU Member States: France, Germany, the Netherlands and the United Kingdom. The book shows clearly the most important tax differences and outlines the points on which EC harmonization is not only the most imperative, but also the most difficult to realize. This publication is ideal for consultants and students in international law.
(B. 115.356)

Seibold, W.; Stegmüller, H.; Horn, W.
Die Gewerbesteuer- und Umsatzsteuer-Erklärung für 1995. 47. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 122. ISBN: 3 08 317295 8.
1995 Business tax – VAT declaration. Annual instructions on filing business tax forms and VAT form, including the most recent administrative guidelines and case law explanations.
(B. 115.338)

Sauer, Otto.
Schlagwortregister zur Rechtsprechung und Literatur des gesamten Steuerrechts 1995.
Bonn, Stollfuss Verlag. 1996, pp. 1543. DEM 205. ISBN: 3 08 372095 5.
List of keywords in taxation. Manual providing in alphabetical order information and sources of tax law publications in 1995.
(B. 115.378)

Steuerberater Handbuch 1996/97. 7. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 2130. DEM 198. ISBN: 3 08 374096 4.
Publication of the German Association of Tax Advisers containing information on taxation (including changes made by the 1996 Tax Law, Reorganization Tax Law, Frontier Workers Act, tax treatment of dwellings), and other tax-related topics, e.g. accounting principles, business law, social security and labour law.
(B. 115.339)

WP Handbuch 1996. Wirtschaftsprüfer Handbuch 1996. Handbuch für Rechnungslegung, Prüfung und Beratung. Band I. 11. Auflage.
Düsseldorf, IDW Verlag GmbH. 1996, pp. 2006. ISBN: 3 8021 0692 X.
1996 Manual for auditors. Manual for accounting, auditing and advising dealing with e.g. enterprise valuation, data protection, cross-border legal forms, cartel law and insolvency law.
(B. 115.347)

German capital market law.
Editors Ulf R. Siebel, Robert Finney and Michael Prinz zu Löwenstein.
New York, Oceana Publications, Inc.; Munich, Verlag C.H. Beck. 1995, pp. 232. DEM 89. ISBN: 3 406 399134.
This publication aims to provide German and international capital markets participants with the information needed to act on the German financial markets.
(B. 115.387)

Netherlands

Miechielse, G.; David, C.; Theisen, R.; Wenz, M.; Tiley, J.
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The Hague, Kluwer Law International. 1996. Series on International Taxation, No. 14, pp. 344. NLG 240.62. ISBN: 90 6544 666 4.
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Sweden

Grosskopf, G.; Johansson, G.; Rabe, G.
Det svenska skattesystemet – Individbeskattning, företagsbeskattning. 9th Edition
Stockholm, Norstedts Juridik. 1996, pp. 565. ISBN: 91 38 50568 1.
The Swedish tax system – Taxation of individuals, taxation of businesses. Textbook to be used for university studies in tax law, as well as in tax practice. This 9th edition has been updated to reflect the laws passed for 1995-1996. The topics discussed include the history, general principles and sources of taxation in Sweden, national and municipal income taxation, net wealth taxation and international aspects of taxation. A case register and an index by topic are included.
(B. 115.325)

Register över gällande SFS författningar, 1 januari 1996.
Stockholm, Justitiedepartementet. 1996, pp. 367. SEK 416. ISBN: 91 38 30827 4.
Chronological and subject matter index to the Swedish Official Gazette listing laws in force as of 1 January 1996.
(B. 115.324)

United Kingdom

Whillans's tax tables revised 1995-96. 50th Edition.
London, Butterworths. 1995, pp. 99. GBP 3.50. ISBN: 0 406 05421 5.
This revised 1995-96 edition includes many new features, e.g. penalties, time limits for claims and elections, approved employee share schemes, relocation benefits and expenses and types of relief for investment, all tax facts and figures
(B. 115.390)

Whillans's tax tables 1996-97. 51st Edition.
London, Butterworths. 1996, pp. 101. GBP 4.95. ISBN: 0 406 06448 2.
(B. 115.389)

Miechielse, G.; David, C.; Theisen, Manuel R.; Wenz, M.; Tiley, J.
Tax treatment of financial instruments. A survey of France, Germany, the Netherlands and the United Kingdom.
The Hague, Kluwer Law International. 1996.

Series on International taxation, No. 14, pp. 344. NLG 240.62. ISBN: 90 6544 666 4.
A general overview of the tax treatment of the various financial instruments in four important EU Member States: France, Germany, the Netherlands and the United Kingdom. The book shows clearly the most important tax differences and outlines the points on which EC harmonization is not only the most imperative, but also the most difficult to realize. This publication is ideal for consultants and students in international law.
(B. 115.356)

Value added tax – charities. VAT Notice 701/1/95.
London, Inland Revenue. 1995.
Charities Series, pp. 50.
This edition takes account of changes to the VAT liability of supplies of fuel and powers to charities, and clarifies the VAT position of transactions in securities, medicinal products and charity advertising.
(B. 115.358)

Trading by charities.
London, Inland Revenue. 1995, pp. 44.
Guidelines on the tax treatment of trades carried on by charities.
(B. 115.358A)

INTERNATIONAL

Freight taxes 1996.
Copenhagen, BIMCO Publications A/S. 1996, pp. 152. ISBN: 87 90342 01 1.
Updated annual publication containing summaries of the freight taxes applied in 59 countries and highlights of the more essential sections of the relevant laws.
(B. 115.362)

1996 International tax summaries.
A guide for planning and decisions.
New York, John Wiley & Sons, Inc. 1996, pp. 1150. ISBN: 0 471 13839 8.
An overview of the tax systems of 123 countries. The book provides information on individual and corporate income tax laws, and covers the taxation of non-residents and withholding tax rates under double taxation treaties. Important regulatory and tax considerations for foreign investors, and the basic rules for the computation of taxable income in each of the countries, is also covered. This edition reflects the tax systems as of 31 July 1995. (B. 115.385)

Worldwide executive tax guide and directory.
New York, Ernst & Young International. 1996, pp. 606.
Brief summary of personal tax systems for executives in over 30 countries, based on information current at 1 September 1995 (including anticipated changes for 1996).
(B. 115.379)

The Europa World Yearbook 1996. Volume I. Part one: International organizations; Part two: Afghanistan – Jordan.
London, Europa Publications Limited. 1996, pp. 1803. ISBN: 1 85743 019 0.
Volume I contains international organizations and the first part of the alphabetical survey of countries of the world, from Afghanistan to Jordan. This edition includes a new section on the recently established World Trade Organization.
(B. 115.402)

OECD

Subsidies and environment. Exploring the linkages.
Paris, Organisation for Economic Co-operation and Development. 1996, pp. 218. ISBN: 92 64 14822 1.
Proceedings and synthesis of a workshop on subsidies/tax incentives and the environment on 20-21 November 1995, in Paris, organised by the OECD.
(B. 115.357)

1996 OECD guidelines on transfer pricing. Chapters on intangibles and intra-group services.
London, Ernst & Young. 1996, pp. 11.
(B. 115.374)

OECD economies at a glance. Structural indicators.
Paris, OECD Organisation for Economic Co-operation and Development. 1996, pp. 141. ISBN: 92 64 14805 1.
The first section of this publication provides indicators that cut across sectors and policy areas, including information on basic living standards, comparative price levels, productivity growth and income distribution. The following sections provide information on labour markets, financial markets and institutions, international product and factor flows, production structure, regulation and competition, public finance and expenditure, social services, agriculture, energy and the environment.
(B. 115.380)

NORTH AMERICA

USA

Bittker, Boris I.; Lokken, Lawrence.
Federal taxation of income, estates and gifts. 1995 Cumulative supplement No. 4. Text – annotations through September 1995; Cumulative Tables & Index.
Boston, Warren, Gorham & Lamont. 1996, pp. 1500. ISBN: 0 7913 2566 0.
This supplement brings the text of "Federal Taxation of Income, Estates and Gifts" up-to-date. Presents all relevant judicial, legislative, and administrative developments, and serves both as a means of keeping the main volumes current and as a summary of recent developments.
(B. 115.413A/B)

The effects of taxation on multinational corporations. Editors M. Feldstein, J.R. Hines and R.G. Hubbard.
Chicago, The University of Chicago Press. 1995, pp. 324. ISBN: 0 226 24095 9.
The book examines the effect of tax policy on international investment choices by presenting in-depth analyses of the interaction of international tax rules and the investment decisions of multinational enterprises. Ten papers assess the role of investment by multinational firms in the US economy and the design of international tax rules for multinational investment; the papers also analyse the channels through which international tax rules affect the costs of international business activities; and examine ways in which international tax rules affect the financing decisions of multinational firms. The book will be of interest to researchers in public finance and international economics and to policy makers concerned with tax policy and international investment issues.
(B. 115.381)

Loose-leaf Services

Received between 1 and 31 July 1996

Africa

Fiscalité Africaine
releases 7-11
Editions Fidiciaire France Afrique, Paris.

Belgium

Commentaar op het wetboek van de inkomstenbelasting
release 3
Ministry of Finance, Brussels.

Commentaire du Code des impôts sur les revenus
release 3
Ministry of Finance, Brussels.

Vennootschap en belastingen
release 30
Kluwer Rechtswetenschappen, Deume.

Canada

Foreign investment in Canada
release 1
Carswell Thomson Professional Publishers, Scarborough.

Income tax references/Références à la loi de l'impôt sur le revenu
release 69
Carswell Thomson Professional Publishers, Scarborough.

Denmark

Skattebestemmelser
- Skattenyt – Kronologisk
  releases 14-16
- Skattebestemmelser – Systematisk
  release 7

A.S. Skattekartoteket Informationskontor, Copenhagen.

European Union

Handboek voor de Europese Gemeenschappen
- Verdragsteksten en aanverwante stukken.
  release 369

Kluwer, Deventer.

France

Fiscalité pratique – fiscal
releases 2 and 3
Editions Francis Lefebvre, Levallois.

Réglementation sociale pratique/Sécurité sociale legislation du travail.
release 3
Editions Francis Lefebvre, Levallois.

Germany

Bonner Handbuch GmbH
Brandmüller-Küffner
release 36
Stollfuss Verlag, Bonn.

Deutsche Gesetze
Schönfelder
release 89
Verlag C.H. Beck, Munich.

Deutsches Steuerlexikon
release 9
Verlag C.H. Beck, Munich.

Deutsche Steuerpraxis – Nachschlagwerk praktischer Steuerfälle
Felix
release 169
Verlag Dr. Otto Schmidt, Cologne.

Handbuch der Bauinvestitionen und Immobilien-Kapitalanlagen
release 81
C.F. Müller Juristischer Verlag, Heidelberg.

Kommentar zum Gewerbesteuergesetz
Lenski-Sternberg
release 76
Verlag Dr. Otto Schmidt, Cologne.

Sozialversicherungs Handbuch für die betriebliche Praxis
Figge
release 58
Verlag Dr. Otto Schmidt, Cologne.

Steuererlasse in Karteiform
release 416
Otto Schmidt Verlag, Cologne.

Steuerrechtsprchung in Karteiform
release 533
Otto Schmidt Verlag, Cologne.

Umwandlungsrecht
Wismann-Mayer
release 32
Stollfuss Verlag, Bonn.

International

Handbuch der Einfuhrnebenabgaben
release 3
Mendel Verlag, Aachen.

Interfisc tax treaty service
John Dewhurst
release 72
J.F. Chown, London.

Netherlands

Belastingwetten (De Belastinggids)
release 183
Gouda Quint/D. Brouwer, Arnhem.

Belastingwetgeving
- Omzetbelasting 1968 (BTW/1978)
  release 105

Noorduijn BV., Arnhem.

Cursus belastingrecht
Mobach
releases 244-246
Gouda Quint/D. Brouwer, Arnhem.

Fiscaal fundament
release 4
Kluwer, Deventer.

Fiscale wetten
releases 240 and 241
Fed, Deventer.

Handboek voor de in- en uitvoer
- Algemene wetgeving inzake douane
  releases 42 and 43
- Gecombineerde nomenclatuur
  releases 121-123

Kluwer, Deventer.

Kluwer fiscaal zakboek
releases 16 and 17
Kluwer, Deventer.
Kluwers subsidieboek
release 174
Kluwer, Deventer.

Leidraad bij de belastingstudie
Van Soest-Meering
release 138
Gouda Quint/D. Brouwer, Arnhem.

Modellen voor de rechtspraktijk
release 153
Kluwer, Deventer.

Rechtspersonen
release 131
Kluwer, Deventer.

De sociale verzekeringswetten
- AOW/AWW
  release 80
- AKBW
  releases 62 and 63
- AWBZ
  releases 146 and 147
- Heffing over uitkeringen en loon
  releases 77 and 78

Kluwer, Deventer.

Staats- en administratiefrechtelijke wetten
releases 326 and 327
Kluwer, Deventer.

Vakstudie – Fiscale encyclopedie
- Algemene deel
  releases 268 and 269
- Belastingheffing van motorrijtuigen
  releases 10 and 11
- Inkomstenbelasting 1964
  release 1002
- Invorderingswet
  release 84
- Lokale belastingen en milieuheffing
  release 44
- Omzetbelasting
  release 302
- Successiewet 1956
  release 185
- Vennootschapsbelasting 1969
  releases 385-387
- Vermogensbelasting 1964
  release 177

Kluwer, Deventer.

Norway

Skatte-nytt
A, releases 6 and 7
Norsk Skattebetalerforening, Oslo.

Peru

Codigo Tributario
release 61
Editorial Economia y Finanzas, Lima.

Impuesto a la renta
release 82
Editorial Economia y Finanzas, Lima.

Impuesto a las ventas
release 92
Editorial Economia y Finanzas, Lima.

Tributos municipales
release 39
Editorial Economia y Finanzas, Lima.

Switzerland

Die Praxis der Bundessteuern
Agner
Band I, release 48
Verlag für Recht und Gesellschaft AG., Basel.

Die Eidgnössische Mehrwertsteuer
release 6
Verlag für Recht und Gesellschaft AG., Basel.

Die Steuern der Schweiz/Les impôts de la Suisse
Band IV, release 89
Verlag für Recht und Gesellschaft AG., Basel.

United Kingdom

Simon's tax cases
releases 26-30
Butterworth & Co., London.

Simon's direct tax service
release 17
Butterworth & Co., London.

Simon's tax intelligence
releases 26-30
Butterworth & Co., London.

De Voil – Indirect tax service
(formerly Value added tax – De Voil)
release 7
Butterworth & Co., London.

USA

Tax ideas – Report bulletin
release 6
Warren Gorham Lamont, Boston.

Tax treaties – Report bulletin
release 6
Warran Gorham Lamont, Boston.

United States income tax treaties
Vogel-Shannon-Doernberg
release 7
Kluwer Law and Taxation Publishers, Deventer.

US taxation of international operations
releases 12 and 13
Warren, Gorham Lamont, Boston.

CUMULATIVE INDEX – 1996

I. ARTICLES

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

SEPTEMBER 1996

Financial Planning through International Taxation Treaties, the Langham Court Hotel, London W1, 19 September 1996 (English):

Conference Secretariat, ESC International Ltd, 565 Fullham Road, London SW6 1ES, Tel.: 44-171-386 9322, Fax: 44-171-381 8914.

Corporate Debt Taxation, Langham Court Hotel, London W1, 20 September 1996 (English):

Conference Secretariat, ESC International Ltd, 565 Fullham Road, London SW6 1ES, Tel.: 44-171-386 9322, Fax: 44-171-381 8914.

Advanced Group Tax Planning in Asia, Conrad International Hotel, 88 Queensway, Hong Kong, 24-25 September 1996 (English):

Asia Law & Practice Ltd, Attn William Shiu, 1/F Chinachem Centre, 1-13 Hollywood Road, Central, Hong Kong, Tel.: 852-2842 6987, Fax: 852-2544 6205 or 852-2537 8730.

International Tax Avoidance and Anti-Avoidance, Amsterdam, 25-26 September 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1996

International Commissionary Arrangements, Amsterdam, 4 October 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Transfer Pricing, Le Meridien Hotel, 21 Piccadilly, London W1, 7-8 October 1996 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Taxation of International Companies in Russia and the Republics of the Former Soviet Union, The Hilton Hotel, Vienna, 8-9 October 1996 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle, East Sussex, TN33 OAL, United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-773 334.

International Aspects of VAT, Amsterdam, 23-24 October 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

VAT: A Strategic Programme for final Arrangements, Trier, Germany, 24-25 October 1996 (English, German, French):

ERA, Academy of European Law, Dasbachstraße 10, D-54292 Trier, Germany, Tel.: 49-651-147 100, Fax: 49-651-147 1020.

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

Global Joint Ventures, The Park Lane Hotel, Piccadilly, London W1Y, 31 October and 1 November 1996 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

NOVEMBER 1996

13th Asia-Pacific Tax Conference: Practical Problems in International Taxation, Singapore, 18-19 November 1996 (English):

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INTERNATIONAL

HARMONIZING TAXATION LAW WITHIN APEC: A FISCAL AND CULTURAL ANALYSIS

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I. INTRODUCTION

Over the past few years, there has been a pronounced acceleration in the trend towards economic integration in different regions of the world. The completion of the single European Market, the introduction of the United States–Canada Free Trade Agreement and its subsequent expansion into the North American Free Trade Agreement (NAFTA), the projected completion of the Association of South East Asian Nations (ASEAN) free trade region (AFTA) by the year 2003, and the declaration of the objective by the Asia-Pacific Economic Cooperation (APEC) to accomplish free trade and investment in the Asia and Pacific region by the year 2020 provide recent examples of this trend.

In the Asia-Pacific region, the trend towards economic integration was first recognized as far back as 1967 when ASEAN[1] came into existence. However, the development of the region has been promoted in recent times by initiatives put forward by APEC. In November 1989, at the invitation of the then Australian Prime Minister Bob Hawke, Asia-Pacific trade and foreign ministers met in Canberra and established APEC. The original members of the APEC forum consisted of Australia, Brunei Darussalam, Canada, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, Thailand and the United States.

Owing to apprehension about the lack of progress in the GATT Uruguay trade negotiations, and the growing interdependence of the economies of the Asia-Pacific region, the new organization was developed to better coordinate economic policy and trade amongst member countries. There was a certain amount of scepticism on the part of some of the South East Asian participants at the forum who were concerned that the new regional organization would transcend their own ASEAN organization. A further concern was that they would be subsumed by the larger economies in APEC. Even though there was some consensus when the meeting was closed, uncertainty still persisted about the long-term future of APEC. However, it continued to exist and at the Seoul Ministerial Meeting in 1991, Korea negotiated the entry of China, Hong Kong and Taiwan to the organization.

The Seoul Meeting was also important because it established the following original set of objectives for APEC:

- to sustain the growth and development of the region for the common good of its peoples and to contribute to the growth and development of the world economy;
- to enhance the positive gains, both for the region and the world economy, resulting from economic interdependence, by encouraging the flow of goods, services, capital and technology;
- to develop and strengthen the open multilateral trading system in the interest of the Asia-Pacific and all other economies; and
- to reduce barriers to trade in goods and services and investment among participants in a manner consistent with GATT principles, where applicable, and without detriment to other economies.

In 1993, United States President Clinton gave further creditability to the organization when he invited his Asia-Pacific colleagues to the first APEC Leaders' Meeting in association with the Seattle Ministerial Meeting. At the Meeting, the ministers approved immediate membership of Mexico and Papua New Guinea to the organization and set a November 1994 date for the admission of Chile.

The Bogor Declaration of 17 November 1994 contained the first group of major decisions made by the heads of government, including:

- the setting of target dates for the liberalization of trade and investment within the region on the basis of an open system (the year 2010 for the industrialized nations within APEC and 2020 for the rest); and

1. ASEAN originally consisted of Indonesia, the Philippines, Singapore, Thailand and Malaysia. Subsequently, Brunei Darussalam and Vietnam have become members.

- to agree to a set of non-binding investment principles (including the avoidance of double taxation related to foreign investment).[2]

When APEC was created in 1989, it was at best, a vague consultative body. Nevertheless, the Bogor declaration gave the organization the potential to transform itself into a formal trading arrangement. Despite this potential, APEC's goals and objectives did not become tangible until the 1995 Osaka Summit Meeting of heads of government. At the Osaka Meeting, a detailed "Action Agenda" was adopted by APEC. From January 1997 the decisions made at the Bogor Summit will begin to be implemented. The agenda contains particulars on:

- tariff reduction (the APEC economies will achieve free and open trade in the region by progressively reducing tariffs and ensuring the transparency of APEC economies' respective tariff regimes);
- investment liberalization (the APEC economies will secure free and open investment in the Asia-Pacific region by liberalizing their respective investment rules and the overall investment environment by gradually providing for "most favoured nation" treatment and "national" treatment; and facilitating investment activities through technical assistance and cooperation);
- deregulation (APEC economies will encourage the transparency of their individual regulatory rules and eliminate trade and investment distortion arising from domestic regulations); and
- implementation of the Uruguay Round outcomes (APEC economies will ensure full and effective implementation of the Uruguay Round outcomes within the agreed time frame and in a manner fully consistent with the World Trade Organization Agreement).

Most recently, at the APEC Finance Ministers' Summit in Kyoto, Japan in March 1996, the forum recognized that tax issues were important in the context of international trade and investment within the APEC region. Consequently, the forum endorsed a proposal put forward by the Australian Federal Treasurer, Mr Peter Costello to hold a symposium on international business taxation issues in association with the Organisation for Economic Cooperation and Development (OECD) in Australia later this year.[3] The forum also recognized that further progress in concluding bilateral tax treaties in the region would also facilitate trade and investment linkages.

Given the recent admission at the APEC Finance Ministers' Summit in Kyoto, that tax issues were important in the context of international trade and investment within the Asia-Pacific region, the main purpose of this paper is to consider the question of harmonizing taxation law within APEC. Accordingly, the paper is organized as follows. First, the economic potential of APEC is considered. Second, a comparison is then made between the APEC member countries' tax systems. Third, the cases for and against tax harmonization within APEC are examined. Fourth, principles influencing the harmonization of taxes within APEC are evaluated.[4] Fifth, cultural impediments to tax harmonization in APEC are analysed, including experience on the harmonization of taxes within the European Union (EU). Finally, some conclusions and recommendations are made in the last section of the paper.

II. ECONOMIC POTENTIAL OF APEC

The economic potential of APEC is vast. As a market, it has a population of approximately 2.3 billion people. In 1993, exports from APEC member countries were valued at USD 1,684 billion (this represented 46 per cent of total world exports) while total imports were valued at USD 1,734 billion. Gross Domestic Product (GDP) for the region was USD 11,665 billion which represents over half of the world's real GDP for 1993. The regional pattern of APEC exports and imports is shown in Table 1 below.

TABLE 1

Regional Patterns of Trade – Total APEC for 1993 (USD Billions)

Destination:	APEC Exports to:	APEC Imports from:
Brunei	2	2
Indonesia	18	31
Malaysia	34	44
Philippines	15	10
Singapore	62	45
Thailand	30	26
Sub-Total ASEAN	161	158
Australia	29	34
Canada	119	130
Chile	5	6
China	83	122
Hong Kong	94	34
Japan	145	278
Korea, Rep.	52	57
Mexico	50	46
New Zealand	6	8
Papua New Guinea	1	2
Taiwan	56	78
United States	397	289
Sub-Total APEC*	1,198	1,242
European Union	257	243
All Other Countries	229	249
Grand Total	1,684	1,734

Source: Australian Department of Foreign Affairs and Trade, "The APEC Region: Trade and Investment" (1994); and The International Monetary Fund (IMF), "Direction of Trade Statistics Yearbook" (1994).

* Includes ASEAN.

2. The other non-binding investment principles deal with:
- transparency;
- non-discrimination between source economies;
- national treatment;
- investment incentives;
- performance requirements;
- expropriation and compensation;
- repatriation and convertibility;
- settlement of disputes;
- entry and sojourn of personnel;
- investor behaviour; and
- removal of barriers to capital exports.

3. Tax avoidance by global companies through the use of transfer pricing has already been identified as a major issue for discussion at the symposium.
4. These encompass fundamental principles of international tax policy: efficiency/neutrality, equity and administration.

The level of enterprise within the APEC region and the pronounced interdependence amongst APEC member countries makes it inevitable that a great deal of APEC's trade will be inter-regional. Indeed, Table 2 below illustrates the fact that over 70 per cent of APEC's exports and imports for 1993 were within the Asia-Pacific region.

TABLE 2
Relative Frequencies of Regional Patterns of Trade – APEC for 1993

Regions/Other Countries	APEC Exports to:	APEC Imports to:
APEC	71%	72%
EU	15%	14%
All Other Countries	14%	14%
Totals	100%	100%

Source: See Table 1 above.

Even though much of APEC's trade is within its own borders, by no means has all of its export growth been restricted to the region. In particular, total APEC exports to the EU have grown by almost 6 per cent per annum over the period 1989-1993.[5] Assisted further by a relative decrease in the rate of growth of imports from the EU (5.2 per cent compared with 9.3 per cent for imports from APEC members),[6] it is clear that given APEC's resources and market size, it will derive numerous benefits from economic integration.

III. COMPARISON OF APEC MEMBER COUNTRIES TAX SYSTEMS

Notwithstanding APEC's vast economic potential, divergence in the stages of economic development of the APEC member countries may possibly hinder the process of economic integration. That is, as the structure of an economy changes with economic development, the nature of the tax base changes as well (Musgrave, 1969). This point can be understood when consideration is given to the nature and emphasis placed on the various tax bases which constitute the APEC member countries tax systems.

A comparison of the tax systems of the countries within APEC has been summarized in Table 3 below. The various taxes of APEC countries are arranged and ranked under the general headings of direct taxes (for example: individual and corporate income tax, taxes on property and social security contributions) and indirect taxes (for example: domestic taxes on goods and services, and customs and excise taxes) expressed as a percentage of GDP. This process may be considered significant because tax systems which rely on direct taxes as a form of raising tax revenue are held to be more progressive and may be less favourable to growth (Musgrave, 1969).

TABLE 3
Taxes Ranked as a Percentage of GDP (1990)*

Country	Direct Taxes	Country	Indirect Taxes
NZ	37.2	THI	12.2
USA	25.4	CHL	11.4
AUS	24.5	MAL	10.3
CAN	21.4	PNG	9.9
PNG	20.0	NZ	9.5
MAL	19.9	PHI	9.1
IDO	18.8	MEX	8.5
THI	18.3	TAI	8.5
KOR	17.0	KOR	8.1
SIN	16.9	AUS	6.7
CHL	16.3	IDO	5.9
MEX	14.9	SIN	4.7
JPN	14.2	CAN	4.2
PHI	14.2	JPN	2.6
TAI	11.2	CHI	2.1
CHI	4.2	USA	1.0
AVG. for APEC	18.4	AVG. for APEC	7.2

Source: IMF, "Government Finance Statistics Yearbook" (1994); United Nations (UN), "Statistical Yearbook for Asia and the Pacific" (1994); and Taiwan, "Statistical Data Book" (1995).

* Brunei and Hong Kong were not included in the analysis due to insufficient data.

As can be seen from Table 3 above, based on the composition of direct taxes and indirect taxes expressed as a percentage of GDP, the APEC member countries can be roughly broken down into three groups. The first group consisting of New Zealand, the United States, Australia and Canada, rely most heavily upon direct taxes as a means of achieving their individual policy objectives. This finding corresponds with the idea that developed economies usually place more emphasis on direct rather than indirect taxes as a mode of collecting tax revenue (Musgrave, 1969). Furthermore, given the first group's reliance upon direct taxes, their tax systems may be considered to be more progressive and may be less favourable to growth than the other countries in the Asia-Pacific region.

The second group consisting of Indonesia, Korea, Singapore, Mexico, Taiwan and Japan rely upon a combination of both direct and indirect taxes. At the other extreme, lies the third group who depend mostly upon indirect taxes to achieve their specific policy objectives. For example, Thailand, Chile, Malaysia, Papua New Guinea and the Philippines make up this group and can be regarded as developing Asia-Pacific economies.[7]

Table 3 above shows that the divergence in tax systems across the APEC member countries could represent a significant barrier to the process of trade and investment liberalization within the Asia-Pacific region. As a consequence, it should be recognized that tax harmonization in one form or another

5. Australian Department of Foreign Affairs and Trade, (November 1994), "The APEC Region: Trade and Investment", at 2.
6. Id. The EU's trade deficit with the APEC region increased from USD 44 billion in 1992 to USD 48 billion in 1993.
7. China could also be included in this group although it is only beginning to make the transition from a socialist economy to a market-based economy.

seems to be inevitable within APEC if it is to pursue the goal of liberalizing trade and investment within the Asia-Pacific region. With APEC's goal in mind, it is now appropriate to formally consider the cases for and against tax harmonization within APEC.

IV. THE CASES FOR AND AGAINST TAX HARMONIZATION WITHIN APEC

Tax harmonization is generally understood as being a process of adjusting tax systems of different jurisdictions in the pursuit of a common policy objective (Kopits, 1992). In the context of APEC, it seems tax harmonization should involve the elimination of tax distortions affecting trade and investment movements in order to bring about a more efficient allocation of resources within an integrated Asia-Pacific market. Thus, tax harmonization led by this policy objective suggests convergence towards a more homogeneous effective tax burden on trade and investment across APEC member countries.

One of the most generally accepted arguments for tax harmonization entails convergence in the definition of product value or income for tax purposes (Kopits, 1992). Such tax base harmonization would encourage transparency for economic decision-making and, consequently, enhance efficiency in resource allocation. In particular, a harmonized income tax base for multinational companies and investors operating in different regions of the world is necessary not only to improve efficiency, but also to prevent overlaps or gaps in tax claims by different countries.

The idea however, that an organized effort to harmonize taxes is a panacea for unifying the Asia-Pacific market could be challenged on technical,[8] political and cultural[9] grounds given that preservation of national sovereignty in relation to tax bases may be the ultimate priority of APEC member countries. Furthermore, it could be argued that spontaneous tax harmonization or tax competition is all that is necessary to bring about an efficient allocation of trade and investment within the Asia-Pacific region.

As APEC member states compete to attract trade and investment, they should adjust their tax systems to market conditions; compensating with preferential tax treatment for differences in risk factors or deficient infrastructure. Under tax competition, effective tax rates would be expected to move to the lowest common denominator and, thus, assist in restraining government spending and foster efficiency in the supply of public services (Kopits, 1992). From this standpoint, it has been argued that organized (rather than spontaneous) tax harmonization is equivalent to tax "cartelization", whereby governments act as oligopolists to protect market tax shares and by implication, sustain a large and wasteful public sector (Cnossen, 1988).

There is enough historical evidence to justify the view that increased economic openness, in association with an international demonstration effect, leads to some degree of spontaneous harmonization of tax systems (Kopits, 1992). However, the ability of a country to engage effectively in tax competition depends upon its revenue demands, which are a function of its social welfare programmes, resource endowment and public sector debt. A country with a particularly small public sector (for example: social welfare programmes) or a large tax base (primarily in terms of natural resources) is in a better position to offer lower effective rates of taxation and to be indifferent to suggestions of organised tax harmonization. Furthermore, a country which endeavours to function as an international finance centre or to generate a free trade zone would want to minimize the tax burden on non-residents through low statutory rates or soft administrative practices. Tax harmonization is essential to nullify the incentive for economic activity to move from high-tax countries to low-tax countries. Thus, in this instance, the case for organized tax harmonization has been argued on equity grounds: to ease an otherwise unreasonable tax burden, particularly on the owners of the least mobile factors of production (Kopits, 1992).

V. PRINCIPLES INFLUENCING THE HARMONIZATION OF TAXES WITHIN APEC

Any attempt made by APEC to harmonize taxes within the Asia-Pacific region in order to achieve an efficient allocation of resources must be grounded upon certain fundamental principles of international taxation policy. Those principles relate to matters concerning efficiency/neutrality, equity and the administration of a tax system.

A. Efficiency/neutrality[10]

If there is to be an efficient allocation of resources between APEC member countries, taxes should not interfere with the flow of capital between them. That is, taxes on the flow of investment capital should be neutral. Efficiency regarding capital export prevails if relative net (after tax) rates of return at home and abroad are the same as relative gross (before tax) rates of return (Musgrave, 1969). This situation arises if investment income is taxed in all APEC countries at the same rate of tax. However, in practice this is not the case since rates of tax do differ significantly across the Asia-Pacific region.

In spite of this obstacle, the same result is achieved without rate uniformity if investment income is taxed according to the rates applicable in the investor's resident APEC country. In this case, if a resident of an APEC country invests in another APEC country, the final tax liability of its foreign source income is set by its country of residence. This does not exclude the other APEC country from levying tax on the investment income, provided the investor's country grants a full tax credit, including refunds where the other APEC country's tax is higher. Neutrality and efficiency in the taxation of

8. Including the need for individual APEC countries to have a broad range of policy instruments to pursue domestic stabilization, growth, equity or regional development.
9. This issue is discussed in more detail in section IV of the paper below.
10. Emphasis is placed here on capital flows, however, similar considerations apply to labour flows.

capital flows requires a full tax crediting system within APEC. Therefore, tax treaties will need to be negotiated and enforced amongst APEC countries in order to provide for this outcome.[11]

B. Equity

Tax policy and tax harmonization cannot be grounded on principles of efficiency alone. The tax policy principle of equity must also be taken into account in assessing whether tax harmonization within APEC is advantageous. Tax policy in an open economy prescribes that there should be equity at the intercountry level.[12] That is, there should be fairness in the allocation of tax revenue between different countries. This consideration may be important in shaping APEC attitudes to various tax harmonization schemes which may be raised in subsequent negotiations.

An APEC country is entitled to tax income generated within its borders even though the factors to which the income accrues (that is, labour or capital) belong to residents of another APEC country. Thus, the fundamental question of international equity concerns the division of national gains and losses between the economies of the two APEC countries. The issue is, at what level should an APEC country be permitted to impose taxes on income generated within its borders, even though it accrues to investors resident in another APEC country.

One view of the situation is that the taxing APEC country has total jurisdiction within its borders (the principle of territoriality) and that it can tax as it deems appropriate. With this in mind, as long as non-resident APEC investors choose to invest in and to derive income from the taxing APEC country; that country may tax such income as it considers necessary. However, unilateral action by the other APEC country may lead to countermoves by the taxing APEC country and a bargaining position ensues. Joint adherence to reasonable equitable principles in tax base sharing or acceptance of equitable principles in tax treaty negotiations both appear to be reasonable solutions.

One of the first major decisions at the APEC heads of government meeting at Bogor in Indonesia in November 1994 was to agree to a set of non-binding investment principles; including the avoidance of double taxation related to foreign investment. If the avoidance of double taxation on foreign investment is to become a reality, tax treaties will need to be negotiated and enforced amongst APEC member countries based on principles of international equity.

As can be seen from Table 4 below, (with the exception of Brunei Darussalam which has no formal taxation arrangements with other countries in the Asia-Pacific region, and Chile, Hong Kong and Taiwan which have limited tax arrangements) many tax treaties have already been arbitrated and implemented on the basis of the principles of international equity, in order to eliminate double taxation of income and investment between the countries which represent APEC. Additional initiatives directed towards increasing the number of tax treaties among the APEC member countries and reconciling those treaties should be carried out. Perhaps this effort could be managed at the APEC level.

TABLE 4
Summary of Bilateral Tax Treaty Agreements Amongst APEC Member Countries

Country	Tax Treaty Agreements with:	Total
Brunei	Does not have any double tax agreements within APEC.	0
Australia	CAN, CHI, IDO, JPN, KOR, MAL, NZ, PNG, PHI, SIN, THI and USA.	12
Canada	AUS, CHI, IDO, JPN, KOR, MAL, MEX, NZ, PNG, PHI, SIN, THI and USA.	13
China	AUS, CAN, JPN, MAL, NZ, PNG, SIN, THI and USA.	9
Chile	USA (double tax agreement on transport income only).	1
Hong Kong	USA (double tax agreement on shipping income only).	1
Indonesia	AUS, CAN, JPN, KOR, NZ, PHI, SIN, THI and USA.	9
Japan	AUS, CAN, CHI, IDO, KOR, MAL, NZ, PHI, SIN, THI and USA.	11
Malaysia	AUS, CAN, CHI, IDO, JPN, KOR, NZ, PNG, PHI, IN and THI.	11
Mexico	CAN.	1
New Zealand	AUS, CAN, CHI, IDO, JPN, KOR, MAL, PHI, SIN, and USA.	10
PNG	AUS, CAN, CHI, SIN, MAL, THI (treaties with IDO, JPN, NZ and USA are presently at different stages of negotiation.	6
Philippines	AUS, CAN, IDO, JPN, KOR, MAL, NZ, SIN, THI and USA.	10
Singapore	AUS, CAN, CHI, IDO, JPN, KOR, MAL, NZ, PNG, PHI, TAI and THI.	12
Korea, Rep.	AUS, CAN, IDO, JPN, MAL, NZ, PHI, SIN, THI and USA.	10
Taiwan	SIN.	1
Thailand	AUS, CAN, CHI, IDO, JPN, KOR, MAL, PNG, PHI and SIN.	10
United States	AUS, CAN, CHI, CHL, IDO, HK, JPN, KOR, NZ and PHI.	10

Source: Coopers & Lybrand, "International Tax Summaries" (1994).

11. The issue of the use of tax treaties within APEC is explored in more detail below.

12. Tax policy also suggests that there should be equity at the individual level. That is, there should be fairness in the allocation of the tax burden between opposing taxpayers. Furthermore, there are other definitions of individual equity: equity between residents of a given country or equity among residents of different countries. In the preceding definition, equity could be accomplished through international tax coordination, however, if the latter definition was to be realized, it would require harmonization of the structure of personal income taxes amongst the APEC countries which may be beyond the scope of tax harmonization efforts in APEC at this stage.

Individual equity in relation to factor ownership should also be considered (Kopits, 1992). In a closed economy, tax levied on capital assets consistently across all sectors is borne in the long run by the owners of capital. However, in an open economy, the tax is switched in part to non-taxed assets; primarily to labour and other immobile factors (Harberger, 1982). Consequently, in order to confirm that the tax is borne by the owners of capital, it is necessary to extend tax harmonization to virtually all countries endowed with a similar investment environment (Kopits, 1992).

Based on the tax treaty arrangements which are already in place between most of the APEC countries, a "model convention" could also be developed for APEC founded upon principles of international equity. This convention could deal with the needs and circumstances which are unique to the Asia-Pacific region and could further aid the process of economic integration.

On this issue, lessons could be learnt from the ASEAN experience where in 1985, the "Intra ASEAN Model Taxation Convention on Income" was formulated and adopted by an Ad Hoc Committee on the harmonization of tax treaties of ASEAN countries. The Convention ordinarily follows the UN Model for tax treaties although with the following alterations (Yoingco, 1993):

- the convention does not include taxes on capital or taxes levied by local governments;
- nationality is removed as a standard in ascertaining the residence of a taxpayer;
- the definition of permanent establishment is extended to include a farm, a plantation or any other place of extraction of natural resources including timber or forest products;
- income derived by an enterprise from the operation of ships in international traffic may be taxed in the other contracting state although the tax imposed is reduced by an amount equal to 50 per cent;
- the yardstick for determining the taxation of a resident of a contracting state who provides services or independent personal services has been restricted to specific tests such as length of stay and the monetary test;
- the scope of professional services has been extended to include computer hardware and software engineers;
- an exemption is available for income derived from activities performed in a contracting state by public entertainers or athletes if their visit is significantly supported by public funds or a political subdivision or local authority;
- the exemption of payments from scholarship grants is confined to scholarships granted by government institutions, research institutes or charitable organizations; and
- an article is included providing for an exemption for teachers and researchers who are on an official fellowship or an exchange arrangement between universities.

The adjustments in the model were directed towards allowing ASEAN governments extra power in taxing foreign investment income. The model is regarded as a significant step in the harmonization of tax treaties in ASEAN, particularly in relation to the rules and practices in defining income, locating source and avoiding double taxation (Yoingco, 1993).

C. Administration

There are numerous administrative problems associated with having 18 different national tax systems within the Asia-Pacific region trying to tax businesses who have international objectives. The ability of governments to tax profits emanating within their borders is being eroded over time. International businesses are able to switch profits around from one country to another. As a result, complicated rules have been introduced by countries to regulate transfer pricing[13] and thin capitalization.[14] Nonetheless in practice, it has been found that these rules are only partially successful in confining profits to specific countries (Devereux and Pearson, 1990).

In any case, regional economic integration should considerably reduce the incentive for international businesses to engage in transfer pricing. For example, with the integration of the Asia-Pacific market, the shifting of profits by international business enterprises within the APEC countries becomes arbitrary. Particularly when over 70 per cent of APEC's trade (that is, exports and imports) is within the Asia-Pacific region.[15]

Administrative difficulties suggest that taxation of profits on an Asia-Pacific wide basis is necessary or failing this, the incentives for businesses to manipulate profits from one country to another should be reduced. This result could be achieved by bringing the tax systems throughout the Asia-Pacific region more closely into line by harmonization. Nevertheless, it is doubtful whether the economic costs of administering the present system for international businesses are as yet large enough to warrant the transition costs exacted on all businesses resulting from any major change in the tax systems (Devereux and Pearson, 1990) of all the APEC countries.

VI. CULTURAL IMPEDIMENTS TO TAX HARMONIZATION IN APEC

The notion that an organized effort to harmonize taxes is a panacea for unifying the Asia-Pacific market could be contested not only on tax policy grounds, but also on cultural grounds given that the preservation of national sovereignty over tax systems might be the basic preference of individual APEC member countries.

Cultural and historical factors have been identified in the social sciences as influencing the development and thus producing differences among tax systems internationally (Hofstede, 1991). Hofstede argues that, *cultural constructs* or

13. That is, the price which a business imposes when selling to another division of the same business located in a different country.
14. That is, businesses finance foreign operations through debt instead of equity and thereby move their tax liability from high-tax countries to low-tax countries.
15. See Table 2 above.

values[16] clearly play a role in a tax systems development and sustainability. If this relationship is proven to be significant, tax harmonization within APEC could face substantial difficulties even before any formal agreements are reached or if the agreements are introduced, could cause unintended dysfunctional behaviour (Boulding, 1973). Furthermore, specific features of an individual country's tax system may not necessarily achieve their intended objectives if they are applied in other countries due to differences in cultural values between those countries (Boulding, 1973).

According to Hofstede (1983), cultural constructs or values may also be used as a basis for distinguishing one country from another. This was accomplished by Hofstede in Table 5 below. The Table lists over 50 countries clustered[17] into so-called cultural areas.

TABLE 5
Hofstede's Cultural Clusters

More Developed Latin	Less Developed Latin	More Developed Asian	Less Developed Asian	Near Eastern
Belgium*	Colombia	Japan**	Indonesia**	Arab Countries
France*	Ecuador	Korea, Rep.**	Pakistan	Greece*
Argentina	Mexico**		Taiwan**	Iran
Brazil	Venezuela		Thailand**	Turkey
Spain*	Costa Rica		India	Yugoslavia
Italy*	Chile**		Malaysia**	
	Guatemala		Philippines**	
	Panama		China**	
	Peru			
	Portugal*			
	Salvador			
	Uruguay			

Asian Colonial	Germanic	Anglo	Nordic	African
Hong Kong**	Austria*	Australia**	Denmark*	East Africa
Singapore**	Israel	Canada**	Finland*	West Africa
	Germany*	Ireland*	Netherlands*	
	Switzerland	New Zealand**	Norway	
		United Kingdom*	Sweden*	
		United States**		
		South Africa		

Source: Hofstede (1983).
* Represents EU Member States (Luxembourg was not included as part of Hofstede's original study).
** Represents APEC member countries (Brunei and Papua New Guinea were not included as part of Hofstede's original study).

After studying Table 5 above, it is clear that the APEC member countries are culturally diverse, and this issue could present potential obstacles to any tax harmonization initiatives contemplated within the Asia-Pacific region. A comparison with the EU and its attempts to harmonize taxes is made below.[18] This comparison has been undertaken in order to show that ignorance of the cultural dimension has the potential to cause problems with regard to tax policy initiatives directed towards international tax harmonization.

A. European Union: cultural diversity and tax harmonization

The EU Member States[19] can be classified into six distinct cultural groupings: more developed Latin, less developed

16. Hofstede defines culture as "the collective programming of the mind which distinguishes the members of one human group from another" (Hofstede, 1980: 26). Hofstede states that, much as a computer operating system (for example: MS-DOS) contains a set of rules that act as a reference point and a set of constraints to higher level programmes (for example: a word processing programme), so culture includes a set of societal values that drive institutional form and practice.
Based on comprehensive cultural surveys and subsequent statistical analysis, Hofstede describes four constructs or values of common social preference which can be employed in measuring the values of individual societies. Hofstede's constructs are described as follows (1984: 83-84):
– Individualism versus Collectivism:
Individualism stands for a loosely knit social framework in society wherein individuals are supposed to take care of themselves and their immediate families only. Its opposite, collectivism stands for a preference for a tightly knit social framework in which individuals can expect their relatives, clan or others in the group to look after them in exchange for unquestioning loyalty (it will be clear that the word "collectivism" is not used here to describe any particular political system). The fundamental issue addressed by this dimension is the degree of interdependence a society maintains among individuals. It relates to people's self concept: "I" or "we".
– Large versus Small Power Distance:
Power distance is the extent to which the members of a society accept that power in institutions and organizations is distributed unequally. This affects the behaviour of the less powerful as well as of the more powerful members of society. People in large power distance societies accept a hierarchical order in which everybody has a place which needs no further justification. People in Small Power Distance societies strive for power equalization and demand justification for power inequalities. The fundamental issue addressed by this dimension is how a society handles inequalities among people when they occur. This has obvious consequences for the way people build their institutions and organizations.
– Strong versus Weak Uncertainty Avoidance:
Uncertainty avoidance is the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity. This feeling leads them to beliefs promising certainty and to maintaining institutions protecting conformity. Strong Uncertainty Avoidance societies maintain rigid codes of belief and behaviour and are intolerant towards deviant persons and ideas. Weak Uncertainty Avoidance societies maintain a more relaxed atmosphere in which practice counts more than principles and deviance is more easily tolerated. The fundamental issue addressed by this dimension is how a society reacts to the fact that time only runs one way and that the future is unknown: whether it tries to control the future or let it happen. Like Power Distance, Uncertainty Avoidance has consequences for the way people build their institutions and organizations.
– Masculinity versus Femininity:
Masculinity stands for a preference in society for achievement, heroism, assertiveness, and material success. Its opposite, Femininity, stands for a preference for relationships, modesty, caring for the weak, and the quality of life. The fundamental issue addressed by this dimension is the way in which a society allocates social (as opposed to biological) roles to the sexes.
17. Table 5 is based on Hofstede's (1983) research results for over 50 countries. To obtain the relevant groupings in Table 5, Hofstede (1983) employed the hierarchical cluster analysis technique. The results of which seem to be consistent with other attempts to classify countries into cultural groupings (Ronen and Shenkar, 1985).
18. It should be appreciated that there are substantial differences in the social and physical environments which affect the EU and APEC individually. However, it is still useful, even for purely heuristic reasons, to analyse the EU experience within a cultural context, which if anything, appears at first glance, to be less culturally diverse than APEC.
19. The EU Member States consist of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

Latin, Near Eastern, Germanic, Anglo and Nordic. Despite the EU only extending across one continent, the above mentioned cultural groupings suggest very different cultural environments exist within the EU. Given Hofstede's (1991) and Boulding's (1973) findings, it is possible that the cultural diversity exhibited amongst EU Member States may have restricted efforts made by the EU to harmonize tax systems internally.

Since it was founded by the Treaty of Rome in 1957 the EU as a single market, has made sluggish progress in harmonizing taxes amongst its Member States. Much of the progress to date, has taken place in the harmonization of indirect taxes (for example: customs duty, value added tax (VAT) and excise duties). VAT was introduced in 1967 by the EU with little opposition.[20] The advantages attached to a harmonized VAT were obvious from the beginning to all EU Member States (Hamaekers, 1993). In particular, the high degree of neutrality and the fact that on exportation the VAT burden was cancelled. Moreover, Member States also understood that VAT had superior revenue-raising potential.

The same progress towards harmonization cannot be said for the direct tax systems of the Member States. Any attempts made by the EU to harmonize direct taxes has always been hampered by the fact that there was no explicit requirement to do so in the Treaty of Rome. For many years, this lack of formality on direct tax harmonization has been used as a major reason by Member States not to agree to the harmonization of corporate taxes (Hamaekers, 1993). However, it could be argued that the delay in harmonizing direct taxes within the EU is partly attributable to cultural diversity between the EU Member States as is shown above in Table 5. Furthermore, it could also be argued that the Member States desire to have absolute control over their direct tax systems in order to have a broad range of policy instruments available to pursue their own economic, cultural and political goals free from EU interference.

Undeniably, there are considerable differences between the 15 EU countries' corporate tax systems as is illustrated in Table 6 below. For example, the Netherlands, Austria and Luxembourg employ a classical corporation tax system, whereby the profits of a business are taxed at the corporate level, and again in the hands of the shareholders. While other EU countries, such as Greece, Spain and Sweden allow a full or partial deduction for dividend payments. Only Germany has a split-rate system, where a higher rate of corporation tax is applied to accumulated rather than distributed profits. Relief at the individual shareholder level is accomplished by either allowing imputation credits, as in Finland, France, Ireland, Italy and the United Kingdom, with France and Italy providing a full credit for corporation taxes actually paid; or by applying reduced rates of personal taxes on dividend receipts as is the situation in Belgium, Denmark and Portugal.

TABLE 6

Summary of EU Corporate Tax Systems

Classical System	Imputation System	Reduced Personal Tax Rates	Split-Rate System	Deduction for Dividend Payments
Luxembourg	Finland	Belgium	Germany	Greece
Netherlands	France	Denmark		Spain
Austria	Ireland	Portugal		Sweden
	Italy			
	United Kingdom			

Source: Coopers & Lybrand, *International Tax Summaries* (1994).

Whether the differences found in corporate tax systems amongst the EU Member States are influenced solely by cultural diversity as opposed to other factors (e.g. political and economic factors), is of course, contestable. For instance, when Hofstede's cultural clusters in relation to EU Member States in Table 5 above, are compared to the different categories of EU Member States corporate tax systems in Table 6, only the Germanic and split-rate corporate tax system categories directly coincide.

Nonetheless, based on a recent empirical study by Lanis and Richardson (1996), culture was found to be a significant variable in explaining differences between tax regimes in over 50 countries internationally.[21] Thus, it could be argued that culture is one among a number of important factors which influence the choice of corporate tax systems within the EU.

Because of the influence of cultural, economic and political factors, for example, on corporate tax systems within the EU, it was allowed to market forces[22] over a period of more than 20 years to bring about modest advances in the harmonization of corporate taxes. This occurred in 1990 when three measures were sanctioned by the EU to encourage cross-border operations within the EU as follows:

- the Parent-Subsidiary Directive (this allows dividends to be paid free from withholding tax where the parent company and its subsidiary are both EU residents);
- the Mergers-Divisions Directive (this permits the deferral of tax on capital gains on defined cross-border mergers and reorganizations within the EU); and

20. Although all Member States have applied VAT since 1987, some differences in national VAT systems need to be overcome. For instance, the number and level of VAT rates which vary from country to country. However, the possibility of changing VAT rates in the future appears to be restricted due to the adoption of minimum rates by Member States.

21. Lanis and Richardson (1996) employed the Gray (1988)-Hofstede (1980) framework which has been applied in studies of accounting systems (for example: see Perera, 1989; Fechner and Kilgore, 1994; and Salter and Niswander, 1995). Cultural diversity, was found to statistically explain around 30 per cent of the total variation between the countries tax systems studied.

22. Including much pressure from business circles on EU Member States (Hamaekers, 1993).

- the Arbitration Convention (this introduces binding arbitration for transfer pricing disputes between EU Member States).[23]

In 1992, the Ruding Committee reported that the differing corporate tax systems, rates and bases in the EU Member States caused distortions in the internal market. Its conclusions are briefly summarized as follows:

- there are major differences in tax systems, rates of tax, tax bases and also in the treatment of cross-border income flows amongst the EU Member States;
- there are distortions caused by withholding taxes on cross-border payments; and
- competition is distorted by tax differences, particularly in the financial sector.

The Committee subsequently recommended a minimum level for corporate tax rates and the elimination of double taxation of cross-border income flows. However, these recommendations have been stalled and are the subject of further investigation by the EC Commission.

Despite the measures already adopted by the EU it seems that some significant obstacles to tax harmonization activities within the EU still remain and will in fact, remain for quite some time. This result seems to be due to a number of reasons. First, the issue of cultural diversity has not been suitably addressed. It appears that economic factors alone are not sufficient to accomplish tax harmonization within the EU. Second, the fear that EU countries would lose control over their respective direct tax systems so that they would not be free to pursue their own economic, cultural and political goals. Third, market forces have been slow to correct any deficiencies in tax systems within the EU.

B. APEC: cultural diversity and tax harmonization

Based on Hofstede's (1983) culture research as illustrated in Table 5 above, the APEC member countries can be classified into five distinct cultural groupings. That is, less developed Latin (Mexico and Chile), less developed Asian (Taiwan, Thailand, Malaysia, the Philippines and China), Asian Colonial (Hong Kong and Singapore), and Anglo[24] (Australia, Canada, New Zealand and the United States).

As was found in relation to the EU member countries above, there is much cultural diversity in the Asia-Pacific region. Given that tax harmonization in one form or another seems to be desirable within APEC if it is to pursue the goal of liberalizing trade and investment within the Asia-Pacific region, it is clear that any formal moves directed towards tax harmonization within APEC should be moderated with awareness of the potential problems associated with cultural diversity along with other factors.

On this issue, lessons could be learned from the EU experience presented above, where the harmonization of corporate taxes for example, appears to have been stalled not only because there was no requirement to do so in the Treaty of Rome but also, because of the issues of cultural diversity and national sovereignty.

VII. CONCLUSIONS AND RECOMMENDATIONS

As APEC continues to reduce barriers to trade and investment to enable goods, services and capital to flow freely amongst the Asia-Pacific region, it should be prepared to confront some important barriers associated with economic integration. Differences in tax systems amongst the APEC member countries may represent a major barrier to the process of trade and investment liberalization within the Asia-Pacific region.

Despite the absence of a formal mechanism to harmonize tax systems within APEC at this stage, it is argued in this paper that tax harmonization in one form or another seems to be desirable within APEC if it is to pursue the goal of liberalizing trade and investment within the Asia-Pacific region. However, it is doubtful whether any measures introduced by APEC will lead towards the evolution of similar tax systems for at least two important reasons. First, there are cultural and political differences amongst APEC member countries. Second, APEC countries may wish to preserve national sovereignty over their respective tax regimes.

Any formal moves directed towards tax harmonization within APEC should be moderated with awareness of the potential difficulties associated with cultural diversity within the Asia-Pacific region. With this consideration in mind, and based upon the tax policy arguments of efficiency/neutrality, equity and administration and the further issues concerning national sovereignty, it seems that as a first step towards tax harmonization within APEC, both the reconciliation of existing treaties between APEC member countries, and the negotiation of new treaties between countries in the region should be made a priority. Perhaps this effort could be formally coordinated at the APEC level. As a second step towards tax harmonization within APEC, a model tax treaty convention could be formulated and enforced between APEC member countries taking into account the needs and circumstances unique to the Asia-Pacific region.

The recommendations presented in this paper should ensure that any inefficient individual tax systems within APEC are corrected through spontaneous tax harmonization and tax competition rather than through very focused tax harmonization practices as is the case in the EU. Moreover, if these suggestions are adopted APEC member countries should maintain national sovereignty over their respective tax systems and thereby minimize the prospect of cultural diversity becoming a major factor in slowing down the process of fiscal reform within the Asia-Pacific region.

23. One draft measure yet to be adopted includes the Losses Directive which purports to equalize the tax treatment of a company with a subsidiary or branch within a Member State with that of a company with a subsidiary or branch in the same Member State. The Interest and Royalty Directive which proposed to eliminate withholding tax on the payment of interest and royalties made between parent companies and their subsidiaries in different EU Member States was subsequently withdrawn.

24. That is, the United States influence and British influence.

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NEW ZEALAND

Two Significant Legislative Developments: Taxpayer Compliance, Penalties and Disputes Resolution and Taxation Core Provisions Bills Become Law

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I. INTRODUCTION

The month of July 1996 has been particularly active from a tax perspective in New Zealand. Two major pieces of legislation and a third less significant item were passed by the New Zealand Parliament on 16 July 1996 and assented to by the Governor General at the end of July. The two major items were the Taxation (Core Provisions) Bill and the Taxpayer Compliance, Penalties and Disputes Resolution Bill. The third item was the Taxation (Annual Rates of Income Tax 1996-97) Bill.[1]

The ongoing evolution of the proposed tax compliance and disputes resolution regime has been discussed previously in this forum;[2] this article focuses on the final changes to the draft legislation consequent to the consideration of submissions and the response by the Finance and Expenditure Select Committee (the "FESC") of the New Zealand Parliament. With respect to the Taxation (Core Provisions) Bill,[3] this article provides an overview of the major changes arising from this first stage of the rewriting process of the Income Tax Act 1994 (NZ). It also considers the impact of the core provision changes on existing binding rulings.[4]

The changes will be effective from two dates. The disputes resolution procedures provisions in the Tax Compliance, Penalties and Disputes Resolution Bill will be operative from 1 October 1996. The remaining provisions of this Bill commence on 1 April 1997, although taxpayers with an earlier financial year-end could experience the changes from as early as 1 October 1996. The core provisions changes will be effective from 1 April 1997.

II. TAXPAYER COMPLIANCE, PENALTIES AND DISPUTES RESOLUTION BILL: THE FINAL VERSION

Essentially, the new legislation impacts on two major tax policy areas through introducing:

- reforms to correct, strengthen and tighten taxpayers' obligations, including stronger penalties for non-compliance with these obligations; and
- new procedures to resolve tax disputes more efficiently and with less emphasis on litigation.

This underlying philosophical approach has been sustained throughout the parliamentary stages of the draft legislation, with changes predominantly being minor modifications arising from consideration of submissions. The significant changes are now discussed.

1. This third item accounted for changes in the statutory rates of income tax following implementation of the first instalment of the tax cut package contained in the current Government's Tax Reduction and Social Policy Scheme. For further discussion of this package, readers are referred to the New Zealand Budget 1996 and to an article by Sawyer, A. J., "New Zealand's Tax Reduction and Social Policy Program", 13 *Tax Notes International*, 3 (1996), at 162.
2. With respect to the new compliance proposals, see Sawyer, A. J., "Raising the Thresholds for Taxpayer Compliance: A New Era of Compliance Standards and Penalties", 48 *Bulletin for International Fiscal Documentation*, 12 (1994), at 655; Sawyer A. J., "Taxpayer Compliance Standards and Penalties: Version II Signifies Progress", 49 *Bulletin for International Fiscal Documentation*, 11 (1995), at 510; and Sawyer, A. J., "Taxpayer Compliance, Penalties and Disputes Resolution Bill: An Update", 50 *Bulletin for International Fiscal Documentation*, 2 (1996), at 72. Readers are encouraged to refer to these three articles to gain a fuller appreciation of the reforms.
3. For a brief discussion on the new core provisions, see Sawyer, A.J., "New Zealand Introduces New Core Provisions Bill", 12 *Tax Notes International*, 8 (1996), at 539. This Bill has over 400 pages of changes, most arising as consequential changes necessary to give effect to the changes to the core provisions of the Income Tax Act 1994, contained within Part B of this Act.
4. The binding rulings regime has been discussed further in this forum, see Sawyer, A. J., "A Proposed Binding Rulings Regime", 48 *Bulletin for International Fiscal Documentation*, 10 (1994), at 582; and Sawyer, A. J., "Update on the New Binding Rulings Regime and Amendments to the Entertainment Tax Regime", 49 *Bulletin for International Fiscal Documentation*, 4 (1995), at 189.

A. Select Committee's modifications to the standards of care

1. Taxpayers' primary obligations

The legislation retains the primary obligations of taxpayers with one modification to the requirement that taxpayers cooperate with the Commissioner of the Inland Revenue (the "Commissioner"). Taxpayers are only required to cooperate with the Commissioner where required to do so by a tax act. Previously the legislation was drafted more widely in requiring taxpayers to cooperate with the Commissioner in assisting the Commissioner to exercise his or her powers; taxpayers would have been expected to act as de facto tax officers with respect to their own tax affairs!

The taxpayer's primary obligations may be summarized as follows. He must:

- correctly determine the amount of tax payable under the tax laws;
- deduct or withhold the correct amounts of tax from payments or receipts as required by the tax laws;
- pay tax on time;
- keep all necessary information (including books and records) and maintain all necessary accounts or balances as required under the tax laws;
- disclose to the Commissioner in a timely and useful manner all information as required by the tax laws;
- cooperate with the Commissioner in the exercise of the Commissioner's powers to the extent required by the revenue acts;
- comply with other specific tax obligations as required by the tax laws.[5]

The FESC declined to adopt recommendations in submissions requesting that a section setting out taxpayers' rights (or the Commissioner's obligations) be included in the legislation.[6] The FESC's reasoning focused on the following observations:

- the Commissioner has already published a series of taxpayers' rights;[7]
- a statutory declaration of rights could fetter the application of certain rights in circumstances outside the contemplation of the legislature at the time of drafting the rights;
- there is the Bill of Rights Act 1990 which contains fundamental (human) rights which are not excluded from application to taxpayers; and
- the Commissioner is responsible to Parliament and must regularly report to it.

When appraising the new legislation in its totality, it reflects a balance in favour of the Inland Revenue Department (IRD) rather than taxpayers; this is a deliberate choice intended to rectify a perceived imbalance in favour of taxpayers under the previous legislation.

2. Taxpayers' expected standards of care

All taxpayers will be required to exercise higher levels of care. The standards expected of taxpayers are minimum standards, and vary depending on the seriousness of the breach and the amount of tax at issue, as well as on the circumstances of the taxpayer (such as whether they are a wage earner, or a large business etc.). Failure to exercise the necessary level of care in meeting tax obligations will lead to a penalty. The range and amounts of standard penalties remain largely unaffected following the select committee process, and are summarized in Table 1 below:

Table 1: The New Tax Shortfall Penalties and Rates

Reason for Tax Shortfall Culpable Behaviour	Standard penalty %	Reduced penalty for disclosure on filing return (by 75%) %	Reduced penalty for disclosure before an audit (by 75%) %	Reduced penalty for disclosure during an audit (by 40%) %	Increased penalty for obstructing the Commissioner (by 25%) %
Evasion	150	37.5	37.5	90	187.5
Abusive tax position	100	25	25	60	125
Gross carelessness	40	10	10	24	50
Adopting an unacceptable interpretation	20	5	5	12	25
Not taking reasonable care	20	5	5	12	25
Late payment of tax	5% on day after due date 2% monthly, compounding on balance				
Late filing penalty (NZD)	Net income less than 100,000 50		Net income 100,000 to 1,000,000 250		Net income greater than 1,000,000 500
Underestimation of provisional tax	10% of the unpaid tax				

Other areas have also been clarified including the situation regarding legal professional privilege. Submissions expressed concern over the proposed powers to be granted to the courts to compel taxpayers to produce information when requested to by the Commissioner. These powers will be qualified by an amendment granting such powers subject to

5. See new Sec. 15B of the Tax Administration Act 1994.
6. See Sawyer, A. J., (1995), op. cit. *supra* note 2 at 74.
7. These appear in the Annual Report of the Inland Revenue Department to Parliament and within IRD offices.

legal professional privilege as it exists at common law and within the Tax Administration Act.[8]

Three substantial changes emerged from the Select Committee process;
- the importance of the IRD's interpretation of "reasonable care";
- the redefining of the "reasonably arguable position" standard; and
- Parliament's new role as "watch-dog" over the IRD's administration of the shortfall penalties.

(a) *Draft IRD Interpretation Statement on reasonable care*

Reasonable care is not defined in the legislation;[9] this was a policy decision made at the outset of the reform process. Indeed, reference is to be made to judicial interpretation of the term in the common law, and the IRD's persuasive, but non-legislatively binding, interpretation of reasonable care in a tax context. The Commentary to the Taxpayer Compliance, Penalties and Disputes Resolution Bill, as reported back from the FESC to Parliament, contains the Draft IRD Interpretation Statement. In the IRD's view the important factors to be considered include, the category of taxpayer at issue (e.g. whether the taxpayer is an individual or a business), the nature of the error, and the potential defences to any breach of this standard of care. Arithmetic errors do not of themselves prove an absence of reasonable care; the internal procedures, nature and size of the error and the taxpayer's circumstances will be given due weight and consideration.

Important circumstances to be taken into account to determine whether an individual has exercised reasonable care include:
- the complexity of the law and the transaction, relating particularly to the difficulty in interpreting the legislation;
- the materiality of the shortfall (size of the risk and gravity of the consequence);
- the difficulty and expense in taking the necessary precautions to avoid the tax shortfall; and
- the age of the taxpayer, his health and background.

Important considerations for business taxpayers in this context include:
- the size and nature of the business;
- the internal controls in place;
- the business records keeping practice; and
- system failures, balanced by the reasons for such failures.

An absolute defence to an assertion by the Commissioner that a taxpayer has failed to exercise reasonable care would be for this taxpayer to establish that their interpretation is an acceptable one.[10] Reliance on tax advisers and agents is not a defence to an allegation of failing to exercise reasonable care if the taxpayer was able to avoid the reason for the failure. For example, if the failure was avoidable by the taxpayer properly recording information, drawing attention to matters when providing information to their tax adviser, or by answering questions accurately and honestly, then reasonable care will not have been exercised by the taxpayer.

US and Australian negligence case law will be influential, but fundamental differences in underlying legislation are pivotal for application of the principle in New Zealand. For example, Australian case law on the situation of "a lack of reasonable care", *Case 34/95*,[11] establishes that the knowledge, experience and skill of the tax agent in the circumstances required that they undertook sufficient research effort to establish the requirements for the deduction of superannuation contributions.[12] Vicarious liability made the taxpayer liable for the agent's actions; this feature is absent from the New Zealand legal system with respect to taxation. Reasonable reliance on a tax agent's advice would be sufficient for the taxpayer to have demonstrated that they had taken reasonable care.

(b) *Unacceptable interpretation of tax legislation*

The requirement that taxpayers be able to demonstrate that they have adopted a reasonably arguable position, such position being interpreted as meaning "having a position, when viewed objectively, to be about as likely as not to be correct", received significant attention in submissions on the Taxpayer Compliance, Penalties and Disputes Resolution Bill. While the phrase "reasonably arguable position" exists in the corresponding legislation in Australia, it remains untested in the judicial forum. The FESC accepted that the ordinary meaning of "reasonably arguable" position did not equate with the proposed definition "about as likely as not to be correct".[13] The result was a new standard penalty and definition, together with a draft interpretation statement from the IRD.

The new penalty is for an "unacceptable interpretation", defined as one that "fails to meet the standard of being, viewed objectively, about as likely as not to be the correct tax position." The objective nature of the test removes any opportunity for taxpayers to raise specific aspects of their circumstances that would permit a subjective view to infiltrate the objective analysis of the interpretation of a tax law or case authority.

The IRD's Draft Interpretation Statement makes it clear that the likelihood that a court will endorse the taxpayer's interpretation must be substantial, but need not be as high as 50 per cent; nevertheless, the interpretation must be one that a court would give serious attention to. The threshold for the test to apply is when the tax shortfall exceeds both NZD 10,000, and the lesser of NZD 200,000 and 1 per cent of the taxpayer's total tax figure for the return period. Failure to satisfy this test involves the imposition of a shortfall penalty of 20 per cent. Special provisions are contained in the Draft

8. See Sec. 20, Tax Administration Act 1994 for the legislative reference to privilege. Legal professional privilege in New Zealand also exists at common law and may be invoked as litigation privilege.
9. See new Sec. 141A of the Tax Administration Act 1994.
10. Formerly a taxpayer was required to have a position that was reasonably arguable. This change in terminology is discussed later in the article.
11. 95 ATC 319.
12. Reference was made to the explanatory memorandum for guidance on the Australian Parliament's intended meaning of "reasonable care".
13. See new Sec. 141B of the Tax Administration Act 1994. This raises an interesting question for the Australian Tax Office and for Australian governmental officials; do they need to review their decision to adopt the reasonably arguable position test in the light of New Zealand's FESC's statements?

Interpretation Statement for partnerships, trusts and joint ventures.

The underlying difference between reasonable care and adopting an acceptable interpretation is that the former refers more to the approach required to satisfy the taxpayer's fundamental tax obligations, while the latter focuses on the application of tax laws and relevant court decisions to an arrangement or tax position. The Draft Interpretation Statement provides specific guidance as to what is meant by relevant tax laws and relevant court decisions for the purpose of ascertaining whether an interpretation is unacceptable. Having an unacceptable interpretation attracts a standard penalty of 20 per cent of the tax shortfall.

An example of an unacceptable interpretation is provided in the Draft Interpretation Statement whereby a taxpayer relies on a relevant Taxation Review Authority decision, but fails to also consider a relevant Privy Council decision containing similar factual circumstances. Such a position would cause the taxpayer to fail to have taken an acceptable interpretation and necessitate implementation of the penalty, provided that the required tax shortfall threshold had been reached. The position taken would not be "about as likely as not to be correct", making the interpretation unacceptable.[14] While this example is illustrative of the revised standard of care, it is highly unlikely to be a situation faced by a sophisticated taxpayer who is reliant on case law to interpret complex tax legislation.

The new definition for an unacceptable interpretation has created some confusion as to the distinction between it and the abusive tax position.[15] For a taxpayer to have adopted an abusive tax position, the Commissioner must satisfy a two stage test.

Firstly, the Commissioner must establish that the taxpayer had applied an unacceptable interpretation to a tax law, and secondly, that this unacceptable interpretation was associated with the taxpayer's involvement in an arrangement having as its dominant purpose the taking or supporting of a tax position that reduces or removes a tax liability, or which gives rise to tax benefits. This distinction has both financial consequences (a 20 per cent versus a 100 per cent penalty), as well as the informal sanction of the publication of the names of taxpayers who have taken an abusive tax position.

The definition of *gross carelessness* has also been slightly modified, with the removal of a provision providing that a taxpayer could be grossly careless even if the taxpayer did not intend to breach, or did not know of, a tax obligation.[16] The previous qualification introduced a knowledge or intent element, a feature which unintentionally would modify the common law interpretation of gross carelessness. The common law meaning was intended to be the standard by which to measure taxpayers' behaviour. Gross carelessness is defined as "doing or not doing something in a way that, in all the circumstances, suggests a complete or high level of disregard for the consequences".

(c) Parliamentary monitoring of the IRD's administration of the shortfall penalties

In what is a revolutionary development for New Zealand, a safeguard over the manner in which the IRD administers the new shortfall penalties has been introduced.[17] The Commissioner will be required to furnish annually a report to the Minister of Revenue on the manner in which the shortfall penalties are being applied and to present this report to Parliament; consequently this report will be a public document open to review. The FESC will scrutinize the report and has the power to instigate an inquiry or invite submissions if it believes there is need for a public review of the Commissioner's administration of shortfall penalties. A light-handed form of statutory or regulatory control was preferred by the FESC to the alternative of providing taxpayers with challengeable rights within the tax legislation.

B. Select Committee's refinement of the disputes resolution process

The intention behind the new disputes resolution procedures is an emphasis on early disclosure of information between the Commissioner and taxpayers. Cases are to proceed to court as a last resort following the issue of disclosure notices and the exhausting of earlier avenues of possible conflict resolution.

The FESC recommended several changes to the dispute resolution process. The restrictions imposed on the use of evidence have been partially relaxed through a new provision which enables a court to allow the admission of new matters, where this is necessary to avoid manifest injustice.[18] This feature will be welcomed by many taxpayers, and will be viewed as an improvement to the strict and highly technical evidence exclusion process; a move toward user-friendliness? The exclusion rule and its effect must be brought clearly to the taxpayer's attention by the Commissioner. To facilitate this, the Commissioner has been required to include a reference to this rule in the disclosure notice, issued after a failure to resolve the dispute at the conference stage of the dispute resolution process.

The due diligence test will now apply at the time of delivery of each party's statement of position, requiring each party to make available for inspection items requested by the other party. This test will nevertheless remain subject to the legal professional privilege provisions.[19]

The provision to allow suspension of the four year statute bar period has been removed. This provision originally applied

14. Since the Privy Council decision would be materially indistinguishable from the taxpayer's situation, it is authoritative being the final court within the New Zealand judicial system, and it clearly outweighs the TRA, which is the lowest tax court in New Zealand's judicial system.
15. See Sec. 141D of the Tax Administration Act 1994.
16. See new Sec. 141C of the Tax Administration Act 1994.
17. See new Sec. 141L of the Tax Administration Act 1994.
18. See new Sec. 17(2A) of the Taxation Review Act 1994, introduced via clause 71(2) of the Taxpayer Compliance, Penalties and Disputes Resolution Bill.
19. See new Sec. 17A(7)(b)(ii) of the Taxation Review Authorities Act 1994.

where a taxpayer brought proceedings to challenge the pre-assessment process or during such time as a Section 17 notice was in force.[20] The matter will be revisited following the outcome of the Commission of Inquiry into the Cook Islands tax credit scheme.[21] On the assumption that both the Commissioner and taxpayers rethink their strategies to fit the new environment the overall result of these changes is anticipated to be improved efficiency and speed in resolving disputes.

The influence of the Adjudication Unit (the "Unit") on the dispute resolution process has recently been clarified.[22] The role of the Unit is to provide an "... impartial 'fresh look' at the issues and to ensure that a high level of technical expertise is applied before a final assessment is issued in a disputed case."[23] The Unit is unable to act as an investigator or mediator; its role is limited to reviewing the information presented in the case file referred to it. Nevertheless, in exceptional cases, the adjudicator may conclude that either of the parties are disputing the issue on the wrong grounds. If this is the case, the file will be returned to the investigator to reconsider the issues raised by the adjudicator, and the taxpayer will be notified accordingly.

The adjudicator clearly fulfils a quality control function within the IRD.[24] This contention is buttressed by the ability of the adjudicator to arrive at a conclusion contrary to previous Interpretation Statements issued by the IRD, and to decline to follow the Commissioner's Interpretation Statements if the adjudicator believes that they are in conflict with the correct legal interpretation of the law. As the adage goes, the "proof of the pudding will be in the eating"; only time will tell if the Adjudication Unit successfully challenges IRD Interpretation Statements. Interpretation Statements have contained views on previous occasions which were contrary to compelling case authority.

A fortiori, the adjudicator can conclusively decide the case in favour of the taxpayer. In arriving at this decision, the adjudicator is required to provide the reasons for the decision to both the taxpayer and the investigator, and arrange for the necessary amendment to the assessment (or retraction of the Notice of Proposed Adjustment to the assessment). The audit division within the IRD cannot then appeal the adjudicator's decision. Perhaps this feature goes some way to restoring faith in the ability of the Unit to both act impartially and have the appearance of acting impartially (thereby exhibiting natural justice). Until the Unit has several years of operating experience behind it, tax practitioners and taxpayers have every reason to remain cautious and unconvinced of any real substantive change in the audit process.

Any taxpayer or tax adviser potentially affected by New Zealand's tax legislation should seriously consider reading the Finance and Expenditure Select Committee's (FESC's) Report to Parliament, since it contains a clear signal of Parliament's intentions in passing the legislation and also the meaning of the new concepts used. Additionally it provides clear guidelines for the Commissioner as to how the IRD is to administer the legislation and to the courts where they must adjudicate on disputes over aspects of the new legislation. The draft IRD Interpretation Statement attached to the Report, in the words of the Chair of the FESC, is "... Parliament's intention as much as the words in the Act itself".[25] It will be vital for taxpayers to use this legislation together with the Parliamentary Reports for both guidance to the application of the tax laws and as a defence of their interpretation of the law.

C. Draft Tax Information Bulletin on new provisions

To facilitate consultation the IRD has issued a draft Tax Information Bulletin ("TIB").[26] This document attempts to provide a practical guide to the operational aspects of the disputes resolution process. Through comprehensive worked examples, explanation of terms, and a diagrammatical overview of the process, taxpayers and advisers will have an excellent source of reference for the new dispute resolution environment. Non-resident taxpayers are advised to consult their New Zealand tax advisers over the implications of the changes to their New Zealand tax affairs.

Information on the new compliance standards and penalties is also under review for release as a Tax Information Bulletin. Previous research in New Zealand has indicated that if a significant proportion of the population is to understand and comprehend their tax obligations the new information must be presented in TIB format or as simple guides to tax returns.[27]

III. TAXATION (CORE PROVISIONS) BILL: THE CHANGES IN PERSPECTIVE

A. Reasons for the changes

New Zealand had been operating under legislation which traces its origins to the Land and Income Assessment Act 1891. Since that time, it had undergone several consolida-

20. This refers to Sec. 17 of the Tax Administration Act 1994, the section which empowers the Commissioner to request inspect, remove, retain and copy information in the form of books, documents, or otherwise, which must be furnished by the taxpayer concerned; see also Sec. 108B of the Tax Administration Act 1994.
21. The Final Report of the Commission of Inquiry is expected to be laid before Parliament after the Inquiry is scheduled to be completed in March 1997.
22. The Adjudication Unit remains an administrative function within the IRD without any statutory authority, but has the endorsement of Parliament through the FESC.
23. See Cordue, J., "IRD establishes Adjudication Unit", *Lawtalk* 459, 8 July 1996, at 10. Cordue is Manager (Adjudication) in the IRD.
24. Quality control is an important component of the reporting environment for Government Departments following the reforms to the state sector in the late 1980s, and the new reporting standards for public sector entities, which focus on service performance criteria.
25. Bradford, M. "Taxpayer Compliance, Penalties and Disputes Resolution Act", 76 *Chartered Accountants Journal of New Zealand*, July (1996), at 50. Max Bradford is Chair of the FESC.
26. The main document and appendix combined exceed 150 pages, making reading and reflecting upon the contents a colossal task for taxpayers trying to apply the new operating environment to their particular circumstances. Nevertheless, the majority of taxpayers in New Zealand are wage and salary earners who will be largely unaffected by the changes, provided they exercise reasonable care in dealing with the IRD and in managing their tax affairs.
27. See Tan, L. M. and Tower, G., "The Readability of Tax Laws: An Empirical Study in New Zealand", 9 *Australian Tax Forum*, (1992) at 355.

tions and numerous amendments, culminating in the Income Tax Act 1976. This particular Act was generally accepted as being fraught with inconsistencies and poorly organized. The Government recognized the need for substantial improvement and instigated the formation of a consultative committee to investigate the possibilities for change.

The Consultative Committee on the Taxation of Income from Capital (the Valabh Committee[28]) prepared several reports. It noted in its final report the importance of a coherent scheme in tax legislation. The Valabh Committee stated that:

"The core provisions embody the fundamental scheme and purpose of the Act. Inconsistencies within these provisions are therefore likely to lead to anomalous tax law and practice."

Submissions endorsed the recommendation to provide a coherent scheme, an approach which would necessitate a complete rewriting of the legislation. The Government was convinced by the consultative committee and the weight of submissions it therefore accepted the recommendation of a reorganization and rewriting process. This process involved two major stages; first the existing core provisions were to be isolated through the reorganization of the Income Tax Act 1976 to form the Income Tax Act 1994.[29] Second, a rewriting process would be undertaken progressively, the first being a rewriting of the core provisions, along with the necessary consequential amendments to the other parts of the Income Tax Act 1994. Further rewriting phases would follow; a discussion document on the next phase of rewriting is expected to be published towards the end of this year. One motivation for this approach of reorganizing and rewriting the legislation was to reduce a variety of costs (such as compliance, administrative and legal costs) incurred by taxpayers and society generally. Specifically, the focus was on the costs that arise due to the way the law is expressed.

The rewriting approach has not been universally endorsed by the tax community; several commentators have stated their preferences for a complete rewrite in one step rather than a piecemeal approach. The comprehensive versus piecemeal approach, together with the associated arguments in support of each approach, was raised in a discussion document for which submissions were requested. The discussion document was released in December 1994.[30]

Submissions were received and further consultation undertaken by the Government. The submissions raised issues which required further consultation, culminating in a second discussion document issued in May 1995.[31] Its focus was on providing a coherent scheme to the Income Tax Act through a conceptual and comprehensive rewrite of the core provisions. Unresolved issues included whether a gross or net approach to income would be included. Adopting a gross approach would involve considerably less rewriting of the legislation, while the latter would be more in accord with financial accounting principles. The Government indicated its preference for the gross approach, a position which would drive the wedge in further between financial accounting and tax accounting. The global or gross approach would also require the integration of various rules and regimes. In conjunction with the gross versus net decision, the interrelationship of the core provisions with extra-statutory principles and practice was opened for public comment.

The global approach involves adding together gross income from all sources. Consequently, taxable income is determined by calculating gross income and then deducting the sum of expenditures incurred in deriving that income. The gross/global approach is also in accord with the previous judicial interpretation of income tax legislation in New Zealand; legislation containing a mixture of gross and net concepts of income.

A net approach, however, involves calculating income in accordance with commercial and accounting practice and then adjusting that net income figure to comply with the provisions of the Income Tax Act.

Draft legislation (the Taxation (Core Provisions) Bill) emerged as the next development in the rewriting process. The Bill was accompanied by a commentary explaining the intention behind each of the major changes. While the amended core provisions amounted to just over 18 pages of legislation (including diagrams), it involved necessary consequential amendments to the other sections of the Income Tax Act 1994. These consequential amendments relate primarily to inclusion of the gross/global approach and to necessary language and drafting changes. In all, the Bill was over 400 pages in length.

B. Key features and their contents

The new core provisions are intended to achieve three functions, which may be summarized as to:

- provide an overview of the scheme and purposes of the Act;
- specify the key steps taxpayers must follow to determine and satisfy their tax obligations; and
- clarify the inter-relationships between the core provisions and the application of other Parts of the Act.

To achieve these functions, the Taxation (Core Provisions) Bill includes a number of key features:

- A purpose provision to be applied to the entire Income Tax Act 1994, a new rule of interpretation (included in Part A of the new Act), and a description of the persons to whom the Income Tax Act 1994 applies.

28. Consultative Committee on the Taxation of Income from Capital, (1991), "The Taxation of Income from Capital: Final Report", Government Printer, Wellington.

29. This reorganization of the Income Tax Act 1976 and the Inland Revenue Department Act 1974 to form the Income Tax Act 1994, Tax Administration Act 1994 and the Taxation Review Authorities Act 1994 did not alter the law. This process merely reorganized the tax legislation into what the legislation purports to be "soundly based and coherent structures of Parts and Subparts", with the removal of administrative provisions to the Tax Administration Act. For further discussion on the interpretational issues see, Nannestad, A., "Reading the 1994 tax legislation", *CCH Tax Planning Report*, No. 1, (1995), at 5.

30. "Rewriting the Income Tax Act: Objectives, process, guidelines: A discussion document" (1994), Government Printer, Wellington.

31. "Core provisions: Rewriting the Income Tax Act: A discussion document" (1995), Government Printer, Wellington.

- An overview of the scheme of the Act and the basis for application of the later Parts through improved core provisions.
- Creation of sections that impose income tax and various other taxes, together with key assessability and deductibility provisions.
- A clear statement that the global/gross approach is to be applied in the calculation of a taxpayer's income tax liability.
- An exception to the gross/global approach, which separates the income, deductions and timing components, for net provisions or regimes. This was a feature designed to reflect existing policy.
- Inclusion of minor changes in terminology of various Revenue Acts.
- A plain English drafting style incorporating diagrams, predominantly in the nature of flow charts. To ensure that the substantive provisions prevail when conflict arises, the diagrams are illustrative only.

An outline of the proposed core provisions (Part B of the Income Tax Act 1994) follows:[32]

- Subpart BA sets out the purposes of Part B.
- Subpart BB imposes income tax and then directs taxpayers to those Subparts that explain how those liabilities are to be calculated and satisfied by payment or otherwise.
- Subpart BC sets out the methods for calculating a person's income tax liability depending on the type of taxpayer he is; that is, a non-filing taxpayer, not a non-filing taxpayer, or a taxpayer with schedular income. This Subpart outlines methods for taxpayers to satisfy their income tax liability, determined in the manner set out in Figure 1.

Figure 1: Determining Liability to Taxation – The Scheme of the Income Tax Act 1994

	Annual gross income
less	Annual allowable deductions
equals	Net income or net loss
less	Available net losses
equals	Taxable income
multiplied	By tax rate
equals	Initial income tax liability
plus	Surcharges
less	Rebates and credits
equals	Income tax liability

- Subpart BD defines the terms gross income and allowable deductions, and then outlines the timing rules to be applied to determine the amount of annual gross income and annual allowable deductions.
- Subpart BE imposes the major withholding liabilities, including the fringe benefits tax and dividend withholding payments. This Subpart also directs taxpayers to other parts of the Act which outline the way in which these liabilities are to be calculated and satisfied.
- Subpart BF relates to specific types of taxpayers and imposes obligations such as the qualifying company election tax and tax on distributions from non-qualifying trusts. Again, in similar manner to the earlier Subparts, it directs taxpayers to other parts of the Act that outline the way in which the liabilities arising from these obligations are to be calculated and satisfied.
- Subpart BG deals with avoidance and non-market transactions, which must be considered as part of the process of calculating a taxpayer's income tax liability. Subpart BB directs taxpayers to give consideration of Subpart BG in entering and recording transactions.
- Subpart BH outlines the process for dealing with double tax agreements to which New Zealand is a party and explains when these should be considered by taxpayers in determining their income tax liability. The approach taken in developing the core provisions, including the consultative process employed by the Government, has been to enable taxpayers to more readily identify the fundamental scheme and purposes of the Act, and thereby enhance a taxpayer's ability to ascertain their liability to tax within the developing environment of self-assessment in New Zealand.

C. Areas attracting modification of tax policy

The proposed core provisions should substantially reduce the number of inconsistencies in tax legislation, many of which have been identified either during the reorganization of the Income Tax Act 1976 or as a consequence of influential court decisions. The submission process has identified a variety of policy issues that need to be addressed notwithstanding the premise that proposed changes involving policy issues were to remain outside the scope of the early phases of the rewrite.[33]

Of the several changes involving policy issues that have been included in the rewritten Income Tax Act following the review of submissions, the majority reflect existing case law interpretations of contentious terms. Others serve to clarify inconsistencies and uncertainties that accompanied the move to the reorganized Income Tax Act.[34]

D. Impact on the binding rulings regime

The core provisions, despite being only the first stage in the rewriting process, have introduced significant changes to tax legislation. As provided in the binding rulings legislation,[35] changes in legislation dictate that a binding ruling relying on amended legislation ceases to have legal effect. From the date of application of the Taxation (Core Provisions) Bill, public,

32. Key words and phrases are defined for the purposes of the Income Tax Act 1994 in Part B.
33. Moreover, policy issues considered during the rewriting process arose despite having the following checks and balances in place: Treasury and the IRD having joint responsibility to check each other's analyses, the use of outside consultants, the establishment of an Advisory Panel comprising leading tax accountants and lawyers, Treasury and IRD officials, the issue of consultative documents and further consultations with officials and accountants.
34. The policy changes include clarification of terms, the use of credits for foreign tax paid, the basis on which rebates are to be claimed, and the tax treatment of certain personal and property transactions.
35. See Sec. 91G Tax Administration Act 1994; and Sawyer, A. J., (1995) op. cit. *supra* note 4 at 192.

private and product rulings which relied on the pre-amendment state of the Income Tax Act 1994 will be terminated. On the basis that the amendments contained in the Taxation (Core Provisions) Bill are not intended to change underlying policy, a simple transition process to restore certainty to taxpayers with a binding ruling was proposed.

Originally officials intended that the IRD firstly provide written notification to taxpayers who had received a private ruling or product ruling, and secondly issue a general notice in a TIB of the potential impact of the Taxation (Core Provisions) Bill on binding rulings. This general notice would seek to encourage taxpayers with binding rulings to review their situation, the objective being for those taxpayers to ascertain whether their rulings are affected, and advise the IRD accordingly.[36] If the IRD agreed that there was a substantive law change, then the policy would compel the IRD to reissue any affected ruling in a revised form.

The process eventually agreed between the IRD, the Minister of Revenue and the FESC to handle this situation encompasses the following:

- The Rulings Unit within the IRD will examine all private rulings and product rulings, issued before the enactment of the Taxation (Core Provisions) Bill (the "Bill"), which apply for the 1997/98 year onwards and which are potentially affected by the Bill;
- The IRD's review will be directed at determining whether the ruling in each case will terminate on the application date of the Bill, and whether the ruling may be issued under the new legislation, or whether it needs to be altered because of policy changes in the Bill;
- Where possible, the ruling will be reissued as a new ruling with the same assumptions and effect as contained in the terminated ruling, being applicable for the balance of the period specified in the terminated ruling. A copy of the new ruling is sent to the person to whom the terminated ruling applied. Rulings in this situation will be reissued without cost to the applicant;
- If the core provisions have substantially altered the way the law applies to the taxpayer, the taxpayer will be notified that the terminated ruling cannot be reissued. The applicant will be invited to request a new ruling, without a requirement to pay an application fee or incur any further cost from the IRD;
- If the request is made for a new ruling, a new ruling will be issued with the same assumptions as the terminated ruling, applicable for the balance of the period specified in the terminated ruling, and a copy is sent to the person to whom the terminated ruling applied.

This compromise approach, on balance, is fair to both taxpayers and the IRD; it enables as far as is legally permissible retention of the status quo concerning the content of binding rulings, while making the necessary changes to reflect substantive changes in the law. Taxpayers have the following options: they may request a new ruling; continue without the ruling (if the change in the legislation is perceived to be favourable) or await future judicial consideration of the change in legislation. Nevertheless, there is the risk that with a substantive law change, the new ruling may adversely affect the taxpayer. If a new ruling is requested (this is expected to be the preferred option for most recipients of affected rulings), it can be obtained free of charge.

The IRD is somewhat restrained in its process of reissuing rulings; it will need to absorb the costs involved in preparing new rulings, which may be substantial where substantive law changes have occurred.

IV. CONCLUSIONS

The period 1 October 1996 to 1 April 1997 will herald the implementation of several years of impending substantial change. A significant number of taxpayers will need to make a greater effort if they are to comply with their tax obligations. When disputes arise, there is a new game, a game with unfamiliar rules for many of the players. IRD personnel affected by the changes are gradually becoming familiar with the essential rules and procedures as 1 October 1996 approaches, but the majority of taxpayers and their agents have a new system to struggle with. Re-education and familiarity will increase compliance costs to a critical level; even attempting to comprehend relevant Tax Information Bulletins from the IRD will require high levels of dedication from taxpayers and their agents. For a number of taxpayers, it will be the notification of an impending audit or the recommendation of the investigator proposing a reassessment that draws attention to the new standards and dispute resolution process.

A further 400 pages of revisions to the Income Tax Act 1994 also take effect from 1 April 1997. All but a minority of taxpayers will remain oblivious of this event unless they have had a ruling affected by a substantive law change. A few will venture to read relevant aspects of the Income Tax Act 1994, but for those without any special ability of crystal ball gazing (the vast majority), this will be a fruitless exercise to the extent it exceeds a review of the core provisions contained in Part B of the Income Tax Act 1994. The post mortem review of stage one of the rewriting phase should provide valuable experience for the subsequent stages, scheduled for completion over the next three years, as the consequential provisions of Parts C to O of the Income Tax Act 1994 are progressively rewritten.

36. This is based on discussion in ministerial documents and briefings from officials, released to the author as part of the review of submissions.

UNITED STATES

THE BROWN GROUP TRILOGY AND US TAXATION OF INTERNATIONAL PARTNERSHIPS

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I. INTRODUCTION

In the continuing saga of the case of *Brown Group, Inc. v. Commissioner of Internal Revenue*,[1] the Court of Appeals for the Eighth Circuit has held that the entity theory of partnerships should apply when considering the taxation of partnerships in the context of Subpart F[2] of the Internal Revenue Code ("the Code"). In so holding, the Court rejected the conclusion reached in Revenue Ruling 89-72,[3] a ruling which was relied upon by the IRS in its oral argument before the Eighth Circuit. The ramifications of this latest Brown Group decision would appear to be potentially very broad, since the case as it stands could severely curtail the application of Subpart F to international transactions involving partnerships. However, the IRS recently issued Notice 96-39[4] in which it voiced its disagreement with the decision of the Eighth Circuit and announced that it will issue regulations under Subpart F to confirm the position of the IRS that whether a CFC partner's distributive share of partnership income is Subpart F income generally will be determined at the CFC partner level.

II. *BROWN GROUP, INC. AND SUBSIDIARIES V. COMMISSIONER OF INTERNAL REVENUE*

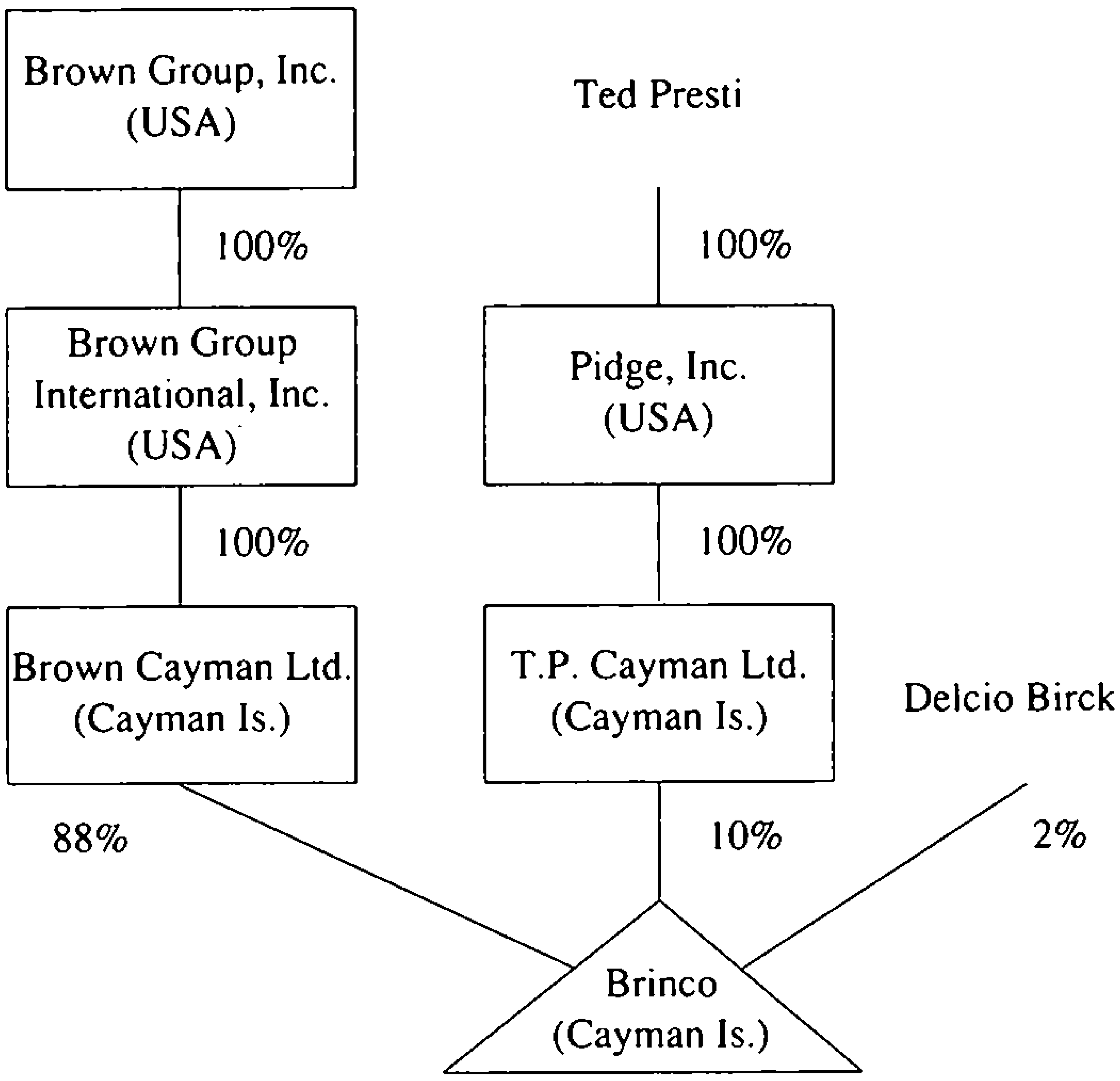
A. The facts

The taxpayer, Brown Group, Inc. ("Brown Group"), is a New York corporation having its principal place of business in St. Louis, Missouri. During 1985 and 1986, the tax years at issue in the case, Brown Group had divisions which manufactured, imported, and sold (at both the wholesale and retail levels) footwear. Brown Group manufactured footwear in the United States, as well as imported footwear from foreign countries, including Brazil. Brown Group also sold family fashions, fabrics, jewellery, cosmetics, and home decorating items through a retail division.[5]

Brown Group International, Inc. ("BGI") is a Delaware corporation which is wholly-owned by Brown Group.[6] During 1985 and 1986, BGI was US shareholder of Brown Cayman, Ltd. ("Brown Cayman"), a controlled foreign corporation.[7] Brown Cayman is a Cayman Islands corporation which was formed in 1985 and was wholly owned by BGI during the years relevant to this case. Brinco is a partnership[8] which was formed in 1985. The partners of Brinco and their respective interests in the profits and losses of the partnership are Brown Cayman (88 per cent), T.P. Cayman Ltd. (10 per cent), and Delcio Birck (2 per cent).[9] T.P. Cayman, Ltd. ("T.P. Cayman") is a Cayman Islands corporation which was incorporated in 1985, while Pidge, Inc. (the sole shareholder of T.P. Cayman) is a Missouri corporation. Ted Presti ("Presti") and Delcio Birck ("Birck") are both individuals. See Illustration 1 for depiction of the relationship of the parties involved in this case.

1. *Brown Group, Inc. and Subsidiaries v. Commissioner of Internal Revenue*, 104 TC 105 (1995), rev'd, 77 F.3d 217 (8th Cir. 1996). The original Tax Court opinion, 102 TC 616 (1994), was withdrawn by order of the Tax Court on 26 September 1994. On 16 April 1996, the US Court of Appeals for the Eighth Circuit denied a petition for a rehearing by the panel and a suggestion for rehearing *en banc* (No. 95-2110).
2. Subpart F is comprised of Secs. 951-964. These provisions are found in part III of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code. All references and citations to sections in this article are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated. All references and citations to regulations are to Treasury Regulations under the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
3. 1989-1 CB 257.
4. 1996-32 IRB 1.
5. 102 TC at 617.
6. Id. at 618.
7. A US shareholder is defined under Sec. 951(b) as any US person which owns or is considered to own 10 per cent or more of the total combined voting power of all classes of stock entitled to vote of that foreign corporation. A controlled foreign corporation is defined under Sec. 957(a) as any foreign corporation of which more than 50 per cent of either (1) the total combined total voting power or (2) the total value of the stock of that corporation is held by US shareholders on any day during the taxable year of that corporation. A US person is defined under Sec. 957(d) and Sec. 7701(a)(30) to include US citizens and resident individuals, domestic partnerships, domestic corporations, and certain trusts and estates.
8. Within the meaning of Sec. 7701 and the underlying regulations.
9. 102 TC at 618.

Illustration 1: Ownership structure



Before Brinco was formed, Brown Group used independent agents to purchase footwear which was manufactured in Brazil.[10] Among other reasons, Brinco was formed in order to attract Presti and Birck (two employees of an independent agent which Brown Group was using at the time) to work exclusively with Brown Group companies and to consolidate buying power in Brazil. During 1985 and 1986, Brinco was a purchasing agent for BGI with respect to footwear produced in Brazil and sold mainly in the United States. As compensation for acting as their purchasing agent for footwear produced in Brazil, Brown Group paid a 10 per cent commission to Brinco, based on the purchase price of the footwear. Commission paid to Brinco in 1985 amounted to USD 1,119,970 and was included by Brown Group in its cost of goods sold.[11]

For the seven-month period ending 2 November 1985, T.P. Cayman received guaranteed payments in lieu of its share of partnership profits as provided for in the Brinco partnership agreement. These guaranteed payments totalled USD 151,662 (or USD 21,666 per month for seven months). After making these guaranteed payments to T.P. Cayman, the net partnership earnings of Brinco were USD 917,465, which were allocated 98 per cent to Brown Cayman and 2 per cent to Birck.[12]

The IRS determined that Brown Cayman's share of the partnership earnings is foreign base company sales income and thereby includable as Subpart F income in the consolidated gross income of Brown Group.[13]

B. The issue

The sole issue before the courts in this case is whether Brown Cayman's share of partnership earnings from Brinco constitutes Subpart F income and is thereby includable in the gross income of a member of the affiliated group under Section 951(a).[14]

C. The arguments of the parties

The taxpayer argued that the character of the income in question should be determined at the partnership level, such that Brinco is treated as a separate entity.[15] The taxpayer also argued that Brinco, as a partnership, was not a related person vis-à-vis either Brown Cayman or BGI. The argument follows, therefore, that Brown Cayman's share of the partnership earnings cannot be Subpart F income to Brown Cayman or BGI. Under this argument, the income at issue in this case would be income to Brinco, and not to Brown Cayman. Since Brinco is not a related person to either Brown Cayman or BGI, Brown Cayman's distributive share of the Brinco partnership income is not Subpart F income with respect to Brown Cayman or BGI.

The Commissioner of Internal Revenue ("Commissioner") did not contest the taxpayer's position that Brinco was not a related party[16] vis-à-vis Brown Cayman or BGI, but rather argued that the aggregate approach to partnership taxation should apply. The Commissioner argued that the aggregate theory is appropriate in this case because it furthers the purposes of Subpart F.[17] Under this theory, Brown Cayman would be treated as if it had directly earned the commission income paid by BGI in connection with the sale of shoes in the United States. Consequently, Brown Cayman's distributive share of partnership income would be classified as Subpart F income to Brown Cayman, and the US shareholder of Brown Cayman (i.e. BGI) must therefore include its pro rata share (in this case, 100 per cent) of this Subpart F income in its gross income under Section 951(a). The Commissioner did not put forth the argument that the Brinco partnership was a sham.[18]

D. The law

Under Subpart F, the US shareholder of a controlled foreign corporation (CFC) is subject to current taxation on its pro rata share of portions of the CFC's earnings and profits, even where the CFC does not make actual distributions of such earnings and profits.[19] If a foreign corporation is classified as a CFC, the US shareholders are taxed directly on the Subpart F income of the CFC. Subpart F income, as defined under Section 952(a), includes the foreign base company sales income of the CFC. Section 954(d), under which foreign base company sales income is determined, provides as follows:

10. Id. at 619.
11. Id. at 619.
12. Id. at 620.
13. Id. at 620.
14. Id. at 617.
15. Id. at 622.
16. The IRS bases its position here on Sec. 954(d)(3) as it stood during the years at issue in this case.
17. 102 TC 616, 622.
18. Id. at 619.
19. See *supra* note 7 for the definitions of US shareholder, US person, and CFC.

Foreign Base Company Sales Income.–

(1) In General.– For purposes of subsection (a)(2), the term "foreign base company sales income means any income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where–

(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

Under the pre-1987 version of Section 954(d)(3), a related person was defined as follows:

– For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if–

(A) such person is an individual, corporation, partnership, trust, or estate which is controlled by, the controlled foreign corporation, or

(B) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the controlled foreign corporation.

The regulations under Section 954 follow the statute and provide that the foreign base company sales income of a CFC includes commission income derived from the purchase of personal property from any person on behalf of a related person.[20]

As a general rule, for purposes of calculating gross income for US tax purposes, a foreign corporation is treated as if it were a domestic (i.e. US) corporation taxable under Section 11 and by applying the principles of Section 61 and the regulations thereunder.[21] The regulations specify certain subchapters of chapter 1 of the Code which will not apply, and subchapter K is not among the enumerated exclusions.[22]

Under subchapter K, a partnership is not taxable as an entity, but rather the persons carrying on the business as partners are subject to tax in their separate or individual capacities.[23] Each partner calculates his tax liability by taking into account separately his distributive share of a variety of income, loss, deduction, and credit items specified in the statute and under the regulations.[24] Each partner must take into account separately his distributive share of any partnership item (i.e. income, gain, loss, deduction, or credit) which, if separately accounted for by any partner, would result in a tax liability to that partner different from that which would result if that partner did not take the item into account separately.[25] The character of partnership items constituting a partner's distributive share must be determined as if the item had been realized directly from the source from which the partnership realized or incurred the item.[26]

E. The case history

On 12 April 1994 the Tax Court issued its first opinion in this case (sometimes referred to as *Brown I*), authored by Judge Julian I. Jacobs.[27] Although holding for the taxpayer and concluding that Brown Cayman's distributive share of Brinco's partnership income is not Subpart F income to either Brown Cayman or BGI, the Court relied on an analysis different from that offered by the taxpayer. Since Brinco is not a CFC as defined under Section 957(a), Brinco's income could be Subpart F income to Brown Cayman or BGI only if Brinco's existence as an entity is ignored and Brown Cayman is treated as if it were engaged itself in the activities of the partnership.[28] The Court rejected the aggregate theory of partnership taxation and concluded that the status of Brinco as an entity should be respected.[29] Therefore the determination as to whether Brown Cayman's distributive share of partnership income is to be characterized as Subpart F income is to be made at the partnership level.

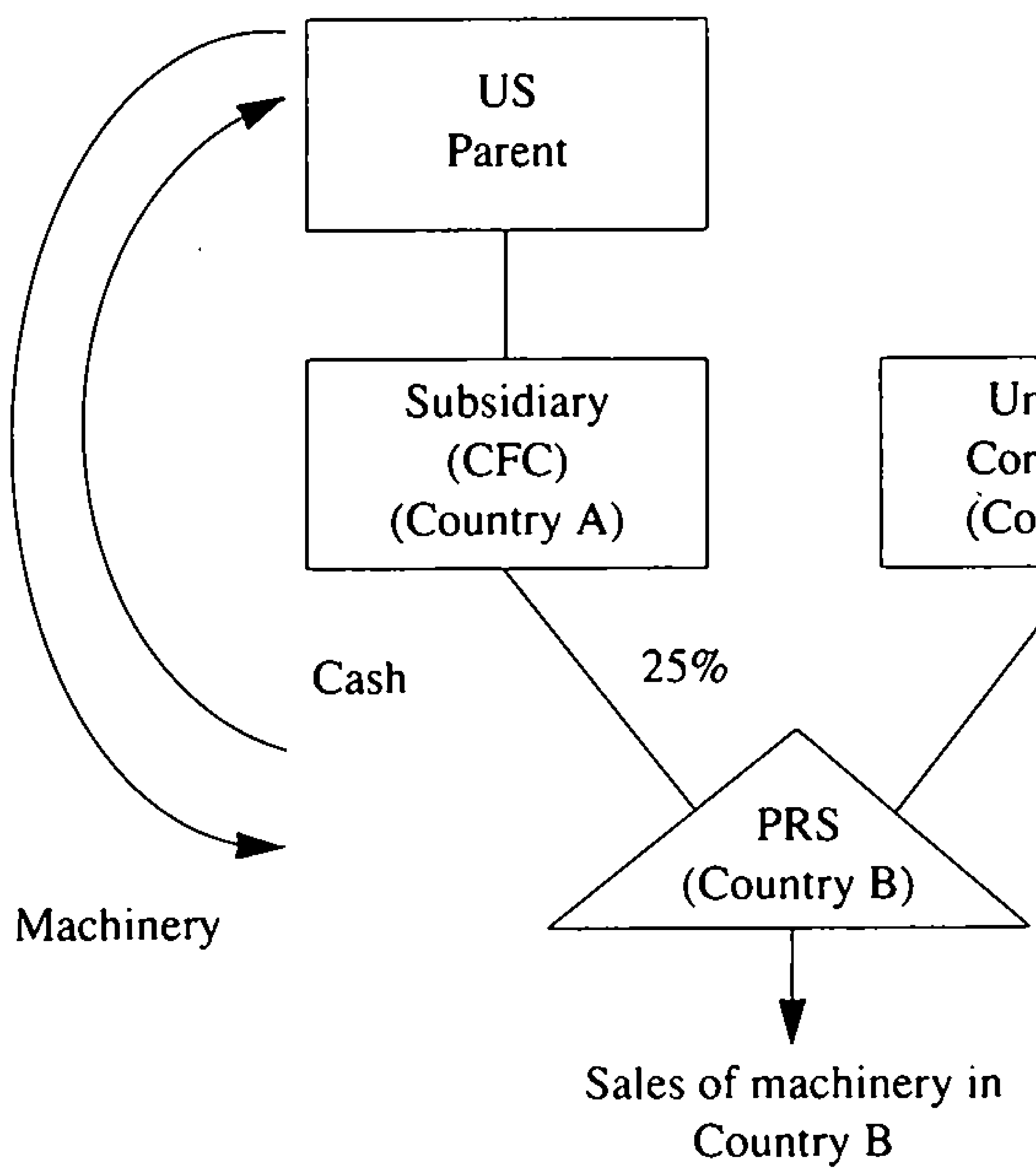
One reason cited by the Court for its conclusion is that Brinco, as a partnership, is not a sham.[30] Brinco was formed in order to make it more attractive for both Presti and Birck to source Brazilian footwear exclusively for Brown Group, as well as to centralize Brown Group's buying power in Brazil.[31] The Court went on to state that if, under a different fact pattern, a partnership were found to be a sham, the existence of the partnership as an entity could be ignored so that income earned by the partnership could be characterized as Subpart F income to the CFC.[32]

More significantly, the Court effectively rejected the holding of Revenue Ruling 89-72[33] and refused to follow it.[34] This ruling was relied on by the Commissioner to support her argument that the determination of foreign base company sales income was to be determined at the partner level. Revenue Ruling 89-72 involved the following facts: P, a domestic corporation, manufactured machines in the United States. PRS was an entity classified as a partnership for US tax purposes and was organized in Country X. S, a CFC and subsidiary of P, was organized in Country Y and owned a 25 per cent interest in PRS. The other 75 per cent was held by an unrelated Country X corporation. (See Illustration 2 for a depiction of the relationship of the parties.) PRS bought machines from P for subsequent sale in Country X; the pro-

20. Treas. Reg. Sec. 1.954-3(a)(1).
21. Treas. Reg. Sec. 1.952-2(a)(1).
22. Subchapter K governs the taxation of partners and partnerships and is found in chapter 1, subtitle A of the Code.
23. Sec. 701.
24. Sec. 702(a)(1)-(8).
25. Treas. Reg. Sec. 1.702-1(a)(8)(ii).
26. Sec. 702(b).
27. 102 TC 616 (1994).
28. Id. at 625.
29. Ibid.
30. 102 TC at 625, n.1.
31. Id. at 619.
32. Ibid.
33. 1989-1 CB 257.
34. 102 TC at 626. However, the Court did not explicitly mention the ruling itself.

ceeds from those sales were not subject to an effective tax rate high enough to meet the high-tax exception.[35]

Illustration 2: Rev. Rul. 89-72



The ruling held that under these facts, S's distributive share of PRS's income derived from the sale of machines purchased from P was to be treated as foreign base company sales income. The ruling stated that this sales income was to be taken into account separately by S, and the income was to be characterized as if it had been realized directly by S from the source from which PRS derived the income. For purposes of Section 954(a), an item of income included in a CFC partner's distributive share is to be characterized so as to include the attributes of the income which would make it Subpart F income if realized directly by the CFC partner, including whether the person from whom the goods were bought is "related" to the CFC partner. This Revenue Ruling therefore espouses an aggregate theory of partnership taxation for purposes of characterizing the income of a CFC partner. In rejecting the holding of Revenue Ruling 89-72, the Tax Court noted that it was not obliged to follow a revenue ruling which conflicts with the statute it is supposed to interpret, conflicts with the legislative history, or is unreasonable.[36]

The Tax Court also went on to further consider the aggregate v. entity theories of partnership taxation. In holding that the entity approach is the correct approach in the context of Subpart F, the Court analysed a long line of cases which have held that partnership items should be characterized at the partnership level.[37] In applying the holdings in those cases to the characterization of foreign base company sales income, the Court explicitly rejected the holding of Revenue Ruling 89-72 and held that the entity approach must be applied.[38] Therefore, no part of Brown Cayman's distributive share of Brinco's partnership income could be characterized as Subpart F income.[39]

The IRS filed a motion for reconsideration on 12 May 1994, arguing that the Court's opinion in *Brown I* was unnecessarily broad and could be interpreted so as to effectively repeal all Subpart F provisions in the Code. That motion was granted on 26 September 1994 by Judge Jacobs and the Tax Court accordingly withdrew its initial opinion.[40]

In their second opinion on the case (sometimes referred to as Brown II), the Tax Court, sitting *en banc*, held that the commission income derived by Brown Cayman was foreign base company sales income, and that such income must be included by BGI in its gross income as Subpart F income.[41] In addition to the majority opinion, with which six other Judges agreed, there were three separate concurring opinions and one dissent.

The majority opinion, authored by Judge Halpern and joined by Judges Hamblen, Parker, Cohen, Swift, Parr, and Beghe, first analysed the applicability of subchapter K to the case at hand and concluded that Brinco must separately state its commission income. This conclusion is necessary, the Court reasoned, in order to give effect to Section 702(a)(7)[42] and Treas. Reg. Section 1.702-1(a)(8)(ii),[43] as well as to give meaning to the intent of Congress in enacting Subpart F.[44] Since BGI would not be able to compute those items of Brown Cayman's income which constitute Subpart F income unless items which constitute foreign base company sales income are separately stated, Brinco must separately state its commission income.

The majority went on to discuss the purpose of Subpart F as enacted by Congress. This set of rules was intended to remove the tax deferral benefits which had been derived from certain offshore operations which were deemed to be "tax haven" devices (e.g. foreign operations which were established to take advantage of low tax rates in certain foreign countries).[45] Under the conduit scheme imposed by Subpart F, US shareholders of a CFC are taxed directly on certain income even where no actual distributions have been made. The Court rejected the notion that one could avoid the snare of Subpart F and the obvious intent of Congress by engaging in activities, such as those at issue in this case, through an entity which is taxed on a conduit basis and whose non-tax-

35. Sec. 954(b)(4) permits an adjustment in calculating foreign base company income by excluding any income that is subject to an income tax imposed by a foreign country at an "effective rate" exceeding 90 per cent of the highest tax rate under Sec. 11. The effective rate is determined by dividing the amount of taxes by the excess of the gross income over the deductions allocated to that income.
36. 102 TC at 626, citing *Threlkeld v. Commissioner*, 87 TC 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988); *Brook, Inc. v. Commissioner*, 799 F.2d 833 (2d Cir. 1986), *aff'g*. TC Memo. 1985-462 and supplemental opinion TC Memo. 1985-614; *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982).
37. 102 TC at 627.
38. Id. at 631.
39. Ibid.
40. 94 TNT 192-21.
41. 104 TC 105, 121.
42. Sec. 702(a)(7) requires that a partner take into account separately those items of partnership income, loss, gain, deduction, or credit as provided under the regulations.
43. Requiring that each partner take into account separately his share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner different than that which would result if that partner did not take the item into account separately.
44. 104 TC at 114.
45. Id. at 114.

law nature often is similar to an aggregate of persons doing business jointly (i.e. as mutual agents) rather than as an entity.[46] Considering the facts of this case, the Court reasoned that not to apply Subpart F would be to permit the "siphoning of profits" which was the concern of Congress when it enacted Subpart F and decided that the US shareholders of a CFC should be taxed currently on foreign base company sales income.[47]

Finally, the Court engaged in a detailed analysis of the aggregate v. entity approach to partnership taxation and concluded that the treatment of a partnership in different contexts must be determined based on the characterization most appropriate under the circumstances.[48] Again citing the need to effectuate the purpose of Subpart F, the Court held that in the case being considered the aggregate approach must be followed since the issue was not one merely of computing the income of Brinco, but more importantly concerned the consequences to the partners of the characterization of that income.[49] The Court relied on the holdings in two cases[50] in which the activities and even the property of a partnership have been attributed to a partner in order to establish whether, as a result of engaging in the activity or owning the property, the partner had a special status which was important to the determination of an aspect of the partner's status for federal income tax purposes.

In support of its analysis, the Court cited its construction of the phrase "in connection with" in the case of *Fort Howard Corp. v. Commissioner*.[51] Foreign base company sales income is defined under Section 954(d)(1) to include income derived "in connection with" the purchase of personal property from any person on behalf of a related person. The Court in *Fort Howard*, noting that the words in a statute should be interpreted in their ordinary sense, concluded that "in connection with" should be interpreted to mean "associated with, or related."[52] Since this type of relationship exists in Brown, the Court concluded that Brown Cayman was a CFC and that its distributive share of partnership revenue was in actuality connected to the purchases made on behalf of a party which was related to Brown Cayman.[53]

In one of the concurring opinions, Judge Ruwe accepted the majority's conclusion that Brown Cayman's distributive share of partnership income was Subpart F income, although he rejected the majority's reliance on subchapter K and the aggregate v. entity analysis. Judge Ruwe relied instead on the literal language of Section 954. Brown Cayman's distributive share falls within the broad meaning of the term "income" as found in Section 954(d)(1), and Brown Cayman derived the income from Brinco as part of Brown Cayman's distributive share of Brinco's profits. Finally, the income from Brinco was derived "in connection with" the purchase of personal property on behalf of a related person because Brinco's purchasing activities as an agent for BGI was the reason why commission income was generated.

Judge Beghe, in a concurring opinion joined by Judge Swift, did not disagree with the majority's analysis of Section 702 and the underlying regulations. Rather, Judge Beghe felt that the rationale of Rev. Rul. 86-138[54] supported the majority's conclusion that a taxpayer should not be allowed to interpose an entity without US income tax liability (e.g. a partnership) so as to avoid the conduit treatment required under Subpart F and subchapter K.[55] While concluding that the aggregate theory should apply, Judge Beghe reasoned that notions of mutual agency more appropriately lead to this conclusion than does an analysis of the aggregate v. entity theory of partnership taxation under subchapter K.

Although agreeing with the majority's conclusion, Judge Chiechi rejected two of the three reasons cited in the majority opinion. She argued Section 702(a)(7) and Treas. Reg. Section 1.702-1(a)(8)(ii) do not apply in this case because Brown Cayman, as a CFC, has no US tax liability.[56] Judge Chiechi also rejected the majority's interpretation of the words "in connection with" as found in Section 954(d)(1), stating in her concurring opinion that the conclusion reached by the majority follows only if the aggregate approach to partnership taxation is emphasized. Therefore this concurring opinion agreed only with the aggregate v. entity rationale as a means of concluding that the income at issue in this case is foreign base company sales income and therefore Subpart F income includable in the gross income of BGI.[57]

In the only dissenting opinion, Judge Jacobs (joined by Judges Chabot and Laro) recognized that his conclusion would result in a windfall to Brown Group, since all of the commission income received by Brinco would be included in Brown Group's cost of goods sold and 88 per cent of the commissions paid by BGI would escape taxation in the United States.[58] However, it is the responsibility of Congress, and not the courts, to close any loopholes which may exist in a statute.[59] Although the IRS may have closed the loophole, as perceived by Judge Jacobs in this dissent, by issuing partnership anti-abuse regulations in 1994[60], those regulations apply only to transactions entered into on or after 30 December 1994. Since the transactions in this case occurred before

46. Id. at 114-115.
47. Id. at 115.
48. Id. at 117. See H. Conf. Rept. 2543, 83d Cong. 2d Sess. (1954), 1954 USCCAN 5280. H. Rept. 2543 accompanied H.R. 8300, 83d Cong. 2d Sess., which later became the Internal Revenue Code of 1954.
49. 104 TC at 117.
50. *Unger v. Commissioner*, TC Memo. 1990-15, *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991)(a partner was deemed to have a permanent establishment in Boston by virtue of the partnership maintaining a permanent establishment in Boston); *Donroy, Ltd. v. Commissioner*, 301 F.2d 200 (9th Cir. 1962)(similar to *Unger*, but emphasizing the agency nature of a general partner's relationship to a limited partner).
51. 103 TC 345 (1994)(construing the meaning of the phrase "in connection with" in the context of Sec. 162(k)(1)). Sec. 162(k)(1) concerns the deductibility of expenses incurred by a corporation in connection with the redemption of its stock.
52. Id. at 352.
53. 104 TC at 120.
54. 1986-2 CB 84.
55. 104 TC at 128.
56. Id. at 128.
57. Id. at 129.
58. Id. at 139.
59. Id. at 139, (citing *Fabreeka Prods. Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961), vacating and remanding 34 TC 290 (1960)).
60. These regulations would permit the IRS to recast partnership transactions so as to comport with the spirit of subchapter K of the Code. See discussion of these regulations at III, C, infra.

30 December 1994, the anti-abuse regulations are inapplicable here.[61]

To support his conclusion that the commission income received by Brinco should be characterized at the partnership level, Judge Jacobs relied on a lengthy analysis of the entity theory of partnership taxation under which the existence of Brinco as an entity is respected.[62] Since Brown Cayman is a CFC and since BGI is a US shareholder of Brown Cayman, BGI must include its pro rata share of Brown Cayman's foreign base company sales income. However, Brown Cayman did not have any foreign base company sales income. Under Section 954(d)(i), there are five criteria that must be met in order for a CFC to have foreign base company sales income, one of which requires that there be sales of personal property made from, to, or on behalf of a related person. There is no related party element involved in this case because the purchase of footwear was arranged by Brinco from third parties on behalf of BGI, an entity which is not related to Brinco.[63] Judge Jacobs rejected the conclusion of the majority that there was a purchase from or to a related party, noting that Brinco was not a sham and that the partnership was established for "substantial business purposes."[64]

In advocating the entity approach, Judge Jacobs noted that the income of a partnership is characterized in a two-step process. First, the partnership is treated as an entity in whose hands the income is characterized. Next, the partnership is regarded as a conduit through which the income passes to the partners, retaining the characterization made at the entity level. The judge went on to cite a line of cases which have held that the issue of characterization should be resolved at the partnership (i.e. entity) level.[65] By applying the logic of these cases to the facts in the case at hand, Judge Jacobs concluded that the commission income should be characterized at the partnership level such that the income is not Subpart F income.[66]

On appeal by the taxpayer, the Eighth Circuit vacated the opinion of the Tax Court in *Brown II* and held that Brown Cayman's distributive share of Brinco's income cannot be characterized as Subpart F income where the commissions at issue did not constitute "Subpart F income" under the pre-1987 version of Section 954(d)(3), since Brinco did not control a CFC such as Brown Cayman.[67] In concluding that the Tax Court erred in its 25 January 1995 opinion in which the Tax Court had followed the aggregate approach, Judge Garth adopted the dissenting opinion of Judge Jacobs in *Brown II*.[68]

Judge Garth accepted the "well-established principle" that partnership income is to be characterized at the partnership level and that the partnership income shall retain the same character in the hands of the individual partners.[69] Therefore the commission income earned by Brinco was not Subpart F income to Brown Cayman, since the income was not Subpart F income in the hands of Brinco. Brinco was not a related person vis-à-vis either BGI or Brown Cayman and could therefore not earn foreign base company sales income.

Just as Judge Jacobs recognized in his dissenting opinion in *Brown II*, Judge Garth noted that the taxpayer might benefit from a windfall under this interpretation of "related party" for Subpart F purposes. Such a loophole was one not for the courts to close, but was rather for Congress to close.[70] In fact, the loophole was closed by Congress in the 1987 amendments to the definition of "related person" under Section 954(d)(3).[71] The 1987 amendment of Section 954(d)(3) broadened the definition of "related person" to include both partnerships which *control* CFCs and partnerships which are *controlled by* CFCs. The opinion also notes another means by which the perceived loophole in this case was closed, namely the issuance of the partnership anti-abuse regulations by Congress in 1994.[72] The Court did not, however, engage in any analysis of subchapter K in reaching its conclusion that a partnership cannot earn Subpart F income.[73]

The Court notes, however, in Footnote 6, that during oral arguments the IRS had argued that BGI was a related party because it was related to Brown Cayman. Although this footnote is somewhat unclear, the opinion of the court in *Brown II* and the conclusion reached in Rev. Rul. 89-72[74] shed some light on the argument of the IRS. Not only did the Court reject this position, it went on to state in Footnote 6 that "even if we were to accept the IRS' broad interpretation of 'related person' it is irrelevant to the present inquiry because Brinco is not a CFC, and therefore its income, whether earned on behalf of a related person or not, cannot be characterized as Subpart F income."[75] This footnote would appear to simply restate the reasoning of the Tax Court in *Brown I*. Despite this fact, in the body of the decision of the Eighth Circuit, Judge Garth agrees that this might be an anomalous result, perhaps even a loophole, but notes that the loophole has been closed because for all post 1986 tax years Brinco and Brown Cayman would be related persons. In light of Judge Garth's statement in Footnote 6, even if the partnership is considered as being related to the partner, the partnership would not earn Subpart F income. Thus it remains unclear how the Court believes that the loophole has been closed.

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61. 104 TC at 139.
62. Id. at 131.
63. Id. at 133.
64. Ibid.
65. 104 TC at 135, citing *US v. Basye*, 410 US 441 (1973); *Barham v. US*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd* 429 F.2d 40 (5th Cir. 1970); *McManus v. Commissioner*), 65 TC 197 (1975), *aff'd*, 583 F.2d 443 (9th Cir. 1975; *Davis v. Commissioner*, 74 TC 88, *aff'd* 746 F.2d 357 (6th Cir. 1984); *Brannen v. Commissioner*, 78 TC 471 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984); *Goodwin v. Commissioner*, 75 TC 424 (1980), *aff'd* 691 F.2d 490 (3d Cir. 1982); *Campbell v. US*, 813 F.2d 694 (5th Cir. 1987); *Resnik v. Commissioner*, 66 TC 74 (1976), *aff'd* 555 F.2d 634 (7th Cir. 1977)(per curiam).
66. 104 TC at 138-139.
67. 77 F.3d 217, 218 (8th Cir. 1996). The opinion was authored by Judge Leonard Garth, sitting by designation from the Third Circuit.
68. Id. at 221.
69. Ibid.
70. 77 F.3d at 222, citing *MCA, Inc. v. US*, 685 F.2d 1099 1104-05 (9th Cir. 1982)(refusing to expand the pre-1987 definition of "related person" to include controlled partnerships).
71. 77 F.3d at 222.
72. Ibid.
73. 77 F.3d at 222, n.9.
74. The conclusion reached in Rev. Rul. 89-72, *supra* note 3, formed the basis of the IRS's position as stated in oral argument before the Eighth Circuit.
75. 77 F.3d at 222, n.6.

III. ANALYSIS OF THE COURTS' HOLDINGS

The fundamental issue in the *Brown Group* cases is whether a partnership should be viewed as an aggregate of the individual partners, each of whom should be regarded as the owner of the assets and business of the partnership, or whether the partnership should be viewed as an entity apart from the individual partners.[76] The Court, rather than merely ruling on the narrow issue of the definition of "related party," based its conclusion in the case on the broad issue of aggregate v. entity. In addition, the Court discussed the partnership anti-abuse rules[77] and their potential applicability to future situations similar to that in *Brown Group*.

A. Aggregate v. entity theories of partnership taxation

If the aggregate, or conduit, approach to partnership taxation were applied in the context of Subpart F, the character of income (e.g. as foreign base company sales income) would be determined at the partner level. The Court applied this approach in *Brown II*, reasoning that it was necessary to do so in order to give effect to the intent of Congress in enacting Subpart F. On the other hand, application of the entity approach in the context of Subpart F would result in the character of income being determined at the partnership level. By applying this approach, the court in *Brown I* and the Eighth Circuit Court of Appeals concluded that because Subpart F applies only to corporations, income earned through a partnership cannot be Subpart F income. Thus, the test of whether income is foreign base company sales income is made at the partnership level. The conclusion reached by the Court in *Brown I* and by the Eighth Circuit is that the commission income paid by Brown Group to Brinco was not a payment to a related party as that term was defined under 954(d)(3) for the tax years at issue. Since the commissions were not paid to a related party, the income was not foreign base company sales income.

There is a long line of cases which address the issue of when to apply the aggregate or entity theories in a wide variety of contexts, and these cases were examined in depth by the Court in *Brown I*. The Court engaged in this line of analysis since the applicable Subpart F provisions do not provide any guidance as to which theory should be applied. In *US v. Basye*[78], the US Supreme Court stated that a partnership is to be considered as a separate entity for purposes of determining partnership income. In a subsequent case,[79] a Court cited *Basye* in concluding that the characterization of income from the sale of real estate held by a partnership is to be made at the partnership level.

In a case dealing with a similar issue, a District Court held that where a joint venture was involved in the business of purchasing, selling, and developing real estate, the income distributed to a partner from the sales of such real estate was not entitled to capital gains treatment, despite the fact that the partner was not himself involved in the real estate business.[80] The Court stated that the obvious inference to be drawn from the Code and underlying regulations was that for the purposes of determining the nature of an item of income, the partnership is to be viewed as a separate entity and the income items are to be characterized from the standpoint of the partnership.[81] Other courts have supported the notion that the nature of partnership income should be determined at the partnership level, reasoning that to characterize the income at the partner level might result in inconsistent treatment for tax purposes. In the case of *McManus v. Commissioner*,[82] the Court held that an election under Section 1033[83] must be made at the partnership level. The Court reasoned that, "[i]f each partner could determine his share of the partnership's income separately, confusion would result, confusion which Congress meant to avoid..."[84]

In *Brown I*, the IRS cited the case of *Casel v. Commissioner*[85] in support of its argument that the aggregate theory should be applied. *Casel* upheld the application of the aggregate approach in a situation involving partnership distributions and Section 267(a).[86] The *Brown I* Court, however, concluded that *Casel* was not applicable in the case at hand, since *Casel* did not involve the characterization of an item of income. The Court also noted that, unlike with respect to Section 267, there is no existing doctrine which would support the application of the aggregate theory of partnership taxation in the context of Subpart F.[87]

However, a fundamental element of cases holding that the character of income is determined at the partnership level is that the business activities of the partnership should be different from the business of any of the partners. For example, in *Brannen v. Commissioner*,[88] the Court held that with respect to expenses incurred by the partnership in connection with a movie, the issue of whether a partner is entitled to claim a deduction and the issue of a profit-motive must be resolved at the partnership level. In *Brannen*, the taxpayer was a medical doctor by profession, while the partnership investment involved motion pictures. In *Brown Group*, however, the business carried on by Brinco was basically the same as that carried on by Birck, Presti, and Brown Cayman Ltd. prior to forming the partnership. This distinction may be grounds for other courts not to follow the decision of the Eighth Circuit in *Brown Group*.

The proper interpretation of Revenue Ruling 89-72[89] also figured prominently in all three *Brown Group* decisions. Since the IRS could not base its argument on the statutory defini-

76. William S. McKee et al., *Federal Taxation of Partnerships and Partners*, Para. 1.02 (2d Ed., 1990).
77. Treas. Reg. Sec. 1.701-2.
78. 410 US 441 (1973).
79. *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir., 1988), *aff'g in part and rev'g. in part*, TC Memo. 1987-469.
80. *Barham v. US*, 301 F.Supp. 43 (M.D. Ga. 1969), *aff'd*, 429 F.2d 40 (5th Cir. 1970).
81. Id. at 46.
82. 65 TC 197 (1975), *aff'd*, 583 F.2d 443 (9th Cir. 1978).
83. Sec. 1033 concerns the involuntary conversion of property.
84. *McManus*, 583 F.2d 443, 448 (1978).
85. 79 TC 424 (1982).
86. Sec. 267 concerns the deductibility of certain losses, expense, and interest which arise in connection with transactions between related taxpayers.
87. *Brown I*, 102 US TC 616, 630.
88. 78 TC 471 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984).
89. 1989-1 CB 257.

tion of "related party" under Section 954(d)(3), the IRS rather advocated the aggregate approach as enunciated in Rev. Rul. 89-72. The Eighth Circuit not only rejected the notion that income should be characterized as if it were received by the partner directly from the source from which the partnership received such income, but went on to state in a footnote that:

> [E]ven if we were to accept the IRS's broad interpretation of "related person," it is irrelevant to the present inquiry because Brinco is not a controlled foreign corporation, and therefore its income, *whether earned on behalf of a "related person" or not*, cannot be characterised as subpart F income.[90]

In the body of the Eighth Circuit's opinion, the Court concedes that this approach may produce an anomalous result, but also notes that this loophole has been closed by the 1986 amendments to the definition of related party under Section 954(d)(3). It appears to be unclear why the Court believes this loophole has been closed, since the Court states in footnote 5 that it is irrelevant whether the income is earned on behalf of a related person or not.

B. Related parties under Subpart F

The definition of related person under Section 954(d)(3) was amended in 1986 to include partnerships controlled by or controlling a CFC within the definition of related persons with regard to such CFC.[91] The holding in *Brown Group* may well have been different if the case had concerned tax years covered by the Tax Reform Act of 1986 ("the Act"). The legislative history indicates that one of the reasons that the definition of "related party" was changed under the Act is that Congress wanted to prevent the circumvention of Subpart F by taxpayers using CFCs to hold interests in controlled partnerships.[92] The House Ways and Means and Senate Finance Committees noted that "income that would be Subpart F of a controlled foreign corporation if received from a subsidiary can avoid such treatment simply by being routed through a controlled partnership interest."[93]

Since partnerships are flow-through entities and have no tax liability as entities, but rather allow the current inclusion of income and deductions in the income of the partners, the drafters of the pre-1987 version of Subpart F may not have felt it necessary to include partnerships in the definition of "related party." The deemed dividend rules under Subpart F were enacted so that US persons could not shelter income offshore in entities which are not ordinarily subject to current taxation in the United States.

In oral arguments before the Eighth Circuit, the IRS argued that because Brown Cayman was related to BGI, commission income which flowed through Brinco should be treated as if it had been earned by Brown Cayman, a related person vis-à-vis BGI. Not only was this argument explicitly rejected by the Court in its opinion,[94] footnote 5 states that "even if we were to accept the IRS' broad interpretation of 'related person,' it is irrelevant to the present inquiry because Brinco is not a controlled foreign corporation, and therefore its income, whether earned on behalf of a 'related person' or not, cannot be characterized as Subpart F income." Footnote 5 therefore seems to restate the reasoning of the Court in *Brown I*. However, the body of the decision of the Eighth Circuit notes despite the fact that this might be an anomalous result, the loophole was closed by Congress when it amended Section 954(d)(3) in 1986 because under the post-1986 definition of related person, Brinco and Brown Cayman would be related persons.[95] Considering the Court's statement in footnote 5, even if the partnership were deemed to be a related person vis-à-vis the partner, the partnership would not earn Subpart F income. These contradictory statements by the Court bring into question whether the "loophole" has actually been closed.

C. Partnership anti-abuse regulations

On 12 May 1994 Proposed Regulations were issued under Section 701 which would permit the IRS to recast partnership transactions to reflect the underlying economic agreement under subchapter K of the Code[96] or to prevent the use of a partnership to circumvent the intended purpose of a provision of the Code.[97] Under these Proposed Regulations, if a partnership was formed or used in a transaction, a principal purpose of which is to reduce the present value of the partners' federal tax liability in a manner inconsistent with the intent of subchapter K, the IRS could disregard and recast the transaction by: (1) disregarding the partnership, (2) disregarding one or more of the partners, (3) treating the partners as owning their respective shares of partnership assets directly, (4) adjusting the partnership's or a partner's accounting method, (5) disregarding or revising partnership allocations of income, gain, loss, deduction, or credit, or (6) otherwise precluding the intended tax treatment of the transaction. The Proposed Regulations also set forth four examples of transactions and a discussion of whether the transactions would be recast under the regulations. The Proposed Regulations noted that the provisions of subchapter K were intended to allow taxpayers to do business for joint economic profit by using a flexible arrangement that accurately reflects the partners' economic agreement but without being subject to an entity-level tax.[98] In other words, the provisions of subchapter K were not intended to be used by taxpayers to structure transactions to achieve tax results which are inconsistent with the underlying economic agreement between the partners or the substance of the transactions, or to use partnerships to avoid the application of other sections of the Code.[99]

There was a swift response to the Proposed Regulations from tax practitioners, much of it negative. Many expressed the

90. 77 F.3d at 221, n.5 (emphasis added).
91. Tax Reform Act of 1986, Pub. L. 99-514, Sec. 1221(E)(1), 100 Stat. 2085, 2553-2554.
92. S.Rept. No. 99-313, 99th Cong., 2d Sess. 372 (1986); H.Rept. No. 99-426, 99th Cong., 1st Sess. 372 (1985).
93. Ibid.
94. 77 F.3d at 221.
95. Id. at 220.
96. See *supra* note 22.
97. PS-27-94.
98. Prop. Reg. Sec. 1.701-2(a).
99. Ibid.

viewpoint that the Proposed Regulations were too vaguely worded and called into question their validity. In addition, some felt that they were unworkable and contrary to sound tax policies. At a public hearing on these regulations, a representative of the Chicago Bar Association testified:

> In *Brown Group* [*Brown I*], the court focused on purposes of subchapter K in reaching its conclusions. Obviously, the IRS believes that the court improperly analyzed these purposes. If a Tax Court judge cannot, in the view of IRS, properly determine the purposes of subchapter K, how are taxpayers to apply the proposed regulation?

However, the IRS countered that these rules are necessary in order to ensure the fair treatment of all taxpayers and would not interfere with legitimate transactions.[100]

The Final Regulations, which were issued on 29 December 1994, reflect an attempt to take into account the concerns and comments which were voiced following the issuance of the Proposed Regulations. The Final Regulations contain an extensive preamble and set forth 14 examples concerning the intent of subchapter K in order to facilitate the application of the anti-abuse rule. Under these regulations, the IRS may recast a transaction only if (1) the partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability and (2) such transaction is inconsistent with the intent of subchapter K.[101]

The regulations provide five criteria for determining if the transaction comports with the intent of subchapter K:

1. The partnership must be bona fide.
2. Each partnership transaction (individually or collectively, "the transaction") must be entered into for a substantial business purpose.
3. The form of each partnership transaction must be respected under the substance over form principles.
4. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement.
5. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' income.[102]

However, the regulations do concede that certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income.[103] The proper reflection of income requirement is deemed to be met if the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[104] However, with the exception of the examples, the Final Regulations do not provide any guidelines for determining when a tax result is clearly contemplated by the Code. Many taxpayers have complained that the absence of a bright-line test in this regard makes the regulations more likely to be misapplied or misinterpreted. While there are arguments for and against a strict and literal application of the Code, the drafters of the regulations seem to have adopted an approach similar to that of Justice Stewart with respect to obscenity: I can't define it but I'll know it when I see it.[105]

Under the Final Regulations, whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K will be determined in light of all the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The regulations set forth factors which may indicate, but not necessarily prove, that a partnership was used in the prohibited manner. These factors include:

- The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly.
- The present value of the partners' aggregate federal tax liability is substantially less than if the purportedly separate transactions which are designed to achieve a particular end result are integrated and treated as steps in a single transaction.
- One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guarantees agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital.
- Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another.
- Partnership items are allocated in compliance with the literal language of the regulations under Section 704 but with results that are inconsistent with the purpose of Section 704(b) and the regulations thereunder.
- The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party).
- The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).[106]

This "facts and circumstances" test applies to all partnership transactions occurring after 11 May 1994.[107] However, even if

100. BNA *Daily Tax Report*, 26/7/94 at G-5.
101. Treas. Reg. Sec. 1.701-2(b).
102. Treas. Reg. Sec. 1.701-2(a). Criteria 4 and 5 are collectively referred to under the Regulations as the "proper reflection of income" requirement.
103. Treas. Reg. Sec. 1.701-2(a)(3).
104. Treas. Reg. Sec. 1.701-2(a)(3).
105. *Jacobellis v. Ohio*, 378 US 184, 197, 84 S. Ct. 1676, 12 L. Ed. 2d 793, 28 Ohio Op. 2d 101 (1964)(Stewart, J., concurring).
106. Treas. Reg. Sec. 1.701-2(c)(1)-(7).
107. Treas. Reg. Sec. 1.701-2(g).

a transaction falls within the literal language of a particular statutory or regulatory provision, the IRS may determine that, based on the specific facts and circumstances, that in order to achieve tax results which are consistent with the intent of subchapter K, the transaction may be recast in one of the following ways:

- The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners.
- One or more of the purported partners of the partnership should not be treated as a partner.
- The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income.
- The partnership items of income, gain, loss, deduction, or credit should be reallocated.
- The claimed tax treatment should otherwise be adjusted or modified.[108]

Perhaps the most significant provision under the regulations, vis-à-vis *Brown Group*, is the aggregate rule.[109] Under the Proposed Regulations, the IRS would have been permitted to attack transactions in which a partnership was used to avoid the purposes of other provisions of the Code.[110] However, this provision was not included in the Final Regulations in response to the intense criticism following issuance of the Proposed Regulations. Rather, the Final Regulations provide that the IRS can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.[111] This provision was inserted based on the belief of the IRS that there is much potential for abuse in the inappropriate treatment of a partnership as an entity for purposes of the application of rules outside of subchapter K to transactions involving a partnership.[112]

Despite the fact that the purpose of the Final Regulations is to attack only a small number of abusive transactions, the underlying problem with respect to these regulations is that they do not take into account the intention of the taxpayer. All partnerships could conceivably be subject to the rule, not just those which evidence an "abusive" intent. That the IRS would reserve to itself the power to determine when a partnership should be regarded as an aggregate of the partners seems to contradict the stated purpose of the Final Regulations, namely that the regulations are meant to apply only to "abusive" partnerships. One commentator has suggested that in this regard the aggregate rule is a broad, vaguely worded rule which could be applied to non-abusive transactions.[113] Another flaw inherent in the aggregate rule is that it permits the Commissioner to recast a partnership as aggregate or an entity as appropriate unless entity treatment is clearly contemplated,[114] while taxpayers are not afforded the same opportunity. Another commentator has noted that this is an especially troubling and unfair aspect of the aggregate rule, since the IRS has previously treated a partnership as an entity when the results are detrimental to the partners.[115] This potential for unfair treatment of taxpayers could be ameliorated by the amendment of the aggregate rule so as to provide for a more limited and even-handed application of the rule.

The regulations provide that the only circumstance in which this general rule will not apply is where (1) a provision of the Code or regulations prescribes the treatment of a partnership as an entity, in whole or in part, and (2) that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[116] This provision is effective for all partnership transactions taking place after 28 December 1994.[117] In addition to the fact that this provision was included in the Final Regulations without giving practitioners any notice or chance to comment, perhaps the most troubling aspect of the aggregate rule is that it is not limited in its scope of application. Not only would abusive partnership transactions be subject to scrutiny under this rule, but legitimate transactions could be attacked as well.

In its decision, the Eighth Circuit does not state whether or not the partnership anti-abuse regulations would now apply to transactions such as the one at issue in *Brown Group*, although the Court does raise the issue.[118] This could be ominous for taxpayers since there is much confusion about the types of transactions that will be subject to attack under the regulations. Although the facts at issue in *Brown Group* are not specifically covered by any of the examples under the regulations, the regulations do permit the IRS to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.[119] The lack of definitive standards in this regard could make these rules very difficult for taxpayers to apply in practice.

IV. CONCLUSION

The impact of the decision of the Eighth Circuit Court of Appeals in the latest *Brown Group* ruling may be much broader than the general holding in the case. In addition to the exclusion from Subpart F income of foreign base company sales income earned through a partnership, Brown could also apply to exclude other types of passive income from Subpart F (e.g. interest, dividends, foreign personal holding company income). In addition, certain passive income which would normally be classified as foreign personal holding company income might escape such classification when earned

108. Treas. Reg. Sec. 1.701-2(b)(1)-(5).
109. Treas. Reg. Sec. 1 701-2(e).
110. Prop. Reg. Sec. 1.701-2(a).
111. Treas. Reg. Sec. 1.701-2(e)(1).
112. "Lipton, IRS Improves Partnership Anti-Abuse Regs., but Major Problems Remain", 82 J. *TAX'N* 132 (Mar. 1995).
113. Id. at 138.
114. Treas. Reg. Sec. 1.701-2(e).
115. "Dell, Sanctifying the Smell Test: Some Thoughts on the Final Partnership Anti-Abuse Regulation", 22 J. *REAL EST. TAX'N* 307, 316 (Summer 1995).
116. Treas. Reg. Sec. 1.701-2(e)(2).
117. Treas. Reg. Sec. 1.701-2(g).
118. The anti-abuse regulations are applicable only to transactions occurring on or after 12 May 1994.
119. Treas. Reg. Sec: 1.701-2(e)(1).

through a partnership. Only foreign base company shipping income would continue to be classified as Subpart F income when earned through a partnership, since the statute so explicitly provides.[120] Some might argue that if Congress intended to include other types of income as Subpart F income when such income is earned through a partnership, the drafters of the Code would have so provided, just as they did in the case of foreign base company shipping income.

However, on 16 July 1996 the IRS issued Notice 96-39[121] in which it announced its disagreement with the decision of the Eighth Circuit in *Brown Group.* To permit a CFC to avoid Subpart F by earning income through a partnership under circumstances in which the income would be Subpart F income if earned directly by the CFC contravenes the purposes of Subpart F.[122] The Notice also discusses the legislative history of subchapter K of the Code and notes that although a partnership is to be considered an entity in the treatment of transactions between a partner and a partnership, it need not be considered a separate entity for purposes of applying other provisions of the Code if the concept of the partnership as a collection of individuals is more appropriate for such provisions.[123] In addition, the IRS cites several cases which advocate the aggregate approach in certain circumstances, cases which were relied on by the Tax Court in *Brown II*.[124] Furthermore, the partnership anti-abuse regulations also permit the Commissioner to adopt the aggregate approach when necessary to carry out the purpose of any provision of the Code or regulations thereunder.[125]

The IRS also announced in Notice 96-39 that it will issue regulations under Subpart F to confirm the position of the IRS that whether a CFC partner's distributive share of partnership income is Subpart F income generally will be determined at the CFC partner level. Until such time as these regulations become effective, the IRS will rely on principles and authorities under Subpart F and subchapter K to apply the aggregate approach, including Treas. Reg. §§ 1.701-2(e) and (f) for periods in which the anti-abuse regulations are effective.

In light of the position of the IRS as set forth in Notice 96-39 and the strong arguments which exist for both sides of the controversy, taxpayers should be cautious in relying on the decision of the Eighth Circuit in *Brown Group.* In addition to the fact that the IRS had made its negative views on this decision very well known prior to the issuance of Notice 96-39,[126] the partnership anti-abuse regulations were issued after the decision in *Brown I* was handed down. Finally, the fact that the Eighth Circuit Court of Appeals judgement contains confusing and contradictory language, and also fails to show a clear grasp of the issues attendant to the taxation of partnerships in the context of Subpart F indicates that the decision may well not be followed by courts in other circuits when faced with the same issue.

120. Sec. 954(f)(2) explicitly adopts the aggregate approach by including in foreign base company shipping income that portion of the distributive share of income of a partnership which is attributable to foreign base company shipping income.
121. 1996-32 IRB 1.
122. 1996-32 IRB 1, citing S. Rep. No. 1881, 87th Cong., 2d Sess., 78-79 (1962).
123. 1996-32 IRB 1, citing H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).
124. 1996-32 IRB 1, citing *Unger v. Commissioner*, *supra* note 50, and *Casel v. Commissioner*, 79 TC 424, 433 (1982).
125. Treas. Reg. § 1.701-2(e) and (f).
126. See BNA *Daily Tax Report*, 3 May 1996, 16 May 1996, and 26 May 1996.

BRAZIL

DUAL RESIDENCE AND OTHER TAX ISSUES AFFECTING EMPLOYMENT INCOME UNDER THE BRAZIL–JAPAN TREATY.[1]

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I. INTRODUCTION

One of the major goals of a tax treaty,[2] is to encourage the exchange of goods and services and movements of capital, technology and persons by eliminating double taxation. However, even where a treaty exists certain problems of double taxation may still remain due to the interaction of the treaty with the domestic rules of the countries concerned.

This paper examines the possible double taxation of employment income[3] under the Brazil–Japan treaty.[4]

II. OUTLINE OF THE PROBLEM

Let's suppose that a Brazilian individual (e.g. an engineer) who works for a Brazilian subsidiary of a multinational company signs an employment contract with the representatives of the parent company to go to Japan for a two year-period to work in a special training programme. During this time his salary is paid directly by the parent company. The engineer leaves Brazil on 29 February 1996 and arrives in Japan on 1 March 1996. He starts work on 2 March 1996.

It was agreed that during January 1997 he will take a month's holiday in Brazil and that he will be granted an extra month's vacation to travel around Japan during February 1998. On 1 March 1998 he will return and rejoin the Brazilian company.

A. Tax consequences

Article 14(1),[5] of the Treaty provides that both states may tax the engineer.[6] Summarizing the relevant rules agreed upon under this provision, in general, a Brazilian resident employed in Japan may be subject to tax in Japan. In this case, Brazil must grant to its resident an ordinary credit for the tax paid in respect of the employment income earned in Japan.[7]

However, before arriving at this conclusion it is necessary to determine the engineer's country of residence. This issue is addressed below. A secondary issue concerning the computation of the foreign tax credit under Brazilian domestic law is also reviewed.

B. The residence rules under both domestic laws

Under Article 3(1) of the treaty[8] the issue of residence must be determined by the laws of each contracting state.

1. Brazil

Under Article 14(3) of the Brazilian income tax law (RIR)[9] a person who leaves the country without the intention of being absent permanently *will be treated as a Brazilian resident during the first twelve months following departure*. Accordingly, he will be liable to monthly individual income tax (*carnê leâo*[10]) on his worldwide income. In addition, he will also be obliged to file an annual adjusted income tax return.

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2. In fact, the purpose of a double taxation treaty depends on the view of the different subjects involved. See, Philip Baker, *Double Taxation and International Tax Law*, Sweet & Maxwell 1994, London, at 10.

3. As the main issue deals with the dual residence of an individual, many other problems concerning items of income may arise; however, I focus, in this article, only on employment income-related situations.

4. These two countries signed a comprehensive tax treaty on 24 January 1967 (the Convention between Japan and the Federative Republic of Brazil for the avoidance of double taxation with respect to taxes on income,) which entered into force on 1 January 1968, and was amended by a protocol of 23 March 1976 (hereinafter the Treaty). Notes and minutes, confirming understandings to the Treaty, have been exchanged on the latter date.

5. Art. 14(1): "Subject to the provisions of Articles 18, 19 and 20, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be exempt from tax of the other Contracting State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other Contracting State."

6. It is assumed that this case does not fall into the scope of Art. 17 of the Treaty.

7. Art. 22(1) of the Treaty states: " Where a resident of Brazil derives income which, in accordance with the provisions of this Convention, may be taxed in Japan, Brazil shall allow as a deduction from the tax on the income of that person, an amount equal to the income tax paid in Japan. The deduction shall not, however, exceed that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Japan".

8. Art. 3(1): "For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the law of that Contracting State, is liable to taxation therein by reason of his domicile, residence, place of head or main office, place of management or any other criterion of a similar nature."

9. Regulamento do imposto da renda (RIR), consolidated text of the income tax law contained in Decree 2411 published in the Official Gazette of 12 January 1994, as amended most recently by Law 9250 published in the *Official Gazette* of 27 December 1995.

10. The rules of monthly individual income tax are contained in Arts. 115 to 118 of RIR.

The application of these residence rules to the Brazil–Japan treaty has been confirmed by a ruling recently issued by the Brazilian tax authorities[11] (hereinafter the Ruling). Under the Ruling:

> An individual who leaves the country without having an intention of remaining abroad permanently will be taxed on his income during his stay abroad as follows (Articles 14(3), and 743 of RIR/94):[12]
> During the first twelve months of absence, his income will be subject to the taxation rules applicable in Brazil, as this individual maintains the condition of "resident of this country". Foreign-source income, whether or not transferred to Brazil, will be taxed in the form of monthly payments (carnê leão). This taxpayer, is subject to the ordinary time-limits and terms for filing the annual adjusted income tax return.
>
> After twelve months of absence the taxpayer acquires non-resident status, from that date, Brazilian-source income will be taxed exclusively in Brazil at the rate of 25 per cent. The taxpayer is under a statutory obligation to file a tax return disclosing income derived from the first of January of the relevant year until the date in which he lost the status of Brazilian resident.
>
> When he returns, after staying abroad for more than twelve months, the individual will automatically be subject to the Brazilian resident regime (i.e. taxed again on worldwide income).

The content of the Ruling is in accordance with the rules laid down in the new individual income tax regulations applicable, in general, as from 2 May 1996.[13] Furthermore, IN 25/96 clarifies that an individual who transfers his residence abroad for the purposes of rendering services in a foreign subsidiary, branch, agency or other representation of a Brazilian resident company is subject to Brazilian tax as a resident during the first twelve months after departure. After that period he becomes a non-resident. The option of being treated as a Brazilian resident after the 12-month period is no longer available under the rules for 1996.

Therefore, a Brazilian resident who is transferred abroad will loose his resident status for income tax purposes either because he is absent from the country during a 12-month period (thus being a non-resident as from the first day of the thirteenth month of absence) or because of his intention of leaving Brazil permanently (thus being a non-resident as from the date specified in the relevant certificate issued by the tax authorities upon request).

2. Japan

Under Japanese tax law[14] an individual may be considered to be, for income tax purposes, a resident or a non-resident and, in the former case, a permanent resident or a non-permanent resident. To be deemed a permanent resident of Japan an individual must have been domiciled[15] or had his residence[16] in Japan for a minimum period of five years. Therefore a Brazilian (or any other foreign) resident who works in Japan for a period of more than one year (and less than five) will be a "non-permanent" resident of Japan and subject to withholding tax on the remuneration earned from his first day of employment.

The scope of the individual's tax base is determined by reference to his residence status. Whilst a permanent resident is subject to Japanese income tax on worldwide income (i.e. unlimited taxation), a non-permanent resident is only subject to income tax on Japanese source income and on certain foreign-source income (i.e. income which is either remitted to or paid in Japan). A non-resident is subject to tax on Japanese-source income only. In the case in question, the Brazilian engineer would be treated as a non-permanent resident (because of his two-year contract) and taxed on the remuneration earned from 2 March 1996.

III. DUAL RESIDENCE

Following from the above, this individual will potentially face double taxation since during the period 1 March 1996 – 28 February 1997 he will be deemed to be a resident of both Brazil and Japan under the domestic laws of these states.[17] So, which country is he a resident of? If he is deemed to be a resident of Japan for Treaty purposes, then under the Treaty Brazil is only allowed to tax Brazilian-source employment income. If, on the other hand, he were a resident of Brazil for the purposes of the Treaty, in principle,[18] he would be taxed in Japan as well as in Brazil, but an ordinary credit (for the Japanese tax) would be granted by Brazil under Article 22 of the Treaty.

Another issue that relates to the residence test is whether the individual will be subject to the rules applicable to non-residents or to non-permanent residents. It should be noted that

11. "Parecer normativo nº 3, de 01.09.95, do Coordenador-Geral do Sistema de Tributação", published in the Official Gazette of 5 September 1995, *Textos Legais*, Issue 37/95 at 1232.
12. See Alberto Tebechrani, Fortunato Bassani Campos and José Luis Ribeiro Machado. "Regulamento do imposto de renda para 1996", *Resenha-Gráfica*, Editora, Sao Paulo, Brasil.
13. Instruçâo Normativa do SRF nº 25 published in the *Official Gazette* of 2 May 1996 (hereinafter IN 25/96).
14. Japanese income tax law (Shotokuzei Ho), Law 73 of 1965 as amended by Law 27 of 1994 and further amended by a Law of 1995.
15. The term "domicile" is defined in Art. 22 of the Civil Code as the place in which a person has "the base and centre of his life". This concept resembles the centre of vital interest rule laid down in Art. 4(2)(a) of the OECD Model Convention.
16. Residence is the place where an individual stays continuously for a certain period but which is not necessarily his centre of living.
17. Where the individual has the "intention" (animus) of leaving Brazil permanently, the problem is solved as, from that date (according to the relevant certificate), he will no longer be deemed to be a Brazilian resident. There are no regulations stating the conditions for this "permanent" departure. However, in principle, travelling abroad for a fixed period with the "intention" of returning to Brazil in two years time would not satisfy this type of residence status test.
18. See Art. 14(2) of the Treaty for special situations whereby the Brazilian resident would be exempt from tax in Japan. Concerning the period 1 January 1997 – 28 February 1997, it should be noted that under Art.14(2)(a) of the Treaty a resident of a contracting State deriving employment income from the other State is exempt in the source country provided he is present there for not more than 183 days *in the calendar year concerned.*

the rates of Japanese tax on employment income for residents are progressive whilst non-residents are taxed at a flat rate.[19]

Additionally, if an individual is deemed to be a resident of Japan (a non-permanent resident in the case in question) for the purposes of the Treaty, he could be taxed (under Japanese domestic rules) on foreign-source income paid in or remitted to Japan. Of course, in the latter situation the application of other treaty rules must be taken into consideration as they may conflict with this domestic law principle.

The Treaty provides for a solution that unfortunately is not very practical. Under Article 3(2)[20] of the Treaty, when there is a dual-residence situation, it has to be solved under a mutual agreement procedure. This procedure is very lengthy and could take many years to implement.[21]

In an effort to improve the poor drafting of the original Article 3(2) of the Treaty, under paragraph 1 of the Exchange of Notes agreed upon on 23 March 1976[22] (hereinafter the Notes), both countries agreed the rules that would be followed under the mutual agreement procedure to resolve double residence disputes. Unfortunately, despite the steps that have been taken,[23] the legal attachment to the mutual agreement procedure is still causing problems.[24] Thus, an individual who is taxed in both states is obliged to apply for a tie-breaker decision under a mutual agreement procedure.

It is rather common that when a tie-breaker provision has not been included in a tax treaty and the solution deviates from the domestic laws, both states try to enact laws with a broad scope.[25] The Brazilian tax authorities have stated under the Ruling[26] that an individual who is absent from Brazil without a definite intention to stay permanently abroad remains Brazilian resident for the first twelve month-period and is taxed as such during that time. In view of this and taking into consideration that the Ruling expressly refers to the Treaty it appears that the tax authorities consider that the fact that an individual does not have an "intention" to permanently leave Brazil means that he qualifies as a Brazilian resident under the tie-breaker rules agreed upon in the Notes. This conclusion does not seem very reasonable. What would be the result if the Brazilian individual, not owning a house in Brazil, moves with his whole family for those two years to Japan where he rents a house for the period? Would he not be a resident of Japan for the purposes of the Treaty though he intends to return to Brazil? Although the dual residence issue must be decided upon using the mutual agreement procedure it should not be forgotten that according to the Notes the "permanent home available to him" rule is the primary test.[27]

It should also be noted that no reference to the tie-breaker rules has been made in paragraphs 4 and 4.1 of the Ruling which refers mainly to the rules laid down by Brazilian domestic law. Actually, it looks as if, when drafting the Ruling, neither the Japanese tax laws nor the Notes have been considered. The Brazilian tax authorities should have clarified their position about the dual residence problem under the Ruling.

Further to the situation under discussion, the problem of determining which country is the Brazilian engineer's country of residence should be reviewed upon his return to Brazil as, in this country, there is an "automatic-return automatic-residence rule" which means that according to Brazilian domestic law he will be deemed to be a resident (thus subject to monthly advance income tax) as from his first month of re-employment in the subsidiary (i.e. from March 1998) even though under Japanese domestic law he could still be taxable in Japan.

19. The fact that Japan (as the source State) is restricted to tax within the limits set under the Treaty does not imply that the Japanese rules for resident employees cannot be applied to tax an individual deriving employment income who is deemed to be a non-resident for Treaty purposes. See on this issue Klaus Vogel, (1991), *Klaus Vogel on Double Taxation Conventions*, Kluwer, Art. 4 marginal note 13, which states "This, however, does not mean that in such case the latter State must (or will) apply its domestic rules on taxation of non-residents. Since the taxpayer is deemed to be a non-resident only in regard to the application of the treaty's distributive rules".

20. Art. 3(2): "Where by reason of the provisions of paragraph 1 a person is a resident of both Contracting States, then the competent authorities shall determine by mutual agreement the Contracting State of which that person shall be deemed to be a resident for the purpose of this Convention."

21. This is consistent with the reservation made by Japan to Art. 4 of the OECD Model Convention, in effect at the time the Treaty was concluded: "Japan wishes to be free to conclude a bilateral convention which provides that the fiscal domicile of a resident of both Contracting States is to be determined through consultation between competent authorities. When entering into such consultation, Japan is prepared to take into consideration the rules set out in paragraph 2 of this Article as far as practicable". This reservation was later withdrawn by Japan, and this amendment was incorporated in "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992.

22. I: "With reference to paragraph 2 of Article 3 of the Convention:
Where an individual is a resident of both Contracting States, the question shall be settled by mutual agreement *taking into consideration* the following rules:
(a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);
(b) If the Contracting State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either Contracting State, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;
(c) If he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;
(d) If he is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement".

23. Such as the OECD Model's classic steps to determine the residence of an individual, see Art. 4(2) of the OECD Model tax convention on income and capital.

24. As stated by John F. Avery Jones in "Dual residence of individuals: the meaning of the expressions in the OECD Model Convention-I", *British Tax Review*, 1981, at 17: "Article 4 is a scheme to reduce the conflict between the internal law definitions of residence, preferring more permanent connections such as a permanent home, to residence based merely on length of stay, *thereby affording taxpayers a better opportunity to seek a judicial or administrative resolution of the issue without resort to the mutual agreement procedure ...*". (author's emphasis).

25. About this issue see the case *Ingemar Johansson v. US* (1964) quoted by P. Baker, see *supra* note 2 at 126.

26. Paras. 4 and 4.1.

27. On the issue of permanent home available to him see *supra* note 24: John F. Avery Jones. "Dual residence ..." at 22. The OECD MC Commentaries (Art. 4(12) suggest that the meaning of permanent is not a subjective one (i.e. it does not imply that the person has an intention to live there for his whole life), it merely means that the individual uses the home as his ordinary place of abode. However, by introducing the reference to "short duration" different positions may be taken. (I.e. what is short?)

IV. COMPUTATION OF THE FOREIGN TAX CREDIT AND BRAZILIAN DOMESTIC RULES ON ADVANCE PAYMENTS

In addition to the double residence problem, assuming that the engineer is deemed to be a Brazilian resident for the purposes of the Treaty (thus subject to tax in both states), it should be borne in mind that according to Brazilian income tax rules[28] (confirmed by the Ruling) the individual is required to file monthly income tax returns which include the Japanese-source salary in his taxable income and to pay the pertinent tax liability monthly. The Ruling specifically sets out that the Japanese tax may only be credited against the annual income tax resulting from the annual adjusted income tax return[29] and therefore the foreign tax credit cannot be credited against the monthly income tax.[30]

Fortunately, effective 2 May 1996, IN 25[31] changed the relevant rules so that they now allow the foreign tax credit to be set off against monthly payments provided reciprocity of treatment is granted by the other country with respect to Brazilian-source income.[32]

Prior to this amendment, a Brazilian individual had to suffer double taxation of the same income (potentially) throughout the year. Thus the engineer would have faced double taxation[33] as he would have been subject to withholding tax on Japanese-source income; even though that same income would also have to be considered as taxable for Brazilian monthly income tax purposes and the foreign tax credit could not have been credited against these monthly payments on account.

V. CONCLUSION

The double taxation issue with respect to Brazilian monthly payments has now been solved. However, the dual residence problem remains unsolved for situations involving employments of more than twelve months. If the Brazilian engineer's contract is for less than one year, then his residence status is clear: i.e. he is a Brazilian resident. Where the contract exceeds one year, the best solution for the individual would be to be a resident of Japan for treaty purposes as of the date of arrival in that country. If this were the case Brazil would not have the right to tax the Japanese-source employment income, furthermore the Brazilian engineer would not have to file monthly and annual income tax returns in Brazil nor would he have to pay Brazilian income tax on foreign-source income.

Brazilian domestic law could solve the dual residence issue if it provided that the individual will be deemed to be a non-resident as from the date of departure (thus eliminating the first 12-month test) where he is employed in a foreign country which subjects to tax the relevant employment income, even if he intended to return to Brazil after the period of foreign employment. The specific administrative procedure to apply for such transfer of residence status should be regulated. Other unilateral measures could also avoid the dual-residence problem; for instance if Brazil adopted a clear-cut domestic rule on "permanent home available to him" as a connecting factor for defining the residence of a person who falls under the case in discussion.

Where domestic laws do not provide a solution, treaty law should provide relief. Amending the text of Article 3(2) of the Treaty in accordance with the wording of Article 4(2) of the OECD MC would be a positive move towards a solution of the dual residence problem.[34]

Paragraph 10 of the OECD MC Commentaries on Article 4, as amended in 1995, was enlarged and an example similar to the case discussed in this article was included. Applying the solution suggested by the OECD in that amendment, Brazil should treat the engineer as a resident of Japan as of 1 March 1996. However, this would only be feasible, if Brazil amended its domestic legislation.[35]

28. RIR Art. 115.
29. The return must be filed by 30 April of the year following the tax year in question.
30. Art. 26§2 Instruçâo Normativa nº2/93.
31. See *supra* note 13.
32. Arts. 23(2)&(3) of IN 25/96.
33. At least during his first ten months of employment.
34. The withdrawal of the reservation to Art. 4 of the OECD Model (see *supra* note 21) by Japan could be viewed as a change in the policy of this country towards a classic OECD Model provision. It is interesting that the only treaty concluded by Japan after 1992 which includes a complete OECD Model Art. 4 provision is that with Mexico (9 April 1996, not yet in force). Under the treaties with Norway (4 March 1992), Luxembourg (5 March 1992), Israel and Turkey (both 8 March 1993) the permanent home available test is omitted, the first test is the centre of vital interests.
35. Countries that consider the calendar year as the tax period could be against this rule; like Spain which added an observation to the OECD Commentaries. Other issues could arise with respect to the solution suggested by the OECD. See: Rijkele Betten: An analysis of the 1995 update of the OECD Model Convention, 36 *European Taxation*, 2 (1996), at 55.

COMMENTARY

THIN CAPITALIZATION – THE IFA CONGRESS RESOLUTION

During the last IFA Congress held from 1-6 September 1996 in Geneva, amongst other subjects, a resolution regarding thin capitalization was discussed. Twenty-nine national authors had submitted their reports on this topic to Professor Piltz, who wrote the general report.[1] Based on this report the IFA discussed a draft resolution with respect to the thin capitalization issue.

The discussions were opened by an introduction to the topic by Professor Piltz. He stated the main problems appearing in the national reports: the application of Article 9 OECD-MC, the non-discrimination clause, the necessity of safe haven rules and the solutions regarding the avoidance of double taxation.

With respect to the application of Article 9 OECD-MC, the general reporter came to the conclusion that this treaty provision could not be regarded as a practical yardstick against domestic thin capitalization rules. Although I agree with this opinion, the argument used was invalid. The fact that an "arm's length" profit is extremely difficult to determine might well be true, but does not count here. The argument should have been that Article 9 OECD-MC only refers to the *conditions* of the financial relation and thus not to the relationship (i.e. the loan) itself.

Then, by surprise and without any substantial discussion, the Congress adopted another resolution brought in by a US member of the panel. This new resolution took the position that Article 9(1) OECD-MC applies also to domestic thin capitalization rules as far as these rules do not go beyond an "arm's length" correction. In this respect, the resolution describes that "the relevant standard [for the "arm's length" correction;][2] is whether an unrelated lender would make a loan to the taxpayer on the terms proposed, taking account of all of the facts and circumstances, including the security for the loan and the ability of the borrower to generate funds necessary to meet scheduled payments".

Although this view is in its essence similar to the approach chosen by the OECD in its (1987) report[3] on thin capitalization, I still cannot accept this concept. Arguments can be found in the text of Article 9(1) OECD-MC itself as discussed above, but also in history. Article 9(1) OECD-MC was introduced as Article 5 of the League of Nations Model Convention of 1933. Today the wording of Article 9(1) OECD-MC regarding the conditions of the financial relationship remains virtually unaltered. In the study undertaken by Mitchell B. Carroll at the request of the Fiscal Committee of the League of Nations there is a list of "non-arm's length" transactions which includes "loans without interest" and "loans at an excessive interest", not, however, excessive loan financing.[4] Whereas thin capitalization is only recently considered an important issue by some countries, it is clear that Article 9(1) OECD-MC has simply not been written with this issue in mind.[5] Apart from the objections to the contents of the new resolution, one should ask whether such a radical change in views should not be discussed more extensively.

The next part of the resolution to be discussed concerned the question of how to solve the problem of international double taxation. Whereas in the introduction to the thin capitalization issue, a distinction was made between juridical and economic double taxation, this distinction cannot be found again in the resolution. "When thin capitalization rules are applied by countries which are parties to double taxation conventions in a manner consistent with the applicable convention, the recipient's country (i.e. the shareholder's country of residence) should be obliged to accept the recharacterization made by the source country (i.e. the company's country of residence) when applying the convention. If interest is recharacterized as a dividend by the source country, the country of residence of the shareholder should apply its rules for avoiding double taxation of dividends". With respect to the juridical international double taxation, I can agree with this approach. In Article 10(3) OECD-MC an open-ended definition of dividend is given which refers to the treatment in the country of residence of the company. This treatment should be followed by the country of residence of the shareholder according to Article 10(3) OECD-MC *juncto* Article 23 OECD-MC, but only with respect to the credit for tax on dividends (juridical double taxation) and not for the underlying corporate income tax or for the application of the participation exemption (economic double taxation).

Regarding the economic double taxation, the obligatory acceptance of the domestic thin capitalization rules of the country of residence of the company by the country of residence of the shareholder, is a clear invitation to all source countries to introduce the strictest possible thin capitalization provisions according to the "arm's length" standards. Would the United States accept such rules designed by the legislator of any other country? Whereas amongst OECD member states the corresponding adjustment provision of Article 9(2) OECD-MC is not without discussion (and sometimes is even rejected), it is unlikely that most countries will accept the effect of this resolution. That this danger was also considered by the Congress can be shown by the next paragraphs of the resolution: the introduction of a counter-proof if the company exceeds the safe-haven debt/equity ratio, the possibility to open a mutual agreement procedure, and the right to request

1. *Cahiers de droit fiscal international, Volume LXXXIb, International aspects of thin capitalization*, Kluwer Law International, The Hague/London/Boston, 1996.
2. The author's wording was incorporated into the resolution.
3. OECD, (1987), *Issues in International Taxation No. 2, Thin Capitalization.*
4. Mitchell B. Carroll, *Taxation of Foreign and National Enterprises, Methods of Allocating Taxable Income*, League of Nations, Geneva, 1933, No. 358.
5. See: Fred C. de Hosson / Geerten M.M. Michielse, "Treaty aspects of thin capitalization issue – A review of the OECD-report", *Intertax* (November 1989) No. 11.

a binding ruling from the tax authorities as to whether or not a planned financial transaction triggers the application of thin capitalization rules.

Regarding the mutual agreement procedure, I have serious doubts whether the economic double taxation will be dissolved. Even if tax authorities do have a serious intention to solve this double taxation, I cannot imagine what the solutions would be. Either the country of residence of the company should abandon its tax right, which it has according to domestic law, or the country of residence of the shareholder should accept the foreign thin capitalization rules. A country can not accept just half of the consequences of its domestic legal provisions in order to reach a compromise: it is impossible to be "a little bit pregnant".

Whereas thin capitalization essentially is an ordinary fight between the tax authorities in order to achieve as much taxable base as possible, it has to be regretted that IFA came up with a very insufficient and simple resolution. IFA should realize that its voting procedures (by hand and with "thin representation" of public authorities) does not lead to a well balanced ("arm's length") resolution in which the position of these authorities is also reflected. As a result, IFA resolutions will be seen as "quantité negligeable" by tax authorities and will finally leave the taxpayer paying the bill by way of international economic double taxation.

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6. The views expressed in this article do not necessarily reflect the views of the IBFD.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

OCTOBER 1996

VAT: A Strategic Programme for final Arrangements, Trier, Germany, 24-25 October 1996 (English, German, French):

ERA, Academy of European Law, Dasbachstraße 10, D-54292 Trier, Germany, Tel.: 49-651-147 100, Fax: 49-651-147 1020.

8th Singapore Conference on International Business Law: Current Legal Issues in International Commercial Litigation, Singapore, 30 October – 1 November 1996 (English):

Faculty of Law, National University of Singapore, 10 Kent Ridge Crescent, Singapore 119260, Tel.: 65-772 3102, Fax: 65-779 0979.

Global Joint Ventures, The Park Lane Hotel, Piccadilly, London W1Y, 31 October and 1 November 1996 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

NOVEMBER 1996

Tax Minimisation – Exploiting Differences in International Tax Legislation, Forte Crest Hotel, Regents Park, London, 11 November 1996 (English):

AIC Conferences Limited, 2nd Floor, 100 Hatton Garden, London EC1N 8NX, Tel.: 44-171-242 2324, Fax: 44-171-242 2320.

Tax Minimisation – Innovations in UK Tax Products & Planning, Forte Crest Hotel, Regents Park, London, 12 November 1996 (English):

AIC Conferences Limited, 2nd Floor, 100 Hatton Garden, London EC1N 8NX, Tel.: 44-171-242 2324, Fax: 44-171-242 2320.

International Tax Planning, Café Royal, London W1, 14 November 1996 (English):

Juliet Neckar, IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

13th Asia-Pacific Tax Conference: Practical Problems in International Taxation, Singapore, 18-19 November 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Customs & Excise Duties, The Dorchester Hotel, London, 21 November 1996 (English):

Juliet Neckar, IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214, E-mail:juliet_neckar @ibcuklon.ccmail.compuserve.com.

DECEMBER 1996

Practical Planning using Tax Treaties, Hilton Park Lane, London W1, 9 December 1996 (English):

Juliet Neckar, IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214, E-mail:juliet_neckar @ibcuklon.ccmail.compuserve.com.

Strategic Tax Planning for Corporate Acquisitions, Disposals & Reconstructions, SAS Radisson Portman Hotel, London, 10 December 1996 (English):

Juliet Neckar, IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214, E-mail:juliet_neckar @ibcuklon.ccmail.compuserve.com.

Double Taxation Relief: Practice, Theory & Planning, Amsterdam, 12-13 December 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Ninth Annual Institute on Current Issues in International Taxation, J.W. Marriott Hotel, Washington, DC., 12-13 December 1996 (English):

IRS and co-sponsor the George Washington University, George Washington University, Office of Conferences and Institutes, Tel.: 1-202-973-1110.

The International Tax Treatment of NGOs, Danube Hotel, Rybně Namestie 1, 813 38 Bratislava, Slovak Republic, 16-17 December 1996 (English):

EUROPHIL/SAIA-SCTS, Bratislava Office, Klariska 5, P.O. Box 217, 810 00 Bratislava 1, Slovak Republic, Tel.: 42-7-533 5652, Fax: 42-7-533 5672.

Europhil, PO Box 100, F 67069 Strasbourg, Tel.: 33-88-561 646, Fax: 33-88-561 210.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 41-44 of the January 1996 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

South Africa

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Durban, MDR Publications (A division of Butterworths), 8 Walter Place, Waterval Park, Mayville 4091, Durban. 1995.
ISBN: 0 409 11560 6.
Loose-leaf publication on the taxation of individuals, trusts and deceased estates, retirement annuity funds, pension, taxation of lump sum benefits, donations tax, estate duty, capital transfer tax in South Africa. Extracts from the Income Tax Act and the Estate Duty Act, updated with the provisions of the 1995 Income tax and Taxation Laws Amendments Acts, and statutes, are appended.
(B. 13.519)

ASIA & THE PACIFIC

Australia

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Sydney, The Law Book Company Ltd., 44-50 Waterloo Road, North Ryde, N.S.W. 1994
ATAX Research Series, No. 1, pp. 215.
ISBN: 0 455 21319 4.
Contributions by various leading international taxation law experts providing an overview of the key theoretical issues in international taxation and the practical workings of current law. The theoretical background is covered in chapters on the objectives of the international tax system, tax competition and the development of Australia's tax treaties. Five chapters are devoted to an analysis of current law, including studies on withholding tax, financial arrangements, transfer pricing and the international tax implications of trusts, as well as a review of recent trends in Australia's international tax system.
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Japan

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(B. 58.181)

Philippines

International tax and business guide: Philippines.
New York, Deloitte Touche Tohmatsu International. 1996, pp. 75.
The guide provides potential foreign investors with fundamental information about the Philippine environment, including factors a foreign investor should consider in deciding whether to acquire an existing Philippine company or to start a new operation in the country. These factors include tax planning, employment and labour, financing, importing and exporting. The law is stated as of March 1996.
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Vietnam

International tax and business guide: Vietnam.
New York, Deloitte Touche Tohmatsu International. 1996, pp. 63.
This guide provides potential foreign investors with fundamental information about the Vietnamese investment environment. Including tax planning, employment and labour, financing, importing, exporting and accounting.
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EUROPE

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(B. 115.274)

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(B. 115.403)

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(B. 115.419)

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(B. 114.799)

Baker, A.; Bataillon, J.; Baker, A.J.; a.o.
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Marshall J. Langer.
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(B. 115.309)

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(B. 115.226)

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Marshall J. Langer.
The tax exile report/Citizenship, second passports and escaping confiscatory taxes. 5th edition.
Hants, Scope International Limited. 1996, pp. 233. ISBN: 0 906619 34 3.
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Stephens, R.B.; Lind, S.A.; Maxfield, G.B.; Calfee, D.A.
Federal estate and gift taxation. 6th Edition.
Boston, Warren, Gorham & Lamont. 1991, pp. 1900. USD 25. ISBN: 0 7913 0539 2.
An extensive explanation of the federal estate and gift taxation. Future supplements will keep the book up-to-date in the field of legislative, administrative, and judicial changes and expansion of the law.
(B. 115.441)

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(B. 115.440)

CUMULATIVE INDEX – 1996

I. ARTICLES

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INTRODUCTION: FIFTY YEARS OF BULLETIN

Prof. Hubert Hamaekers,
Chief Executive, IBFD

Welcome to the Jubilee issue of the *Bulletin*! In this issue, dedicated to celebrating 50 years of *Bulletin* past, we turn our eyes firmly to the future, to bring you an insight into some of the major controversies that will face tax policy makers, professionals and academics in the 21st century.

But first to the past. The origins of the *Bulletin of International Fiscal Documentation* are closely related to the founding of the International Fiscal Association in 1938. The first statutes of IFA provided for the organization of congresses, the publishing of a periodical and the establishment of a documentation bureau and a library. Preparations for these activities started in 1938. As a result the first IFA Congress was held in The Hague in 1939 and the International Bureau of Fiscal Documentation was established in the form of a separate foundation opening its doors in Amsterdam in July 1939.

The IBFD was entrusted with the tasks of collecting documentation on taxes worldwide, setting up a library and publishing a journal on international taxation. During the initial years of its existence the IBFD was referred to as a daughter organization of IFA, since the Bureau was founded by IFA to promote the realization of several IFA objectives. Gradually the Bureau became an independently functioning organization, keeping a close relationship with IFA, but considered as a sister organization as the chronicler of IFA, W. Dirksen, put it in his book "IFA 1938-1988".

These days – after almost 60 years – sister IBFD cannot be regarded as an old spinster, as it is more lively than ever with a permanent staff of over 100 specialists in taxation, computerization, library services and publishing, coming from 27 countries.

Today the three main activities of the IBFD are:
- research on tax developments worldwide with a current emphasis on developing relatively new areas in taxation on a comparative basis;
- courses on international taxation at all levels, particularly in cooperation with universities and in-company;
- providing information to clients directly, via publications, or via the library.

Recognizing the independent position and objective approach of the IBFD the results of its specific research projects are used by bodies such as the European Court of Justice, the EC Commission, the OECD and the United Nations, by ministries of finance, universities and also by the private sector. Courses on international taxation and VAT are given in various countries, including France, Germany, Hungary, Italy, the Netherlands, Romania, Poland, the United Kingdom, Brazil, Mexico, India, Malaysia, Nepal and Singapore. The IBFD has subscribers to its publications – periodicals, loose-leaf and other books, and databases – in over 150 countries. The library has become a meeting place for scholars of many countries, who benefit from its unique collection of 30,000 books on taxation, tax databases and 400 different tax journals.

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The first issue of what was baptized the "*Bulletin for International Fiscal Documentation*" was ready in April 1940, immediately before the Netherlands became involved in World War II, which was the reason that it was never sent to its subscribers. The second issue reached its readership in the autumn of 1946. In his introduction, the first director of the IBFD, Prof. P.J.A. Adriani, said that the *Bulletin* would contain reviews of new tax legislation, case law and literature, discussions of new tax treaties, a summary of information provided by the IBFD, a dictionary of fiscal law in four languages and information on IFA developments. The subscription price amounted to NLG 16.50, postage included.

The first issues focused on tax developments in various countries during the war. Very useful descriptions of the tax systems of several countries appeared in those early volumes, including one on the Canadian system, written by H. Heward Stikeman, who is still active as a member of the Advisory Council of the IBFD. The later director of the IBFD, J. van Hoorn Jr., who acted as secretary to the editorial board, wrote an article on taxation in Germany, the first of a long series.

* * *

On leafing through 50 years of the *Bulletin* certain trends in domestic and international tax become visible, but it also becomes clear that most major issues come up regularly throughout the whole period. Younger readers may not expect certain topics to have been under discussion so long ago.

Throughout the *Bulletin's* existence recurrent issues have included: double taxation relief, in particular new tax treaties, the OECD Model Tax Conventions and the UN Tax Convention; the pros and cons of tax incentives; the many tax reforms all over the world down through the years; and the rise of "avoir fiscal" based systems from the sixties (we shall of course also follow the likely fall of integration systems in future years).

In the years immediately after the second world war the *Bulletin* focused on post-war tax reform. In 1948 a first sign of integration in Europe was the founding of Benelux, which was welcomed by the *Bulletin*. Another major development in the early years of the *Bulletin* was the conclusion of a tax treaty between the United States and the Netherlands. In the early fifties two topics were dominant: how to tackle tax evasion; and sales taxes.

During the sixties the focus of the *Bulletin* became truly international, covering for example tax harmonization in the Malay Federation (1965) and the African Multilateral Tax

Convention (1967). In the seventies other multilateral tax developments came to the fore, for example Central American Common Market tax harmonization (1971), the Andean Pact Model Tax Convention (1975) and the Comecon Multilateral Tax Treaty (1978). The nineties show an increased interest in tax developments in Asia and in anti-avoidance measures, such as CFC-legislation and specific anti-base erosion measures, which are spreading throughout the world.

The increasing complexity of international taxation, and the accelerating pace of change, have caused the *Bulletin* to spawn a number of offspring. The first followed the conclusion of the Treaty of Rome in 1958, when the harmonization of indirect and direct taxes in the EEC provided many interesting topics for tax debate. The abundance of articles on EEC developments around 1960 necessitated a specialized periodical, *European Taxation*, published monthly from 1960.

Nevertheless the *Bulletin* continued to discuss EEC matters, in particular turnover tax after the release of the Neumark-report in 1963 and the subsequent adoption of the first VAT directives. Two proposed EEC directives on corporate tax attracted much attention in 1969: the parent-subsidiary directive and the merger directive. Not many people expected it to take until 1990 before these proposals were adopted by the EC Council. Since then, despite the burial of the Ruding committee's recommendations by Member States, the EC has again been a major source of articles on direct tax harmonization, due to the avalanche of interesting tax decisions handed down by the EC Court of Justice.

Rapid developments in international taxation in the sixties caused a second offspring of the *Bulletin*, the newsletter *Tax News Service*. *Tax News Service* has been published from 1966, first as a biweekly, later as a weekly, and these days also as a daily electronic service. The proliferation of VAT systems outside the EC from the eighties and the increased offer of articles on this important topic led to the IBFD's third specialized periodical, the *International VAT Monitor*, in 1990.

From 1974 transfer pricing has continuously been on the agenda, in particular the OECD Reports from 1979 and US developments since 1986. Transfer pricing's competitor, unitary taxation, was covered from 1980. In order to avoid undue emphasis on transfer pricing in the *Bulletin*, the *International Transfer Pricing Journal* was set up in 1993 as the fourth child of the *Bulletin*. It is clear that its editors will not be short of copy for the time being.

The Asia-Pacific Tax Bulletin, published by the IBFD from 1995, could be qualified as offspring number five of the *Bulletin*. *APTB* takes over from the *Bulletin of APTIRC*, which provided detailed information on Asia-Pacific tax developments from 1983 to 1994.

* * *

And now to the future! So close to the next millennium we may expect many symposia (e.g. IFA's jubilee symposium held in Geneva last September) and publications on future developments in taxation. The *Bulletin*, as "the mother of international tax publications", intends to play a leading role in the debate.

In the tradition of the *Bulletin* we have invited many distinguished tax lawyers, economists and accountants to give their views.

In articles which focus on the tax base, Malcolm Gammie examines the role income taxes may play in 21st century tax systems, Prof. Ferdinand Grapperhaus advocates a tax system that does not tax profits but rather the use of the factors of production, while Dr Parthasarathi Shome highlights the advantages of introducing a global carbon tax.

In the section on anti-avoidance, Prof. David Williams contemplates future trends in tax avoidance, Dr Robert Kamerling and Mr Hans van der Putten, on the other hand discuss the impact that increased globalization and digitization will have on future tax administration.

On the impact of the communications revolution, David R. Tillinghast warns of an impending dramatic increase in the incidence of double taxation of international income flows, while Frances Horner and Jeffrey Owens explain why the Internet threatens to give tax administrations a 21st century headache.

Other topics dealt with in this special issue include tax simplification by Dr John Avery Jones, the international implications of the United States introducing a flat tax by Charles McLure Jr., the future of the OECD Model Treaty by Prof. Klaus Vogel, European Union direct tax harmonization by Prof. Frans Vanistendael and the future of transfer pricing by Helmut Becker.

The special jubilee issue closes with a paper from Jeffrey Owens and Edward Whitehouse which examines certain key areas of tax reform which may be expected over the next decade.

* * *

We may draw the conclusion that the *Bulletin* has fulfilled its task as described by Prof. Adriani in 1946. In-depth articles on all tax developments, relevant from an international or comparative perspective, have been published over the years as a result of cooperation between expert authors and dedicated and experienced editors.

Information on IFA developments has been provided as a result of the good relationship with the IFA Secretariat in Rotterdam and various branches of IFA. The *Bulletin's* tax bibliography is probably the most comprehensive in the world. And last but not least the dictionary of fiscal law, which was started in the very first issue, has resulted in the *International Tax Glossary* (editions 1988, 1992 and 1996). This glossary is one of the most useful and successful books on international tax ever published.

My colleagues and I are very grateful to all the authors, editors and technical staff who have contributed to the success of the *Bulletin* and indeed to its many friends worldwide. I hope that after reading this special issue you can agree that in the field of international taxation the next 50 years promise to be most interesting!

THE TAX BASE

THE GLOBAL FUTURE OF INCOME TAX

Malcolm Gammie

I. THE DECEPTION OF INCOME TAXATION

Across the world, three taxes contribute the bulk of government tax revenues: income tax, social security taxes and general consumption taxes. The balance between these taxes varies from country to country, but income tax is and will remain into the 21st century a major plank of the tax revenues of developed countries.

And with that observation I could end my contribution to this 50th anniversary look at taxes for the 21st century. However, with taxation, things are rarely what they first seem. Instinctively, people support income taxation. Income measures what everyone has coming to them. The popular conception is that income reflects a person's capacity to pay tax. But, in fact, consumption is a clearer way to measure taxable capacity. Indeed, economists usually define income in terms of consumption. Haig[1] said that income is "the money value of the net accretion to one's economic power between two points in time" and Bradford[2] explains that economic power reflects a person's command over resources "exercised in the form of consumption or held as a potential for future consumption".

As Bradford points out in another context,[3] tax systems allow people to deduct the cost of earning income because, in the end, they want to tax what people have left over to spend. The problem that afflicts income and consumption taxes alike, is deciding when an item is an expense of *earning* income or when it is the *consumption* of income. The element of personal choice that enters many business expenses makes it difficult to disentangle the two.

Two important truths lie behind these observations. First, cash receipts do not necessarily affect a person's command of economic resources. Conventionally, people think of dividends as taxable income. This reflects the practical approach of taxing payments that are easily observed and whose value is self evident. These two features account for the success of taxes on earnings and value added. The tax base for each is current cash flows. But dividends merely recognize economic resources that shareholders already command through their savings in the company. A dividend transfers those resources from one pocket to another, but adds nothing to the economic resources at the taxpayer's command. Second, to tax consumption you do not have to measure what people spend. You can arrive at a measure of people's consumption by starting with their income and subtracting what they save. Indeed, the difference between a direct tax on income and a direct tax on consumption lies entirely in each tax's treatment of savings.

A number of important consequences flow from these points. First, the taxes that people call income taxes are, in fact, very largely consumption taxes. The principal component of the income tax (and most social security taxes) is earnings. Earnings are within the tax base whether you tax income or consumption. Second, the problems you encounter in taxing earnings or consumption are common to both income and consumption taxes. To see this, you need only think of the problems that employee benefits, such as the provision of a company owned car, present for both the income tax and a value added tax.

If income is consumption plus net additions to wealth or new opportunities for future consumption, consumption is common to both taxes on income and taxes on consumption. However, a true income tax presents greater difficulties than a consumption tax because it attempts to tax net additions to wealth or new opportunities for future consumption – or savings. It is because this is so difficult in practical terms that real-world income taxes are closer to being consumption taxes than true income taxes.

II. PRACTICAL TAXATION

Successful taxes reflect two main factors:

- they adopt well defined and sustainable economic concepts that recognize a person's ability to pay; and
- they can be administered, collected and enforced.

Consumption, that we can recognize as earnings and output, is a well defined and sustainable concept. Income, by contrast, is far from being a clear concept. Kaldor[4] concluded that "the problem of *defining* individual income, quite apart from any problem of practical measurement, appears in principle insoluble." If you cannot adequately define as a matter of economic principle what it is that you want to tax, legislators will not supply the answer when they have to convert into legislative language what you want to tax but cannot quite explain. And this is what accounts for some of the growth in the size and complexity of tax law and administrative rules. Rewriting the tax code, as Australia, New Zealand and the United Kingdom are currently embarked upon, will do nothing to solve this basic problem.

1. Haig, *The Concept of Income – Economic and Legal Aspects*, The Federal Income Tax, Columbia University Press, 1921, at 7.
2. Bradford and the US Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd Ed., Revised, Tax Analysts, Arlington, Virginia (1984), at 26.
3. Bradford, *Untangling the Income Tax*, Harvard University Press, 1986, Chapter 1, at 17–18.
4. Kaldor, *An Expenditure Tax*, Allen & Unwin, 1955, at 70.

But the problems of income taxation are not merely problems of principle. Income measurement, as Kaldor recognizes, presents real practical problems. If you want to tax the net accretion over a period in people's new opportunities for consumption, you have to value the opportunities as they accrue and adjust for inflation. No tax system achieves either a true accruals basis or proper inflation adjustment. Furthermore, income taxation requires that you allocate to individuals what accrues to intermediaries – companies, investment funds, trusts, etc. None of these things are practically achievable as a matter of general application but if you fail to allocate income from intermediaries to those ultimately entitled to it, an income tax soon "degenerates" into a consumption tax. You cease to tax the net accretion in new opportunities for consumption and move to taxing accretions only when people withdraw their money from the intermediary and spend it. The practical expedients that most income taxes adopt to get around these problems, for example, taxing capital gains on realization rather than as income as they accrue, are a continuing source of opportunities for tax avoidance and tax arbitrage.

III. TAX ARBITRAGE

Opportunities for tax avoidance and tax arbitrage arise whenever you tax different items at different tax rates. If there is no real distinction between items, or you can easily substitute one item for another, taxpayers have an incentive to favour whichever item is taxed the least. The more numerous and diverse the characteristics and attributes of particular items, the easier it is to tax them differently. This applies both to specific and to general consumption taxes that impose different tax rates on different consumer items. But it is particularly true of savings products.

The relevant characteristics of financial assets are rather limited – typically the rate of return, risk and liquidity. Accordingly, different forms of saving are particularly close substitutes. If a tax system taxes different savings instruments differently, it will be particularly distortive in affecting people's savings behaviour (i.e. where and in what form they save).[5] The practical difficulty of measuring income properly produces fundamentally different tax treatments for financial assets (for example, debt and equity,) where there is no discernible economic distinction between them.

Add to this the problem of taxing different taxpayers at different rates. Market arbitrage then operates to shift taxable capacity from those liable to tax at higher rates to those taxed at lower rates. Even if you levy tax at a single nominal rate, the existence of tax exemptions and the likelihood that taxpayers bear tax at different effective tax rates, whether through tax losses, exemptions or the ability to defer liability, mean that most tax systems are multi-rate tax systems. To eliminate tax arbitrage you must be able to adequately identify taxpayers and monitor transactions between them. The problem of controlling market arbitrage, however, is that it does not just involve manipulation by taxpayers who are related or have some connection. It largely involves independent persons who "trade-off" their respective tax rates and taxable capacity (or lack of it) to achieve a tax saving.

It is difficult enough in a domestic context to eliminate these opportunities to avoid or minimize tax liabilities. In an international context, however, no two tax systems will tax activities and transactions in entirely the same way or apply the same rate of tax to the outcome. The variety of different tax results for similar transactions and the different tax rates that different people pay accordingly multiply the opportunities for tax arbitrage in an international setting.

Three fundamental problems arise where several countries seek to tax the same highly mobile factors. First, multiple taxation distorts what people do. Taxation in any form necessarily affects taxpayers' behaviour. But where there are several countries trying to tax the same thing, the degree of distortion is multiplied for those factors that can easily move from one jurisdiction to another. Second, each country faces the same problem: how can it attract and retain those mobile factors it wants; international capital or goods, but tax them without encouraging them to move elsewhere to a more lenient regime. Third, if factors can move away, how do you monitor the tax base and collect tax?

IV. INTERMEDIARIES

The problems of taxing intermediaries such as companies and trusts reflect all the issues to which I have referred and are central to the taxation of savings within the income tax. To measure individual income properly you must allocate the income from intermediaries to individuals: but this is not practically possible. And because it is not practically possible, tax systems resort to taxing intermediaries at special tax rates that differ from personal tax rates. Intermediaries enable people to create a variety of financial interests that are economically similar but which the problems of measurement mean are taxed differently. All these are a large source of tax arbitrage and avoidance. Taxing savings at a single rate solves some of the problems but losses and other reliefs are likely to mean that there is no single effective rate of tax and, in an international context, the idea of single rate taxation disappears completely. In this respect, intermediaries enable taxpayers to access other tax systems to play off one tax system and set of tax rates against another. In practical terms, the mobility of capital makes it impossible in an international context to achieve a consistent treatment of financial transactions or a consistency of taxation between different taxpayers.

Three particular international tax issues illustrate these problems: first, how to tax the variety of new financial instruments that are traded on the international capital markets; second, what to do about company residence and, finally, transfer pricing. The problems of taxing financial instruments is all to do with achieving consistency between differ-

5. Tax also affects when and how much people save. However, it is very difficult to assess the impact of any tax system – whether income or consumption based – on such decisions.

ent forms of savings and eliminating differences in the effective rates of tax borne by different taxpayers on their savings. So long as there are differences the capital markets will work to arbitrage the differences. And a tool in the market's armoury is the current concept of corporate residence.

You can identify for most individuals where they live, even if they travel regularly in between times. The scope for most people to manipulate where they live is rather limited. Only a few individuals, those with sufficient wealth or ability to market their skills globally, have a freedom of choice. The greater mobility of higher paid individuals, who can sell their skills in a number of countries, is one reason why most tax systems now find it impossible to impose top rates of personal income tax that are significantly out of line with other countries.

Tax systems have sought to adapt the idea of personal residence and apply it to intermediaries, in the shape of effective management. This underlies the basis of the OECD's tax treaty network. But it is a product of a bygone era. There is no recognizable concept of residence for an artificial creation such as a company. And as with any such test lacking in basic principle, it is open to manipulation. Increasingly, the businesses of multi-national enterprises are organized and operated and managed globally. Individual managers can communicate with each other wherever they are in the world. In such a world, effective management that can be found in one jurisdiction or another is meaningless.

On the other hand, the ease with which people can travel and communicate allows taxpayers to choose where to manage their businesses when there is a tax advantage in doing so. Effective management has ceased to be a satisfactory means for countries to identify who they can tax and has become a tool of tax planning. To the extent that the international tax treaty network is built on the idea of effective management, it contains a basic flaw that is the seeds of its own destruction. Effective management allows taxpayers to access particular tax regimes to achieve particular tax outcomes.

In reality, what countries generally seek to tax are the profits attributable to the real assets and activities that are found or conducted within their jurisdiction, irrespective of where those assets or activities happen to be managed. However, the problem a country faces, when confronted with a globally integrated multi-national enterprise, is how to identify the profit attributable to the assets and activities in its jurisdiction. It can see when an enterprise which conducts its research in France, manufactures in South Korea and markets and sells its product in the United States has made a large profit. But there is no principle to answer how you should allocate that profit between France, South Korea and the United States.

The solution presently adopted is to debate what is the correct arm's length price for what the French side of the operation supplies to South Korea and what South Korea supplies to the United States. But no amount of highly paid accounting, economic and tax analysis can answer that question. The acres of woodland that have been cut down to supply the paper to record the recent debate on transfer pricing merely testify to the absence of any clear principle that underlies the transfer pricing debate. Arm's length principles do not in the long run provide a practical way for countries to resolve their competing claims for the tax base.

V. INTERNATIONAL SOLUTIONS

The administrative response to international tax problems is to seek greater cooperation between the tax authorities of different jurisdictions. If each jurisdiction is seeking to tax the same factors, on the face of it, they have a common interest in cooperation. Nevertheless, there are severe limitations on what administrative cooperation alone can achieve. Countries have very different tax cultures, administrative institutions and procedures. The details of the tax systems and the administrative requirements they impose differ significantly. These factors place a limit on cooperation. It is unlikely to be in the interests of country A to impose administrative requirements on its taxpayers solely to assist country B in policing its tax system. Even if the two countries could agree on the mutual enforcement of their administrative obligations, the compliance costs that this would impose on taxpayers may be substantial, and objectionable.

Agreement on administrative measures between the countries also places a substantive limitation on their right to tax as they wish. A country may be constrained in adopting certain policy options if that affects its ability to cooperate with other countries in collecting and enforcing their respective taxes.[6] Of course, international capital markets already implicitly affect a country's taxing rights and this is largely a function of the practical administrative difficulties a country has in collecting and enforcing tax on mobile factors such as capital. There is therefore a tension between the loss of taxing rights through non-cooperation and the limitations implicit in cooperation.

In fact, there are only two responses that governments can adopt to the problems of multiple taxation of highly mobile factors. The first is to agree among themselves a common basis of taxation and a method of dividing the tax revenues they raise. Such agreement would solve the problems presented by multiple taxing jurisdictions, although agreement by itself would not deal with the basic problems of taxing income (such as accruals, indexation and allocation) to which I have referred. However, I doubt that such agreement is realistic as a matter of practical politics. Is it realistic to think that, in the long run, countries can agree on taxation policies without greater political integration? In theory, agreement may be in their (and taxpayers') common interest. But where several countries are competing for the same tax base one at least is always likely to see it as in its interest not to agree to share part of its tax base with others. And knowing where the country's interests lie now is difficult enough. For tomorrow, it is impossible.

6. For example, if it affects the information that the Revenue authority routinely collects from taxpayers.

More to the point, however, taxation lies at the heart of government. The ability to tax is one of the most important indicia of government. It is unsurprising, therefore, that no examples of supra-national taxes spring to mind. You cannot divorce taxation from the exercise of political power by the taxing authority. Apart from anything else, taxation requires an administrative body that answers to the political and taxing authority. Thus, the emergence of a European corporation tax must await the emergence of the European political institutions capable of imposing such a tax. For the same reasons, I believe the Commission's current proposals for the European value added tax will fail.

If countries do not agree on a common basis of taxation, and are unlikely to do so without a degree of political integration that would be unacceptable to many governments, the only solution is to resort to those taxes which can be levied independently of other countries. This is precisely the direction in which tax systems have been moving in response to the problems that I have outlined. Within Europe, tax systems may be converging, but it is a convergence based on those factors that countries can tax independently of the others.

The principal feature of this response is a greater reliance on taxes on earnings and consumption. It is much easier to see where people earn their money and where they spend it, than it is to see where they save it and to discover what return they derive in any period from those savings. Furthermore, by taxing *domestic* output or value added by business activities within the jurisdiction, you avoid many of the problems involved in wondering where an activity is managed or of having to allocate profits between different jurisdictions. Taxes on earnings and output are concerned with taxing consumption rather than savings.

There is no practical way of achieving consistency of taxation between different forms of savings and eliminating differences in the effective rates of tax borne by different taxpayers on their savings, except by abandoning the taxation of savings. And the pressures on governments to scale back their commitments to universal pension provision and health care are likely to be powerful influences at the start of the 21st century to placing greater obligations on individuals to save for these eventualities and exempting those savings from tax. At the same time, the increasing difficulties of central governments in raising tax revenues may lead to their devolving responsibilities (and associated costs) to lower tiers of government, which will rely on less mobile factors of taxation.

VI. CONCLUSION

The problems that I have outlined in this article are not new. As Professor John Kay pointed out in 1995 at an IFS conference on European taxation, the castles on the Rhine were not built for their fine views but to collect and enforce tolls on the commercial traffic that passed along the river.[7] In the long run the castles failed to maintain their right to collect tolls and this was a consequence of the same problems of distortion, jurisdiction to tax and enforcement that currently afflict the international tax system. The ingredients for successful taxation do not alter over time, although the surrounding circumstances within which tax is levied (and therefore what makes a tax successful in one age and not another) do. This will not alter in the 21st century.

This should at least explain the many column inches that commentators devoted to the debate on international tax issues. Those column inches suggest that if only we think about the problems long and hard enough, we should be able to solve the problems. But, fundamentally, the only solution to the inclusion of savings as part of the income tax base lies in agreement between countries on a common basis of taxing and sharing tax revenues. If that is not a practical political option, as I believe it is not, the alternative is to give up taxing what you cannot practically tax and concentrate on what you can.

Governments may not widely acknowledge the fact, but this is the way that tax systems have developed in recent years and the direction in which I believe they will continue to develop. As I said at the beginning, income tax is and will remain into the 21st century a major plank of the tax revenues of developed countries. The income tax to which I refer, however, is the tax on earnings not on savings, on output and consumption not on capital. In 50 years' time, in the 100th anniversary issue of the Bulletin, I expect that commentators will still be discussing the problems of taxing earnings, of benefits and of personal and business expenses. I suspect that the taxation of financial institutions, such as banks and insurance companies, may remain an issue. Such businesses are a problem to the value added tax, just as they are to the income tax, because the value that such businesses add is generally concealed in the turn that they make on other financial transactions.

However, I do not expect the taxation of savings or capital income to be a live issue. Countries may yet prove me wrong through the measure of agreement they can reach on the tax base. I shall leave it, however, to the commentators in the 100th anniversary issue to draw attention to the inaccuracy of my predictions. I shall be with them in spirit, if not in body.

7. I readily acknowledge my indebtedness to the several papers that Professor Kay has delivered over the years, pointing out the fundamental problems of current tax systems in seeking to tax income.

THE TAX BASE

A 21ST CENTURY GLOBAL CARBON TAX

Dr Parthasarathi Shome

Dr Shome is Director, National Institute of Public Finance and Policy, New Delhi, India. The author acknowledges helpful comments from his colleagues Dr Shreekant Gupta, Fellow and In-charge, Environment Economics Cell; Dr Rita Pandey, Fellow, Environment Economics Cell; and Professor Indira Rajaraman, Reserve Bank of India Chair. The opinions expressed in the paper, however, reflect those of the author and not necessarily those of any other institution or individual unless otherwise indicated. The author presented a paper on this subject at a Meeting on "New and Innovative Sources of Financing Development" organized by the UNDP, New York, in October 1995.

I. INTRODUCTION

The world is undergoing rapid economic changes. Its problems are becoming increasingly global in character as we approach the 21st century. To meet the challenges these problems pose, global sources of funding will need to be identified. The quantum and nature of resources available through multilateral financial institutional lending have been criticized as being inadequate to redress particularly distressing increases in poverty. Additionally, activities of global importance and with long-range ramifications, such as space exploration cannot at present be adequately funded. Thus, there seems to be a growing consensus that global taxes be identified and their revenue be earmarked for global objectives pertinent to the next century. This paper addresses one such possibility, focusing on global environmental levies. It considers the efficiency of such a tax in its design and effects, weighed against the feasibility of reaching an international agreement and the practicality of effective implementation.

Section II provides the setting of the paper by addressing the question: why a global environment tax? The answer has to lie on three pedestals. First, it is likely that traditional bases of tax revenue will thin out over the next century, and alternative bases might need to be identified. Second, global objectives would assume importance. Thus, the need to protect the global habitat for future generations would assume increasing importance. Third, global revenue sources could facilitate meeting global objectives such as improving equity for the current generation.

In pursuance of Section II, Section III presents schemata illustrating the constraining influence of today's deleterious environmental practices on the welfare of future generations even if today's generation had the good intention of bequeathing the pecuniary maximum for posterity. Therefore, revenue could be derived by targeting the sources of environmental degradation, and this revenue could be used for achieving global development objectives.

Section IV considers environmentally oriented taxes that could hypothetically be designed for global revenue generation. The list comprises much discussed sources such as a carbon tax, charges or taxes on international transport, as well as tradeable or marketable permits. It is found that not all feasible national instruments are necessarily suitable for global use. A carbon tax is likely to fare best as a global tax but, in order for such a policy to be successful, a case is made for the imposition of a minimum global carbon tax.

Section V discusses selected recent experiences in international treaty making with the objective of gauging the feasibility of introducing a global tax. It then raises global tax administration issues that must be kept in mind if the implementation of a global tax is to be successful. Section VI concludes.

II. WHY A GLOBAL ENVIRONMENT TAX?

An expanding scope for global taxes may reflect a substitute for disappearing tax bases in individual countries. The justification for global taxes may be couched in terms of intergenerational and intragenerational (transnational) equity. Such a tax on environmental degradation would preserve the environment for the future. The revenue from a global tax could be used to meet global objectives, for example, to redress poverty or buttress efforts for accelerated environmental clean-up or space exploration as a global effort. Or, the revenue could be shared by contributing countries for their individual use. Or, possibly, a combination of both.

A. Need for new revenue bases

International tax developments for the next century would probably rest on lower taxability of the factors of production, (i.e. capital, labour, and land). This would be reflected in a decline in revenues from income tax. Today, international capital (in particular, financial) flows are like swarms of bees moving from coast to coast, instantaneously changing direction from shore to shore, triggered by tax and non-tax determinants. Even without necessarily being able to identify whether tax or non-tax determinants are more important in triggering such movements, more countries will become (and are becoming) sensitive to the fact that international financial capital cannot be taxed at internationally non-comparable rates. This is already happening in this century (Shome, 1995).

In the next century, hopefully, for the same reasons, and because of the demographic changes in developed countries, professional labour (from developing countries) will become less taxable because of its increasing mobility across national boundaries. Thus incomes of neither capital nor professional labour could be taxed significantly. Other non-mobile bases would need to be found for taxation.

This begs the question of taxability of land and property. The past reveals poor experience not only in developing countries, but in European, Latin American and East-Asian advanced countries as well. Thus alternative tax bases will have to be found, that would allay heavy dependence on land as a tax base.

This will probably be taxation of consumption. It will take on larger proportions since it can target domestic consumption of goods and services. Latin American countries have shown what can be done. With a 18 per cent Value Added Tax (VAT) rate, Chile gets 9 per cent of GDP in VAT revenue, Argentina receives over 6 per cent of GDP, and so on.

But such a success depends on the efficacy of tax administration, public policy and governance. Many developing countries suffer weaknesses in these areas. Further, for large, fiscally federal countries, i.e. with provinces or states with separate taxing powers, harmonized consumption tax systems that do not suffer from tax base erosion through tax competition, are very difficult to design. If this happens, they would tend to prefer globally shared taxes. From the point of view of developed countries also, the increasing inability to tax income should move them towards global taxes.

Thus, there are likely to be pressures for increased tax sharing methods globally. Some should be avoided, for example, an international tax on financial transactions, which would be adverse for both developing countries and developed countries, because it would distort trade and financial flows. The first obvious choice is formula apportionment of revenue from a global capital income tax. But the anticipated difficulties with capital income as a reliable source of revenue would point towards a second, perhaps better, candidate: a global carbon tax. In order to analyse such a tax, however, it is imperative to explore the rationale for such a tax, on the basis of which it could be justified on a worldwide scale. This is considered next.

B. Intragenerational and intergenerational perspectives

Population, technology and resources have been called the "master variables" connected with a complex interrelationship and resulting in an international tension between growth and development and also between the North and the South (Choucri and North, 1993). The North-South debate could (partially) be seen as an intragenerational one. Although multinationals, mainly from the North, carry technology, trade and investment to the South, they have distributive and allocational as well as global and domestic ramifications. Their investment tends to cause environmental degradation unless checked. Poverty and population growth are affected by environmental degradation. In its turn, the North argues that poverty and population growth cause environmental degradation. This exacerbates the world's economic polarization, necessitating a minimum degree of oversight at the global level (Davidian, 1994).

The recent rise of the "global politics of environmental issues" has involved interdisciplinary research and reflects a genuine interest in global "sustainable development in balance with the biosphere as a whole". This has immediate intergenerational implications (see Brown Weiss, 1993; and Rothenberg, 1993). Past generations have bequeathed to the present generation an endowment reflecting the fruits of the former's efforts through trial and error and learning by doing. Thus there is a backward indebtedness of the latter towards the former. A social contract represented by a social security transfer mechanism is inadequate for reaching sufficiently back into the past to repay this debt. Perhaps an alternative mechanism is for the present to ensure and safeguard its received gift of endowment for the future.

Most environmental threats (e.g. global warming, forest depletion etc.) are not likely to affect us or our immediate descendants.[1] There is no particular reason, therefore, for a human being, or even for a particular country, to individually take action.[2] Commitment at a global level for equity with future generations therefore emerges as a distinct necessity. Global taxes comprise an important vehicle for the realization of that commitment.

C. The atmosphere as an illustration of a global resource

Examples of a global resource may be found in sea, land or air. The oceans are a common example of an international common property resource. Ships ply on the high seas and nation states bury refuse of various sorts in their beds. The quality of seas and oceans as a resource is thus degraded by chemical and nuclear wastes, and also by oil spills and atomic explosions. If and when any compensations are made for accidents, they tend to be small compared to their social cost. Further, payments made and received tend to be confined within individual countries, reflecting international norms regarding the prerogatives of state sovereignty, though some cross country compensation has also taken place. Thus, first, marginal social costs of environmental degradation do not get fully reflected when such degradation occurs and, second, it is safe to say that it is generally not treated as a cutting-edge global issue in international politics. These issues are taken up in some detail in Section V.

Similarly, focusing on land on a global scale, the continent of Antarctica is an example of an abundant common property resource. Though the 1959 Antarctic Treaty has been praised

1. If there is no abatement of environmental degradation, damages from climate change would be negligible for the next 50 years. It would thereafter accelerate and become very high after 150 years or so. See Choucri and North (1993).
2. Indeed, non-governmental organizations (NGOs) formed by interested parties in their individual capacities often seem to do more than their governments. For the role that cooperatives and local governments have been playing, see Singh (1994).

by some (see Victor et al., 1993) for the research coordination it has generated as the central component of international cooperation, the stakes already made out by individual countries for the eventual exploitation of the continent's natural resources again reveal individual motives of nation states which conflict with truly global notions of intergenerational and intragenerational equity.

The common property resource that is most often discussed is, however, the atmosphere (see Soroos, 1991). Its degradation spans the problems of acid deposition, global climate change and ozone depletion. The first, acid deposition, has had the most apparent environmental consequences in the form of acid rain. The second, ozone depletion, affects the upper atmosphere (stratosphere), which houses a thin layer of naturally occurring ozone that absorbs 99 per cent of the incoming ultraviolet solar radiation. Industrially produced chemicals, e.g. chlorofluorocarbons (CFCs) diminish the ozone layer. In 1985, Antarctica's atmosphere was observed to have been punctured with an "ozone hole" i.e. 40 per cent below average ozone levels, caused mainly by CFCs. The situation did not subsequently improve. Resultant increases in ultraviolet radiation are likely to have effects similar to those of carbon gases which are described next; but equally significantly, a 1 per cent reduction in the ozone layer could lead to a 10 per cent increase in human skin cancers.

The third, global climate change, is caused by the excessive emission of carbon dioxide that warms the lower atmosphere (troposphere). It is known that atmospheric concentrations of carbon dioxide have increased significantly over the last two centuries, mainly reflecting a ten-fold increase in energy consumption during the twentieth century as well as the large scale cutting and burning of forests. While relatively small areas such as Scandinavia or Siberia may experience a somewhat longer growing season as a result, much larger tracts of land are destined to suffer hotter and drier seasons and reduced production. It is not at all impossible that glacial ice would melt more rapidly and sea levels would rise due to thermal expansion, thus increasing the salinity of rivers and inundating highly populated areas. OECD (1992) analyses various forms of damage: on agriculture, forests, species, sea level, space cooling and heating, human amenity, life and morbidity, migration, construction, leisure, water supply and urban infrastructure, on an item by item basis.[3]

It is obvious that the targets for penalization should be emissions of acid, CFCs and carbon into the atmosphere. A level of awareness, discussion and debate, if not a critical mass of consensus, already exists in the matter of targeting carbon emission. Appropriate policies at the global level, or policies coordinated at the national level by various nations, could help arrest atmospheric degradation and, at the same time, enable the generation of significant revenues for global use.

III. SCHEMATA TO ILLUSTRATE THE CONSTRAINING INFLUENCE OF A GLOBAL FACTOR

In Section II, we argued that environmental degradation can cause factor depletion both in terms of capital and labour. In this Section we attempt to illustrate the point with the help of a diagrammatic scheme. Its objective is to demonstrate how constraining influences such as environmental degradation could diminish the productivity of factors of production such as labour and capital in future generations. In view of the complicated mathematical proofs involved the detailed arguments are contained in appendix A.

The policy conclusion that may be drawn from the fact that environmental degradation may lead to a reduced output for future generations is that, it is not enough for the present generation to bequeath pecuniary savings and presumed investment and consumption possibilities to posterity, i.e. it is also necessary to bequeath the natural habitat in a condition similar to that in which it was inherited from past generations. In order to do so, it is important to explore the possibilities of devising global tax mechanisms that could minimize environmental degradation and increase future production and consumption. The use of the revenue thus generated to mitigate global developmental concerns would comprise a double dividend.

IV. GLOBAL ENVIRONMENTAL TAXES

Various market-based tax instruments (MBTIs) have been discussed in the literature in the context of checking environmental decline.[4] They have been described, in the context of transportation,[5] in a nutshell by Button (1993) as including: (i) for vehicles: emissions charges, tradeable permits, differential vehicle standards taxation, tax allowances for new vehicles; (ii) for fuel: differential fuel taxation, high fuel taxes; and (iii) for traffic: congestion charges, parking charges, subsidies for less polluting modes.

Except for emissions fees which attempt to attack environmental intrusion directly, the others are indirect instruments that affect vehicle use or associated inputs. In reality, however, even though emissions charges are a direct instrument and attempt to charge an appropriate price to users for the use of the environment, there can be said to be at best a fine dividing line between a user charge and a tax (see Bell, 1995).

Three among the items of the above list could be imagined as possible candidates for a global tax. They are: (1) emissions charges or Pigouvian taxes on international airlines and ship-

3. Also see Cline (1992) for greater details and a benefit-cost approach for estimating such damage.
4. Command and control regulations such as direct controls on emission, fuel composition, traffic incidence and routes, or phasing out of high polluting fuels, as well as indirect controls such as compulsory inspections, scrapping of old and acquisition of new vehicles, fuel economy standards, speed limits and so on, are not considered here since the focus is on revenue generation.
5. MBTIs may, of course, be used to redress industrial or other pollution.

ping companies; (2) tradable permits that would apply across nations within limits set by them; and (3) a global carbon tax. Their usefulness as global levies is examined below. The carbon tax is specially treated since it has been discussed in some detail in the global context and since it seems to offer a not totally infeasible option in terms of its introduction and implementation as a global tax.

A. A Pigouvian global tax on airlines and shipping

A Pigouvian tax is well based in that it attempts to internalize the true value of the environment in product prices. Take traffic: without internalization of external costs, traffic would be produced at greater than optimal levels, reflecting maximization of net private benefit while ignoring external costs. A Pigouvian tax at an appropriate rate t imposed by the authorities would make traffic "producers" produce less traffic; and (2) generate some tax revenue.

If this could be made applicable to all international airlines, the tax would become a global tax candidate. First, it would not be impossible to design it for all states and would have the impact of reducing noise and air pollution. Second, on the assumption that the world's poor do not fly internationally very often, the tax could be expected to be quite equitable. Third, it should be revenue generating as long as international air travel exists, even though its occurrence would be reduced, beneficially from the viewpoint of global welfare. Fourth, it should be an administratively feasible tax. If it turns out to be difficult to administer by a global body, the tax could be collected by national authorities and the revenue handed over to a global regulatory body. Of course, there will be a need for an international convention or treaty, selected related matters of which are addressed in Section V.

A similar tax could be levied on international shipping based on a similar argument i.e. that of their use of the open seas which are global commons, particularly since their use leads to pollution and congestion.

If such a global tax takes hold, it is perhaps not too farfetched to imagine that it might even be possible to introduce differential taxation to reflect congestion costs at airports or ports. For example, the rates could be related to arrivals and departures during heavy or light traffic periods, introducing an element of peak-off-peak differentials such as usually experienced where competition exists, for example, in the telephone, movie or hotel industries. A well crafted design would include two parts: (1) a fixed component for the entitlement to enter; and (2) a differential component reflecting the marginal cost of abatement (see Congressional Budget Office, 1992).

B. International tradeable permits?

Tradeable permits have the merit of exerting direct control over the quantity of emissions. In the case of a Pigouvian tax or charge, if it is calculated to be too low, pollution may exceed optimal levels, necessitating further attempts to set the right tax. Tradable permits do not suffer from this shortcoming.

If a permit is required for each unit of pollution, then the optimal number of permits is determined where MAC (marginal abatement cost) and MEC (marginal external cost) are equalized. There, the equilibrium market price of a tradable permit is also determined. Since MAC is the demand curve for permits, derived as the horizontal summation of these schedules of individual firms, any price higher than the equilibrium price would reduce the number of permits demanded since it would be cheaper to clean up production. Different firms would accordingly buy different numbers of permits. Thus, if initially they are allotted an equal number of permits, they will trade permits between themselves. Thus a permits market emerges.

The United States made explicit use of permits during its lead trading programme whose aim was to allow petroleum refineries greater flexibility during the 1982-86 period when lead in petroleum was being reduced. Permits trading has continued and they are regularly traded, for example, in the Chicago stock exchange, for sulphur dioxide emissions. Tradeable permits may not, however, be easily amenable to international manipulation. Their very merit in fixing pollution levels in the national context becomes a demerit in the international context because the levels of pollution caused by individual industries would have to be agreed upon internationally.

Even if hypothetically the quantum of allowable pollution per industry could be determined at the global level, the revenue impact of each agreement would be one shot, requiring increasing coverage of industries on a continuing basis. It is difficult to predict with confidence that such progress is achievable. To conclude, the use of tradeable permits as a global revenue source is fraught with practical difficulties.

C. A global carbon tax

The incidence of emission of carbon dioxide, the most important greenhouse gas, has been considered in Section II. Energy taxes are a strong and low-cost mechanism for the control of carbon dioxide emission because it is predominantly caused by energy production and use. Most authors seem to agree that the advantage of energy taxes lies in that they could be designed to directly target the primary source (i.e. transport fuels) of carbon dioxide emission, are more amenable to global taxation than other tax candidates, and could yield significant revenue.

1. Appropriate tax base

The base for an energy tax could, of course, be selected from various alternatives, for example, the carbon content of fossil energy or the Btu content of fossil energy. Scheraga and Leary (1994) compare and contrast the advantages and disadvantages of a carbon tax with a Btu tax. They examine both as taxes on the primary production of fossil energy, setting the tax rates such that carbon dioxide emissions in 2000 are equalized to 1990 levels. While the Btu tax generates greater emission reductions, the carbon tax has ancillary benefits in that it comes closest to the ideal of placing a uniform price on carbon dioxide emissions, a condition necessary for least cost abatement, which their model confirms.[6]

Therefore, the carbon tax has been especially subjected to analysis and critique, as well as to various degrees of application in the European Union (EU). Many authors have discussed its advantages and disadvantages; Sterner, Dahl and Franzen (1992), Barker (1993), Shome and Spahn (1994) and Scheraga and Leary (1994), to name only a few.

2. Indicators of growth in energy consumption

Gasoline demand has been widely modelled and analysed. Typically, demand for transport fuels is derived from vehicle stock, its composition and vehicle utilization. Sterner et al. (1992), using such a model, estimated demand elasticities to make inferences regarding the effectiveness of possible tax policies. Applying the model to OECD data, they found that cross-country gasoline price differences were determined mainly by tax differences. Their results also indicated that the consumption of low-tax North America was largely relative to the rest of the OECD.

The more interesting part of their results pertain to the future: (1) if taxes are maintained at the 1987 levels, by the year 2000, the United States would be responsible for over two thirds of the gasoline carbon emissions while, for the OECD as a whole, carbon emissions would increase by about half; (2) if taxes were raised to the highest (Italian) level across the OECD, consumption and emission would fall by approximately one third, reflecting a 50 per cent decline in North America and a 25 per cent fall in the EU; (3) if taxes were reduced to the lowest (Greek) level, the main change would be in the EU which, with its prevailing high tax rates, would experience a tripling in its consumption.

Other interesting conclusions bear on the elasticity estimates: (1) long run elasticities average approximately -0.8 for price and 1.2 for income; (2) the high income elasticity indicates that consumption would tend to increase with world growth; (3) the significant price elasticity indicates that appropriate tax policies could control consumption; and (4) the income elasticity being higher than the price elasticity, that prices will have to rise faster than the rate of economic growth if consumption is to be stabilized.

The justification for the above tour de force lies in the need to drive home the case in favour of a carbon tax on transport fuels on a global scale. From the point of view of global warming, confining such a tax within the EU would serve the purpose only partially; it must extend to North America to have any meaningful effect, South America, Asia or Africa should not be excluded, or should be included soon thereafter, for example, in line with the extra time given to developing countries to conform to the recommendations of the Montreal Protocol.

3. The case for a minimum global carbon tax

Barker (1993) has made the case for a global carbon tax emphatically. According to him, such a tax is, indeed, the optimal instrument for the transfer of clean technology and, therefore, for world growth and development. Since domestic energy prices in developing countries are often below world prices, he argues that a carbon tax would help improve efficiency and perhaps be more revenue productive than conventional domestic revenue sources.[7]

However, Gupta and Mahler (1994) found that domestic petroleum prices and tax rates vary significantly among countries across the world. They have also varied over time. Cross-country variations were also reported by Sterner et al. (1992) for the OECD. In this scenario, an argument in favour of increasing domestic petroleum taxes in countries where prices are low may hold more water than the argument in favour of a global tax. The latter argument is better couched, therefore, in terms of global environmental needs than on the basis of low prices. Nevertheless, this does pose a moral hazard problem for a global carbon tax since countries which already have high tax rates may, to an extent justifiably, feel that the global tax be designed in such a way that they do not suffer inequities because of the tax.[8]

That is not impossible, however. The design could include the stipulation of a minimum global tax on countries. After paying the minimum to the global regulatory body, any country could be free to levy any tax rate for domestic purposes. If the minimum is set at an appropriately high level, the existing high tax countries could be expected to reduce their domestic rates. Those countries that have been taxing below the minimum, would have to increase their overall tax rates significantly, first, to meet the global payment and, second, to meet their own revenue needs.[9]

V. ISSUES IN INTERNATIONAL LAW AND TAX ADMINISTRATION

Whether it is a Tobin tax or a carbon tax or a congestion tax, the prerequisites to implementing a global tax include an international treaty or treaties and an international regulatory and administrative framework. Having dealt with Tobin tax related issues above, in this section we focus mainly on issues related to environment taxes.

A. International law and treaties

International treaty negotiations have reflected two conflicting norms of customary law: a state's sovereign right to

6. Their simulations show that the Btu tax would be between 25 per cent and several times higher than the least cost carbon tax for the same abatement. Despite the attractiveness of the Btu tax, therefore, in terms of revenue, it could not be justified on efficiency grounds.
7. He mentions the income tax, value added tax and customs duties. He even claims that, on balance, the carbon tax, compared to the others, would also have the least harmful effects on inflation and equity. Some of these claims may or may not be provable, but this is just to indicate that, among the analysts, there are indeed some extremely strong proponents of a global carbon tax.
8. These comments should alert the reader to the many practical issues that must be faced in designing the tax on a global scale.
9. If their domestic revenue needs do not change, then they would simply need to increase their tax effort by the global minimum tax.

exploit its own resources and its responsibility to ensure that damage is not caused to other states. The principle of international liability was developed in Article 22 of the 1972 Stockholm Declaration, sometimes manifesting itself in judgments against one country to compensate another for environmental damages. But the Convention on Long Range Transboundary Air Pollution of 1979 did not mandate abatement methods or any specific transboundary reductions in emissions. Since the UN Conference on the Human Environment, 1982, however, states are also assuming greater obligations to inform and consult neighbours before undertaking projects with possible wide ranging environmental ramifications.

Focusing on the atmosphere, the state-of-international treaty law on the atmosphere as opposed to oceans, is still rudimentary (Soroos, 1991). For example, despite scientific evidence of radioactive fallout from extensive atmospheric nuclear testing and a 1963 treaty against it, it has taken some countries much longer to move to underground testing. In matters of warfare, again environmental effects on the atmosphere have not so far been meaningfully recognized within the framework of international treaties.

It is true perhaps that matters with more immediate repercussions such as acid rain face a greater probability of success in finalizing international treaties than problems such as the greenhouse effect or ozone hole that are unlikely to cause immediate symptoms. Nevertheless, the 1987 Montreal Protocol did attempt to freeze the production of CFCs to 1986 levels while giving developing countries breathing space to conform to the norms over a longer period.

The few existing treaties could be said to comprise a limited first step to clean up the environment. Experience reveals that treaty negotiations are fraught with moral hazard in the guise of equity bargaining. Selected important developing countries with low pollution emission histories have arguably positioned themselves as having the right to exploit and pollute, to catch up on the development race, since they did not pollute earlier. On the other hand some developed countries argue that they should be compensated for reductions in pollution already achieved, for example through the introduction of catalytic converters for vehicles. Other states such as in Scandinavia, may feel that they may actually gain from global warming.

It is clear that there is an inertia to finalize international treaties on the environment to alleviate future environmental problems (Choucri and North, 1993); perhaps this reflects a perception that there are more immediate global problems to be addressed. While a global carbon tax will also have to be achieved through negotiations, it may be seen as a more directly interventionist yet complementary instrument that would perhaps work better in a case where the consequences are not as immediate as acid rain but are of a longer term nature, such as the greenhouse effect or the ozone hole. Nevertheless, it will require a fundamental transformation in the thinking on energy policies of major energy consuming states.

B. Administration and implementation

It has been suggested above that the global carbon tax or congestion tax on international transport (airlines and shipping lines) could be administered by country authorities and the revenues submitted to an international regulatory body which would also bear the responsibility of distributing the revenue. However, if a global tax such as a carbon tax is to be successfully implemented on a continuing basis, a global tax administration would be eventually needed. Tanzi (1988) mooted the idea of a global tax administration sometime ago. Thus it is not altogether a new idea. But the required commitment from nation states would be enormous since it would surely imply an intrinsic change in the ways in which governments of every political persuasion function, i.e. some sacrifice of individual country sovereignty for the sake of the global good.

Perhaps an international tax administration would be essential not least because of the possibilities of evasion. Many of the expected problem areas would parallel evasion problems associated with fuel excise taxes (Reno, 1990). Only, in this case, there would be no reason to thrust upon individual countries the responsibility to carry out the task for a global objective.

If the tax were not deftly designed, evasion could take various forms: (1) failure to file information, reports or returns; (2) "daisy chain" schemes involving the use of dummy companies that could claim to have paid the tax through a chain of complex paper transactions; (3) filing false exemptions by claiming to use non-taxed or lower taxed fuels; or (4) failure to pay taxes that have been already assessed or agreed upon by, say, setting up dummy corporations showing little assets.

The objectives of the global tax administration would, therefore, have to include: (1) improving regulations for screening, licensing and bonding of taxpaying entities; (2) introducing innovative measures such as exclusive fuel coloration; (3) enforcing procedures such as fuel purchase invoice requirements; (4) developing a mechanism for and carrying out selective audits; (5) establishing and practising modes of interagency cooperation; and (6) enforcing criminal penalties.

As country finances get inextricably interrelated, with increasing transboundary tax incidence effects often necessitating intercountry cooperation on tax and tax evasion matters, perhaps the need for a global tax administration, rather than a continuance of exclusive dependence on bilateral tax treaties, also increases. While this has obvious pecuniary and opportunity costs; higher expenditure of global monies and another international bureaucracy, its benefits may compensate the costs. Existing multilateral institutions whose mandates comprise mainly international monetary stabilization perhaps should not be burdened with additional tasks given the phenomenal increase in the complexities in world financial markets. A new, autonomous and streamlined global tax administration would, therefore, deserve serious consideration.

VI. CONCLUDING REMARKS

This paper explored the possibility of introducing a global environment tax, the revenue from which could be used for addressing global objectives such as poverty alleviation, environmental improvement, or space exploration, or could be shared among countries for their individual objectives, given that important revenue bases such as capital income or professional labour income might dwindle in the next century. It considered a global tax on carbon emissions and a tax on congestion caused by international transport. These have a double dividend, they not only generate revenue but also correct distortions by internalizing disexternalities.

A global carbon tax, with a minimum contribution, could conceivably be introduced without all countries having to experience the same increase in cost right from the start. Nevertheless, the successful implementation of the tax would eventually require the services of a well trained global tax administration corps. The need for such a corps should be felt, in any event, as world financial markets get increasingly integrated through transboundary tax effects. The idea of an autonomous international tax institution has, perhaps finally arrived on the world's international tax stage!

APPENDIX A

$$1.\quad Y_t = C_t + I_t$$

$$2.\quad I_t^\circ = I_t(L_t, K_t, F_t^\circ)$$

$$3.\quad C_t^\circ = C_t(L_t, K_t, F_t^\circ)$$

$$4.\quad C_{t+1} = f^c + C_t$$

$$5.\quad I_{t+1} = f^i + I_t$$

$$6.\quad L_t = \overline{L_t}$$

$$7.\quad K_t = \overline{K_t} = I_{t-1}$$

$$8.\quad F_t = \overline{F_t}(f^c, f^i)$$

We have a world economy in two periods, present (t) and future (t+1) with a global factor (F) that can constrain world production of consumption goods (C) and investment goods (I) by limiting the productivity of ordinary factors of production, say labour (L) and capital (K). This is depicted in equations 1, 2 and 3. In Diagram 1, the transformation curve EF in period t is not limited by any constraint posed by F, and solely reflects the given endowments of labour and capital in equations 6 and 7.

Assuming that the world is interested in leaving an adequate bequest, it prefers to consume a minimum, OB, in period t. Then OA is the investment good produced.[10] Combined with $\boxed{\overline{L_{t+1}}}$, it yields the transformation curve GH in period (t+1), if unconstrained by F. The community indifference curve UU' determines J as the equilibrium production-consumption combination.

Given Q and J, quadrilateral ABCD is the equilibrium production-consumption configuration for current and future generations.

The constraining influence of F would appear, however, if the production of C_t and I_t ignored, say, environmental factors. This would not show up in the production in period t but would constrain production in period (t+1). This is depicted in equations 4 and 5 which are simple specifications, to facilitate the diagrammatic schema. A more general specification could be equations 4' and 5':

$$4'.\quad [I_t^\circ > I_t^* \;/\; C_t^\circ = C_t^*] \leftrightarrow F_t^\circ > F_t^*$$

$$5'.\quad [C_t^\circ > C_t^* \;/\; I_t^* = I_t^*] \leftrightarrow F_t^\circ > F_t^*$$

which indicate that the production of the investment good or consumption good will increase[11] (the production of the other remaining the same) if and only if, F, the constraining factor increases.[12]

10. OB plus OA yields Y_t at normalized prices.

11. The increase being referred to would be from a constrained equilibrium in period (t+1), such as J' in Diagram 2.

12. F_t could be seen to work in a three-pronged manner: (1) a "fixed endowment" of F_t is determined by f^c and f^i which, in turn, are determined by the previous period's environmental policies; (2) a greater availability of F_{t+1} implies that more I_t can be brought into the production process as a factor of production, thus they are complimentary; and (3) while L_t and K_t are substitutable in the production of I_t and C_t, F_t is not.

Diagram 1

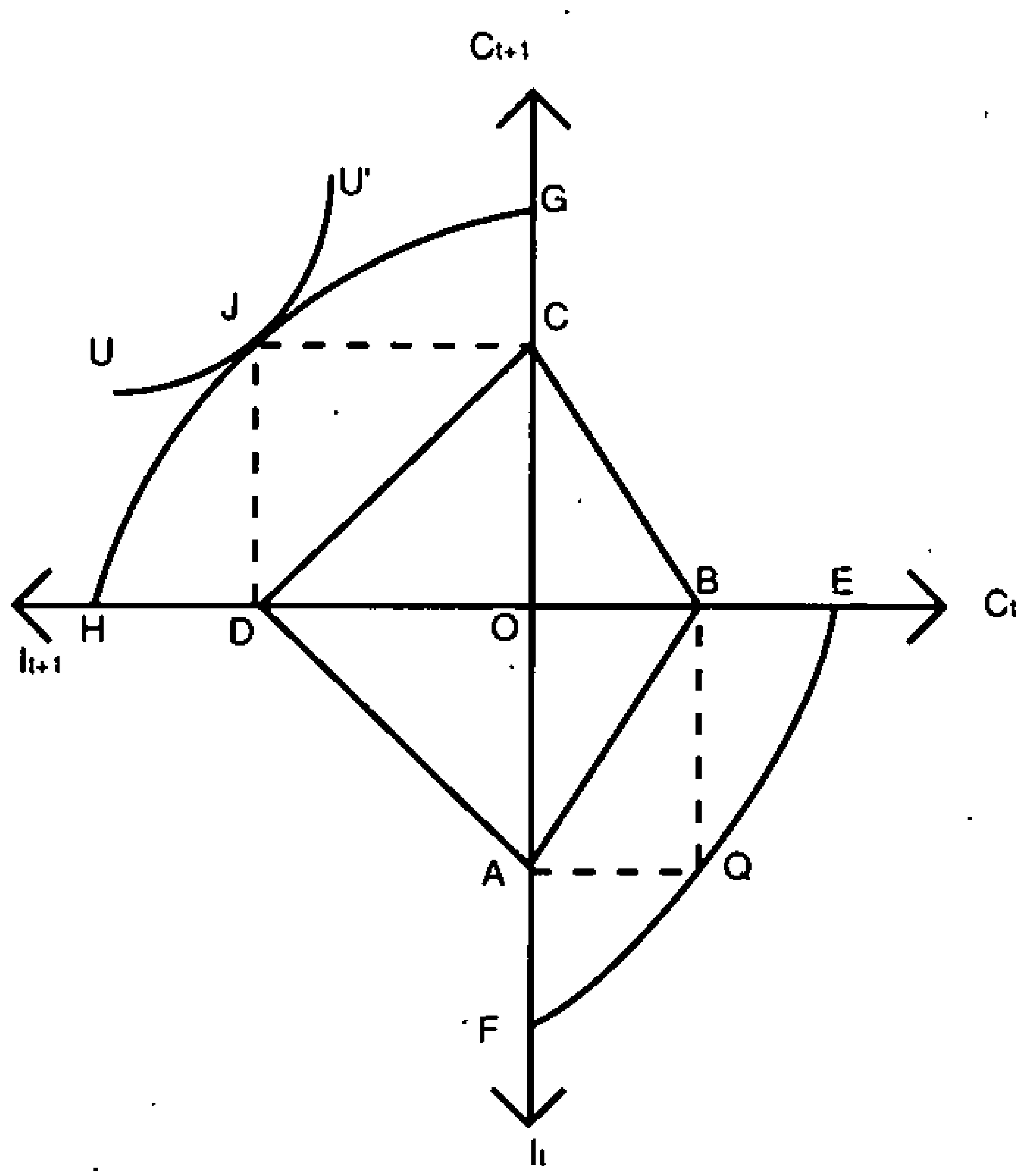


Diagram 2

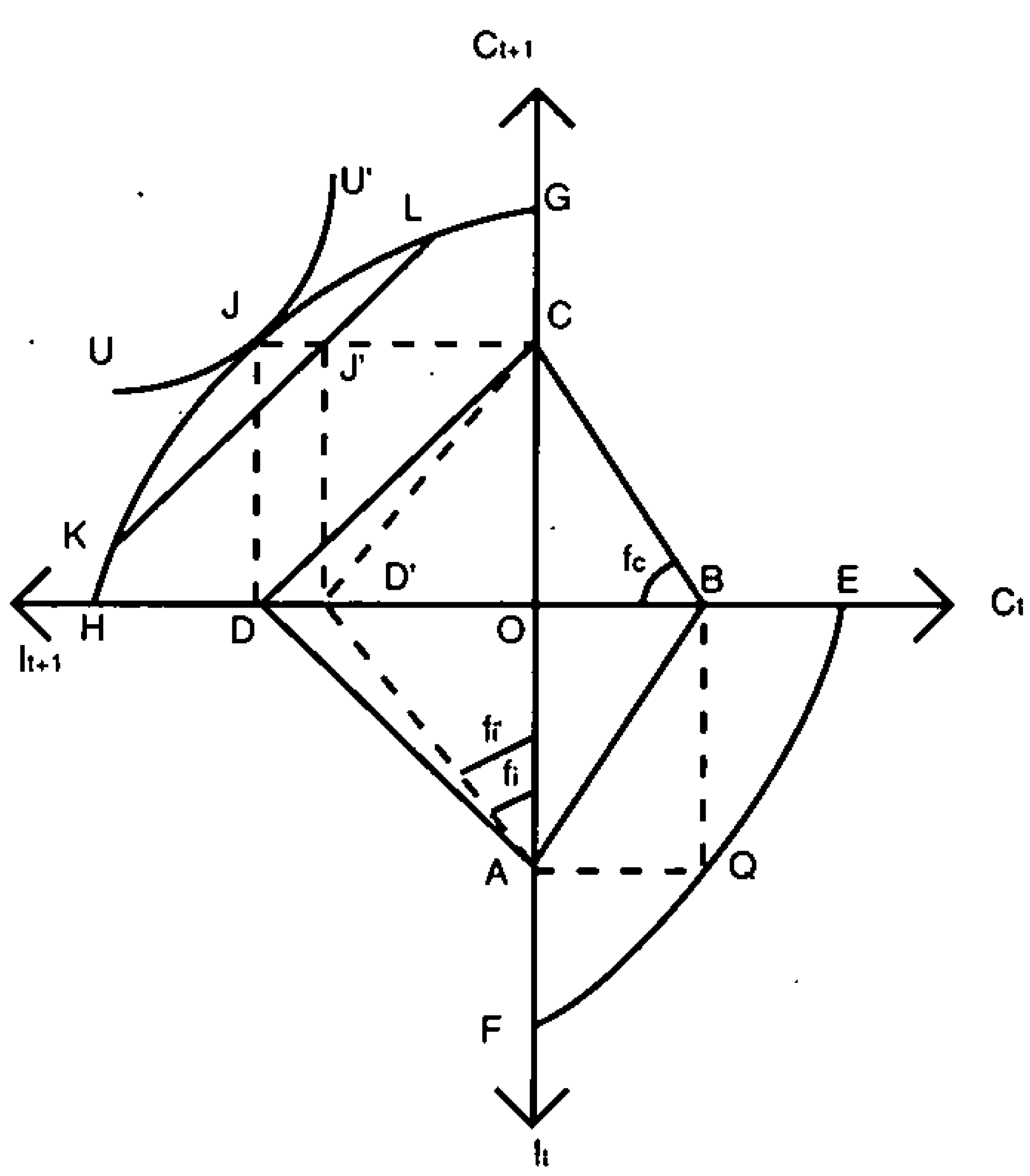
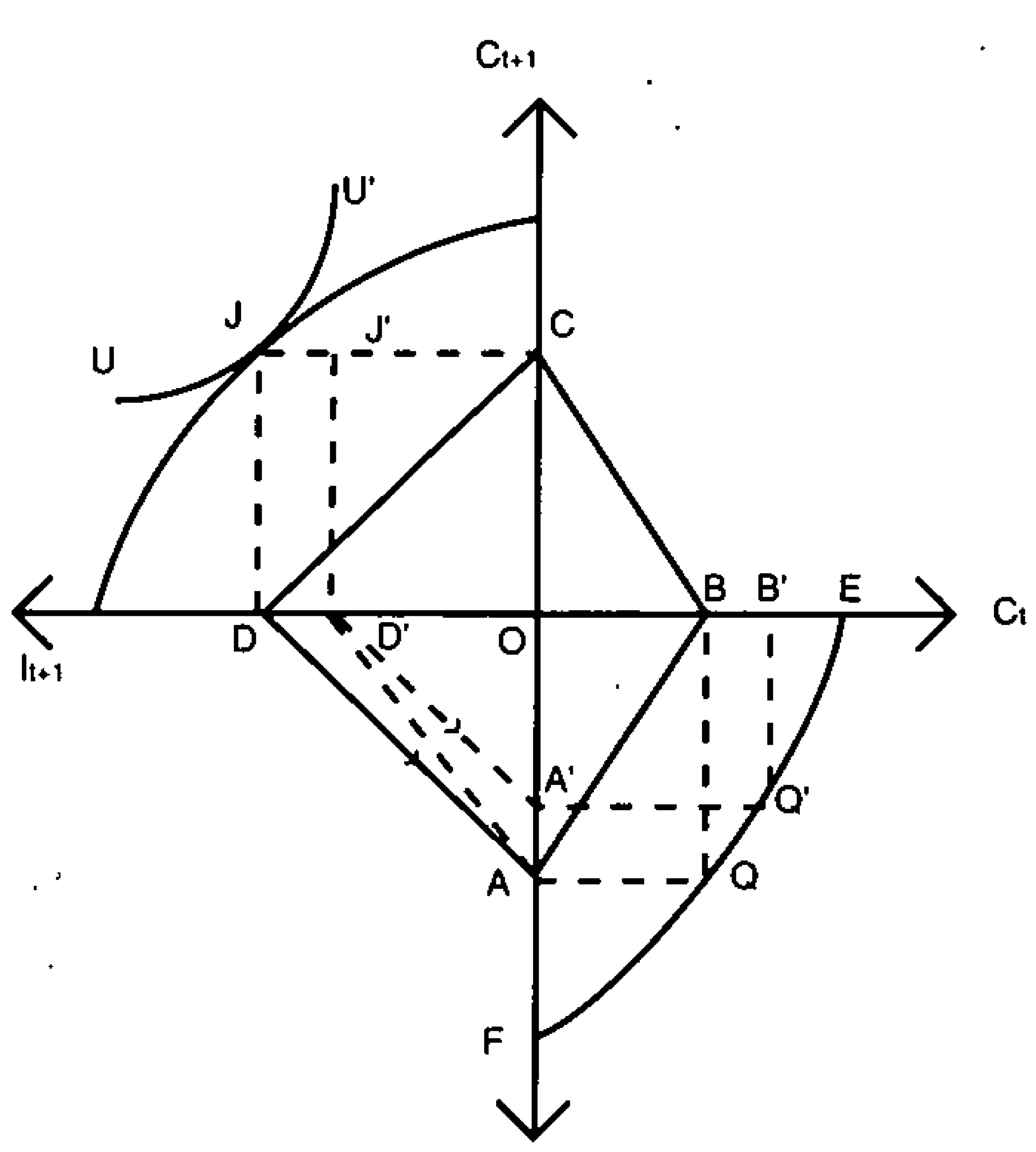


Diagram 3



Using the more restrictive formulation in equations 4 and 5, Diagram 2 shows the impact of environmental degradation on period (t+1) production. Determined by f^c and f^i, factor F (see equation 8) constrains production in period (t+1) to J' which lies within GH. As long as there is environmental degradation in period t, different combinations of f^c and f^i would constrain production in period (t+1) and comprise a binding constraint such as KL in period (t+1).

A reduced quadrilateral such as ABCD' results if, for example, in period t, the capital goods industry causes environmental degradation (i.e. $f^{i'}$ less than f^i)with detrimental consequences on its production in period (t+1).

Diagram 3 illustrates the backward implications of J' for period t if factor F had not been depleted (i.e. $f^{i'} = f^i$): more consumption good OB' may as well have been consumed and less investment good OA' produced. The generation of period t unwittingly sacrificed consumption BB' without receiving the anticipated results in period (t+1).

To sum up: (1) the F constraint (environmental degradation) results in a reduced Y_{t+1}; (2) the maximum possible investment (and minimum consumption) need not be opted for in period t; and (3) the reduced Y_{t+1} results in factor unemployment in period (t+1).

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THE TAX BASE

CHANGING THE TAX BASE

MOVING FROM A TAX ON YIELDS TO A TAX ON THE USE OF THE FACTORS OF PRODUCTION

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I. AN OVERHAUL OF THE TAX SYSTEM IS NECESSARY

The Member States of the European Union have, for the most part,[1] tax systems which conform to international norms: on the one hand, general taxes and specific taxes such as turnover (value added) tax and excises are levied on consumption; on the other hand, the yields from participation in the economic process are taxed, as is the end result of that process.

In the abstract, participation in the economic process consists in the contribution of capital, in whatever form, and in the supply of labour. Income tax is imposed on the yields from capital – interest, dividends and so on – in the hands of the person who contributed the capital; in addition, in approximately half of the EU Member States, net wealth tax, in reality an additional income tax, is levied on the capital itself. Income tax is also levied on wages, often by means of a wages tax which the employer withholds from the pay cheque and which forms a prepayment of tax; this prepayment is, however, sometimes the final levy of income tax.

A separate profits tax for legal persons is imposed on that part of the results of the economic process called profits and which is the end result of the cooperation between the production factors capital and labour. For natural persons, the taxation of profits is included in the income tax. In short, tax is levied on the yields of the production factors capital and labour and also on the combination of the two.

During the nineteenth century, most of the countries in the present European Union struggled, first on scientific grounds and later on political ones, with the problem of how to bring the tax system, having its origin in the principles of classical liberal economics, into better alignment with the ability-to-pay principle, and in particular, how the distorted distribution of the tax burden between rich and poor could be mitigated. Profits and income from capital were hardly taxed at all, while the taxation of the consumption of luxury goods did not outweigh the relatively heavy burden of excise taxes on the lower income groups.

For some people, social ethics was the motivating factor in attempting to achieve a more equitable distribution of the tax burden; others felt the labour movement breathing down their necks and hoped to avert riots and protest movements; yet others argued coolly that such a heavy burden on the primary necessities of life pushed wages upward, which in turn was bad for the economy. Together, these factors led a number of countries to lower the rates of excise taxes and occasionally to do away with them altogether. This was often combined with, or followed by, the introduction of taxes on income, profits and wealth; in the following article, I would like to call such taxes surplus taxes. During the nineteenth century surplus taxes developed gradually in Europe and in the early years of the twentieth century in other countries as well. In the past century they have become increasingly widespread and fine-tuned.

Whether a tax system that was meant to solve the fiscal apportionment problems of more than a century ago, and which has been partially successful in doing so, can still fulfil the requirements of the twenty-first century is an open question, and there are two approaches that can be taken in answering it. On the one hand, one has to consider whether the surplus taxes are obsolete,[2] i.e. whether new problems have arisen, which undermine the surplus taxes and if so what kind of new system would offer the best way of solving them. On the other hand, it is worthwhile examining whether surplus taxes may still play a key role.

The obsolescence of surplus taxes is the result of a number of factors. The demand for increased government spending and the transition to the modern welfare state has led to an increase in tax rates. This has necessitated a more precise definition of taxability versus non-taxability as well as of the size of the taxable base. The result has been an increasingly complex tax law. The strong growth of the economy and the intensified internationalization were contributing factors. An additional factor was that many reform-minded people believed that all of society's evils could be eradicated by means of the first aid measures of taxation. This rather naive, and by now outdated, tax philosophy has helped to further dismantle tax law in general and the surplus taxes in particular. The primary goal of taxation – revenue for the treasury –

1. I.e. they have the same kind of tax system found in numerous other countries.
2. Or as a former Minister of Finance once said to me: "income taxes have suffered from burn out".

has been increasingly obscured by secondary aims that have almost always been geared to special interest groups. Not only have such secondary goals led to more complexity and thereby to less efficiency, they have also resulted in less tax equity, which means that differences in the tax burden do not follow tax apportionment principles.

A secondary goal that has been pursued during the twentieth century in particular is the redistribution of income by means of highly progressive rates for wages and income tax. If and to the extent that taxpayers succeed in shifting the burden of taxation on wages, profit and other income (the consequence of the (inter)play of wages and prices) to other participants in the game, the redistributive income-policy-goals of the tax legislator will get short shrift. The extent to which such a shift occurs at a micro-level is one of the veils that econometrists have not yet been able to pierce, but that such a shift does occur is incontestable. The lofty ideal of distributing wealth more equitably among citizens by means of progressive income tax rates will then be no more than a dream and insofar as is the case society will be left holding the baby in the form of an inflated, but loose, rate structure.

One invisible killjoy which can go unchecked particularly in a complex tax system is the fraud that occurs at all levels of society, and which to a large extent may be seen as a sign of discontent and powerlessness on the part of the state's citizens.

The bankruptcy of the system of surplus taxes found at present in most of the EU Member States cannot be expressed better than in the words of the German president Roman Herzog in an interview on New Year's Eve 1995, published by Bild am Sonntag, in which he attacked tax evaders, but in which he also remarked: "The tax system is still quite incomprehensible. [....] In my opinion we are dealing with a basic question of how to view the state. We depend on citizens to voluntarily gather information about the legal order for themselves. But, to be able to do this, citizens need to know what the legal order expects of them. There is no point in sending them to an attorney or tax consultant to find out what to do and what not to do." (author's translation)

Another issue altogether is whether the problem of the redistribution of the tax burden, which was such a hot item a hundred years ago and which led to the system of surplus taxes, still exists as it did then, whether it exists at all any more or whether it has been replaced by other problems, and whether these necessitate a particular tax system.

In answering these questions, the first thing that comes to mind is that the problem of redistributing the tax burden has taken on a totally new dimension because, on the one hand, the standard of living has increased spectacularly, an increase that in addition has been spread among the citizens more evenly than it was, and, on the other hand, because the tax burden itself has increased a great deal.

I am willing to put forward the proposition that as a result of all of these factors the problem of the distribution of the tax burden between rich and poor has largely lost its importance. To a great extent, the increase in the standard of living has precipitated in collective spending, such as spending for social services, education and improvement of the infrastructure. This benefits the entire population, but society also pays for it in the form of highly increased taxes and premiums. A specific phenomenon should also be mentioned and that is the tremendous increase in the factor of labour in the national income. I will return to this point later.

Other problems have nevertheless appeared on the horizon which we have only become aware of in the past decades. I make mention of the fact that production has in many cases had negative external effects, such as environmental damage and/or the depletion of scarce natural resources, effects which have become more and more onerous and for which the market mechanism in many cases does not offer a solution. Sometimes it is possible to limit the amount of damage by means of agreements between business and government or to recover damages by means of a system of – possibly marketable – permits. In other situations compensation for the damage could be obtained through taxation. I do not see what objections could be raised to this from a tax point of view.

In order to clarify this last statement, I would like to digress by briefly examining the principles of taxation. Two concepts obtrude in taxation and have always done so, viz. on the one hand, the benefits a taxpayer receives from government programmes and, on the other hand, the ability to pay, or the taxpayer's financial capacity. In addition to the benefit and ability-to-pay principles, a third concept is emerging. I would like to call it the principle of damage. This means when a person causes damage through his participation in the production process such damage is a ground for the imposition of tax. The popular expression "the polluter pays" gives a flawless description of the principle. Environmental damage, depletion of scarce natural resources, etc. come to mind. The benefit, ability-to-pay and damage principles will sometimes complement each other and sometimes conflict so that political decisions will be decisive in establishing the order of precedence of the principles.

The assumption underlying the three principles is that the tax system should be neutral. This means that the parameters for choice in the economy should be influenced as little as possible by taxation and that taxes will affect the supply and demand for goods and services and the production factors capital and labour in the same proportion. There is no reason, however, not to use the tax system to achieve broad economic and social goals, as long as the tax instruments can be utilized effectively and efficiently. Such macro-goals include stimulating economic growth, preventing economic fluctuations (industrial or trade), as well as reducing differences in the level of the standard of living and influencing consumer spending.

The problems comprised by the general term "environment" also play a role. The world we live in, and the earth we live on, is characterized, on the one hand, by globalization – faster methods of transportation, so that every part of the world has come as it were within our hands, an enormous increase in communication, more and more regional and international cooperation among states – and, on the other hand, by serious worldwide problems, such as the overpopulation in many and increasingly larger areas, the impending depletion of essential natural resources, water-supply problems, pollution, acid rain, desertification, and other disasters which threaten the natural environment. The tax system should be structured in such a way that wherever possible consideration is given to these problems, or that at least the beginnings of a solution can be sought. The principle of damage will thus have to play a larger role in tax law.

One should not have terribly high expectations of what can be achieved by means of a different tax system. Consumer spending patterns are not easily influenced by taxing certain kinds of expenditures. It appears, however, that in the long run and in combination with educational campaigns, incentives in fact do have some effect on spending. The taxation of production is more focused and is therefore more likely to succeed if the intention is to curb undesirable production. This will be the case in particular when the tax is directed at the input (means) instead of the output (result), under the motto "an ounce of prevention is better than a pound of cure". Especially in the long term the shift in the factors of supply and demand resulting from such a tax can lead to a search for other less damaging or less polluting production methods.

Although it is necessary to be rather cautious when introducing a tax measure, this does not absolve us from the duty of considering whether it is possible to design the basic structure of tax law in such a way that it incorporates the damage principle better and does more justice to the role it plays in the production of goods and services.

II. THE BUSINESS TAX ON LABOUR AND CAPITAL (BTLC)

Although it is possible to think up many ways to tax the means of production, I would like to limit this discussion to one specific tax which I have named the "business tax on labour and capital" (BTLC) and which would replace the present system of income and corporate tax used by the Member States of the European Union.

The BTLC is a tax on the use of the scarce production factors capital and labour. The legal basis is that a person who uses such scarce production factors in order to participate in the production process should contribute to the costs of government, costs which after all aim to a large extent at ensuring the smooth functioning of that process. "Production" should be viewed broadly, so that institutions that are associated with the government will also fall under the BTLC. For this reason I have chosen to use the term "business", which means an independent organization of labour and capital, with as its goal economic production, although profit-seeking is not required. By "labour" I mean the total amount that is paid in cash or in kind in the employer-employee relationship. "Capital" is the sum of the business' own capital and interest-bearing borrowed capital, less domestic participations and interest-bearing placements.

There are two important differences between the BTLC and present-day surplus taxes. First, natural persons would no longer have to pay income tax on wages, interest, dividends, etc. The taxable object remains unchanged, but the taxpayers are different, viz. businesses. It goes without saying that shifting taxation from the citizenry to businesses will result in a decrease in the level of wages: tax-free remuneration in the new system will be the same as net remuneration in the old system. This is not as big a difference as one might think because natural persons usually think in terms of "net".

For the individual taxpayer what is generally important is that they will be relieved of the administrative red tape that is connected with filing a tax return. For that matter, most taxpayers in countries having an analytical income tax system do not have to deal with such red tape.

The differences are much more far-reaching for businesses, and especially for the most important category of business, the enterprise. In the BTLC surplus, or what is generally called "profits", is replaced as the grounds for the levy of tax by a different measure, viz. how much a business has used of the scarce production factors capital and labour. In the existing profits taxes in the EU Member States, it is generally the rule that the more frugally capital and labour are used, the *more* tax must be paid; in the BTLC this would become: the *less* tax is due. For a businessman the adage "profits maximization results in tax maximization" at present leads to tax schizophrenia, and especially when the rates are in double-figure percentages. The present system allows bad businessmen to keep their heads above water longer. It would be a blessing for society if such businessmen were to go bankrupt. Under the BTLC it will not be as easy to use the tax system (read as: other taxpayers) as a means of subsidising old inefficient enterprises. Other advantages are that the choice of a legal structure will no longer be influenced by tax considerations and that the double taxation of dividends will be a thing of the past.

Thus, from an economic point of view the BTLC is an attractive tax since it encourages the frugal use of scarce factors of production. Once such a system is introduced it will be possible by changing its parameters to influence the relationship between the taxation of capital and labour and to influence the relationship between the various tax bases within the factors of production. I would also like to mention the possibility of lowering the BTLC rates and increasing the VAT rates, in other words of shifting the emphasis in taxation from production to consumption.

In addition to affording such a general economic steering mechanism, the BTLC allows the damage principle to be applied better than in the present surplus taxes. Once the BTLC is in place, production processes that harm the environment can be taxed more heavily simply by changing the rates. Regulatory side effects will also become more visible. Because the BTLC directly affects the production of goods and services, it is more suitable than the present-day system to influence supply and demand. To put this in perspective, it should be noted that policy makers need to realize that in a free and open economy tax measures have only a small impact and that their influence will usually only be felt in the long term through a change in consumption patterns or through the adaptation of production methods.

III. TOWARD THE BTLC IN TWO STEPS

It is easier to think up a new tax than to describe how to set up a new tax system without disrupting the economy. Given the fact that it is closely linked to other parts of society, a tax system can only be reconstructed with care, in small steps, over a number of years. I would first like to examine how the BTLC could replace the present-day income tax, with its satellite withholding taxes on wages, interest and dividends. I will then go on to demonstrate how the BTLC can replace taxes on the profits of natural and legal persons.

It seems to me that a trend can be seen in Europe to move from a synthetic to an analytical income tax system; thus, to move from an income tax system under which all the income from various sources is aggregated and then taxed at progressive rates after deduction of certain personal expenses toward a tax whereby the tax rates per source are generally proportional, although not necessarily the same. The importance of this trend is that the step from an analytical income tax to a BTLC is a small one. A synthetic system is more refined and more sophisticated, but does not make good on the claim that it reflects the ability to pay, or even that it contributes to the redistribution of wealth. In contrast, an analytical system is simpler and takes a more general approach to the ability-to-pay principle.

What is the basis for my opinion that the synthetic tax system will be superseded by an analytic one? I am even willing to go a step further and posit that the European Union will act as a catalyst in this process of change. My expectations are based on the following: the Economic and Monetary Union appears to be now getting off the ground,[3] even though there are still thousands of problems to be solved, one of which is the likelihood that the EMU will be delayed. The EMU will lead to quite an increase in the mobility of capital, which is in line with the goals that were formulated in the Treaty of Rome.

Diametrically opposed to these aims, however, is the fact that tax considerations (partially) dictate the movement of capital. The reason for this, in particular, is the separate treatment of income related to the production factor capital; the net wealth tax also plays a role, since it is an additional income tax. As the EMU takes shape, the classical instruments with which countries do battle in order to influence capital movements, such as setting discount and exchange rates, will decrease in importance and may disappear altogether. Therefore the influence of tax measures will increase. Thus, I think it not unlikely that competition considerations will lead the Member States to move to an enlightened tax regime for the factor capital, unless they already have a regime like Belgium and some of the Scandinavian countries. The simplest way to give a tax relief for the factor capital is to imbed it in an analytic system, such as the kind France and Belgium have generally had, or in a system that resembles an analytic system, like the dual income tax systems of the Scandinavian countries; briefly, under the latter systems income derived from the factor capital is taxed at a single and thus proportional rate which is equal to the lowest rate for income from labour.

In the long run, the necessity for tax-neutral capital mobility within the European Union will force its members to harmonize the taxation of natural and legal persons, both with respect to wealth and to income from capital. Therefore, in my opinion, it is not inconceivable that within a couple of decades the Member States will have a split income tax, whereby the yields from the factors of production of capital and labour will be taxed separately, but proportionally. In those countries where it still exists, the net wealth tax will disappear for lack of reasonable, and for taxpayers comprehensible, grounds.

As mentioned above, the logical consequence of the enormous rise in the standard of living in the European Union in the course of this century, an increase which, in addition, has been spread more equitably through society, and of the huge increase in the tax burden is that progressivity in the rates of income tax has become less important.

Because the "wages" element in the national income of almost all of the Member States has become a factor of overriding significance, the income tax on wages has become the most important component in income taxation. There is a tendency to make the rate of the withholding tax (wages tax) more and more proportional. This assumption seems to be less valid for the lower income categories. Nevertheless, the state can influence these categories by means of social benefits and other facilities. The move towards a guaranteed system of social security could make a proportional rate more acceptable to these income groups.

I would like to reinforce the above by pointing out some trends that I think can be seen on a national as well as international level and which certainly will not fail to have an effect on taxation. The standard of living is rising, both in monetary terms and perhaps even more in terms of leisure time. At the same time, solidarity between citizens is decreasing, not only because wealth is more difficult to distribute than poverty but also because a consumer society does not encourage solidarity. In any case, the aging of the population will lead to an increase in the tax burden. The tendency toward proportionality in the income tax rates that already exists will be intensified by these factors.

A less interventionist government will not only have to give up its mercantilistic role in favour of market forces, but will also have to give its individualistically oriented citizens more room. Along with the introduction of a guaranteed system of social security, tax-free allowances and a number of deductions and exemptions are likely to be abolished. Even now, it is difficult to see why expenditures that are voluntary or which can be insured against should be deductible. Social benefits will increasingly be paid on a net basis, and thus tax-free, as is sometimes already the case.

If my expectations with respect to these trends are fulfilled, a drastic simplification of the income concept, a broadening of the taxable base – which opens the possibility of a substantial decrease in the tax rate – will result and will be part of the move towards a proportional rate structure, in which separate

3. Admittedly in fits and starts!

rates apply to the various sources of income. In point of fact, there can then be said to be an analytic income tax. Germany has had plans to reform its income tax for a number of years, whereby, following the lead of the United States and the United Kingdom, rates would be decreased and deductions would be totally or partially abolished. It would appear that the Kohl government at present wants to push through these changes. In the Netherlands political discussion is moving in the same direction. As a sign of the times, I should mention that Steve Forbes, the (then) American presidential candidate, called some months ago for a flat rate income tax of 17 per cent, a position that was supported by scientific analysis.

To move from an analytical income tax system to a BTLC is not difficult in theory. With the exception of owning a home, only a very small part of the taxable income of natural persons is derived from the non-business sector: a nephew who borrows money from his aunt or a neighbour who does the odd job for money, etc. But in the vast majority of cases personal income is derived from business. The BTLC means that the levy of tax is shifted from the person who receives income to the person who pays it. This will not affect their mutual relationship; all they have to do is to adjust their financial agreement once in order to conform to the changed tax situation. This is an enormous operation, but no worse than when the transition was made from a normal turnover tax to the VAT system. In any case, it is not an operation that would be unworkable for economic reasons. What formerly was called after-tax earnings would become gross pay.

Carrying out an operation like this will be more complicated for the production factor capital, because there are different levels of remuneration for a business' own capital and its borrowed capital that relate to the differences in risk profile. Since both forms can be brought under the heading "business capital", taxation will no longer affect the choice of one or the other for financing, which is a plus point. Here, a phased-in introduction will undoubtedly be necessary.

IV. THE BTLC AS AN EU TAX

The European Union, like its Member Countries, has its own specific taxation problems. The resources at its disposal (customs duties, agricultural duties, VAT payments and GNP contributions) are by no means sufficient to cover the growth of existing projects and to pay for new tasks in the future. The accession of a large number of new, mostly Eastern European, members will make extra funds necessary in order to bring the weak economies of those countries in line with the economies of existing members. However, in the long run if the Union has more own resources and expenditures the cohesion between the members will be strengthened, something that is urgently needed if one thinks of the economic, and possibly political, threat of the very expansive Asiatic tigers, with China at the fore. The increased number of members will force the decision-making structure of the Union to move in the direction of majority decision-making particularly with respect to raising additional resources (read: taxation).

A totally new tax, which does not yet exist in the Member States, and which does not have the disadvantage of creating almost insoluble conflicts with existing taxes in the Member States, would be the best way for the Union to get more funds of its own. Such a tax would have to reflect the ability to pay of the Member States. The BTLC could be such a tax. After all, capital and labour is a strong indicator of the strength of the economies of the Member States.

In practical terms, I can imagine that an EU BTLC would look something like the following. The Union would decide on how to define labour and capital and on the tax rate, but would entrust the tax administrations of the Member States with assessing and collecting the tax on its behalf, on the understanding that control would be in the hands of the Union itself. The Court of Auditors of the European Union could be used for that control and could employ the services of the large international accountants as sub-contractors.

Is it not fairly self-evident that once the BTLC is introduced as a European tax, the Member States would make use of it by imposing a surcharge on the BTLC? The extra yield generated in this way could be used to achieve a gradual decrease in the Member States' own surplus taxes, and in particular in the taxation of income and profits. As I explained above, I expect that income taxation in the Member States will move in the direction of an analytical system whereby labour will be taxed proportionately. The replacement of income tax by the BTLC is therefore not really a problem.

The taxation of profits is a different matter altogether. If my proposition holds that the BTLC is better from an economic point of view than existing taxes on the profits of natural and legal persons because it stimulates a frugal use of capital and labour, is it not probable that the Member States will seize the opportunity to gradually reduce their own profits taxation and to replace it by a BTLC surcharge?

In the above, I have argued that the BTLC, once in place, offers better opportunities to link economic policy to the tax structure and that, in particular, it is better suited to be used when applying the damage principle. I have no doubt that this is more of a European (if not a worldwide) concern than a national one and that if taxation by means of the BTLC can make a modest contribution to the improvement of the environment, the opportunity to do so should be seized.

Of course, such a scenario will entail a substantial loss of sovereignty for the Member States in the field of taxation. To those who do not believe this is possible I ask whether, in light of the challenges that face us in the coming decades, Europe can afford to stay on the sidelines.

V. CONCLUSION

There are many unsolved questions with respect to the BTLC. What, for example, should be done with government remunerations for capital and labour? The only answer is that the government itself should not fall under the BTLC and that the remunerations it pays should be tax-free. Obviously, this will only be possible if the remuneration levels are decreased by the amount of tax saved. It goes without saying that the term "government" will have to be defined narrowly so that only those institutions which are funded directly or indirectly through taxes will come within its scope.

Other questions arise as to the position of the businessman-owner, as well as about the treatment of income from wages and capital which is not derived from a business but from relations between private persons and, finally, with respect to the position of the home owner. However, it is possible to find solutions to these problems, for example, deemed remuneration for the labour of the businessman-owner, a net wealth tax on private investment at the same rate as the BTLC – which I have called the Net Wealth Tax 2000 ("NWT 2000") – and exempting from tax labour that is not performed in an employment situation, but for which the remuneration level will be lower as well.

Because the tax treatment of home ownership is a political hot potato, I would like to discuss this issue in more detail. I believe that one should not overwhelm home owners at short notice by an abrupt change in the regime on which they based their tax expectations at the time they bought their homes. One option would be to have home ownership fall under the NWT 2000, so that the present tax benefits that exist for home owners as opposed to renters in some Member States could be reduced.

I hope that this article has fulfilled the promise of its title. I am aware in any case that because of space constraints I may have raised more questions than I have been able to answer. Even if the ideas I have put forward find support in scientific and political circles, it will be many years before the taxation of the use of the factors of production replaces the taxation of the yields of such factors. That such changes may take a considerable period of time has not hindered me from attempting to visualize the way the tax system will look in the coming century.

ANTI-AVOIDANCE

AUDITS, DIGITIZATION AND GLOBALIZATION

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I. INTRODUCTION

In order to achieve an equitable levying of taxes, the tax administration should possess or have access to all data which might affect a taxpayer's liability to tax. Most of the relevant information concerning firms and individual taxpayers is to be found in their books and records. However, these books and records are not always located at the site were the business is carried out. This observation applies in particular to multinational corporations which may have production facilities all over the world and whose books can be kept almost anywhere. Local tax administrations therefore have great difficulty in following the audit trails of these entities. Moreover, tax administrations that operate on a national scale not only have to cope with this trend towards worldwide operations, other developments also increasingly play a determining role. One of these developments is referred to in the title: digitization.

II. INTERNATIONALIZATION

As has been said, the first major development which affects the levying of taxes these days is the increasing internationalization of business. Firms which operate in a particular country, not only multinational companies, but also quite ordinary firms, no longer consider national boundaries to constitute obstacles to their activities.

The inception and implementation of the European Union (EU) and the consequent elimination of national borders is only one of the causes of this trend. Closer contacts have since been established with previous member states of the Comecon. In the Far East not only economic "dragons", but also "tigers" make their voices heard. And direct trading with these far away countries is an "on line" reality and in some cases a necessity 24 hours a day. Digitization and the development of information technology have effectively eradicated borders. Distances are no longer very important to good communications. Not only firms but individuals too are more mobile than ever before.

In accordance with their business philosophy multinational companies seek to achieve an efficient set up of their organization with the world as their playing field. Headquarters, production facilities and distribution centres are being established in various countries. Management, operations and as a consequence the levying of taxes becomes a game without borders and perhaps boundaries. Good management requires in most cases advanced automation which has gradually become the lifeblood of the corporation. Companies thus become increasingly dependent upon automation and electronic link-ups.

III. DIGITIZATION

This brings us to the second major development that influences the levying of taxes: digitization. This phenomenon has crept into our society and our daily life almost without being noticed. Credit cards and other smart cards have become almost synonymous with cash. The average citizen of the world has become quickly accustomed to these new developments, although some take more time to adapt than others. Notwithstanding this it may indeed turn out that not everyone wants or will be able to adjust or accept digitization, because of his or her age, mental or personal development or cultural background. Society is dividing itself into two parts: those "digi-literates" and "digi-illiterates". Just like society as a whole, tax departments are also being confronted with the ongoing process of digitization. To what extent does a tax administration have to follow and adopt to this development? What will the citizen and society still accept and what not? What files and databases can be linked up? What constitutes an infringement of the privacy of individuals and when are limits overstepped? Does digitalization imply an increase in fiscal disobedience? Will tax fraud, which we try to combat with digitization, actually be promoted or facilitated by it? These questions are easy to raise, but very hard to answer.

IV. DIGITIZATION AND THE LAW

Digitization in business and industry may result in tensions between practice and the law. I refer to the application of EDI (electronic data interchange) which has made the paper invoice superfluous. In some countries this immediately caused problems, because the law requires numbered and dated invoices. Legislatures will have to find solutions for such problems. It is to be expected that the increase in digitization will have a profound effect on both the application and content of laws and regulations.

V. TAX AUDITING

A. The new environment

Digitization and globalization thus indisputably have implications for tax auditing. In the early years of automation not only the chartered accountant, but also the tax auditor occasionally ignored the computer and were thus engaged in "auditing around the computer". In the past this was possible because only parts of the accounting system had been digitized. Important parts of the accounts were still recorded and printed on paper. But at the present level of information technology such an approach is no longer acceptable.

It is clear that a tax auditor who is not literate in computer auditing techniques, will not be able to carry out a thorough investigation in companies that have adopted EDI or operate at a high level of automation.

Indeed the tax auditor is increasingly being confronted with data which are only recorded on electronically accessible data carriers (diskettes, tapes, hard discs, WORM-discs etc.) Only selected information will be printed on paper. Thus the tax auditor has to verify if, and to what extent he can or may use in his investigation data which have been recorded electronically.

Also the audit itself has changed as a result of digitization. The more advanced the application of automation is in a company, the greater is the need of the tax auditor to make a judgement on the reliability of the structure and functioning of computerized information systems. The auditing mix will show an increase in the proportion of organization-oriented measures and a decreasing number of data-oriented procedures. In other words the auditing approach shifts from substantive to organization-oriented.

B. EDP auditor

The advances of computerization in the areas of accounting and auditing have been rapid and spectacular. First of all tax administrations have introduced the position of EDP auditor. His task is to support the tax auditor in investigating automated accounting systems. Elaborate audits for which large amounts of information had to be printed on paper, are a thing of the past. Also seizing books and records from companies is less called for.[1]

C. Audit automation

Digitization creates new opportunities for auditing. As a result of the emergence of "audit automation" the tax auditor can rely on even more automated support in carrying out his duties. The tax auditor may draw from this mix of auditing procedures and techniques as he requires. He can have a risk assessment made, select items, chart areas with special risks, require information and (have the EDP-auditor) dig in internal and external computerized databases.

D. Datamining

For the latter activity the accounting profession has introduced a new concept: datamining. The pilot projects are promising. In short this procedure interrogates a database or a series of linked databases to establish whether patterns or deviations from these patterns can be discovered which may alert the tax auditor to fraud.

The impact of this intensive form of data analysis could be increased substantially if Member States of the European Union would cooperate. National databases can only provide a partial picture of for instance a carousel[2] fraud and limited assistance in fighting fraud. This is especially true in the case of digi-fraud.

E. The intelligence base

The auditor benefits if the tax administration itself digitizes. A first example is the introduction of electronic tax returns which is taking place in a growing number of countries. A second application of digitization is the so-called intelligence base. This records in a digitized form the counter-information the tax administration possesses. A growing proportion of this information can already now be provided electronically.

If the processing of tax returns is entirely automated, the computer checks the "counter intelligence database" routinely. A proper selection system that identifies the returns that do not meet predetermined parameters, is of course an essential prerequisite.

This counter-intelligence database can also be linked to a knowledge bank. Soon specialists in different areas of taxation will no longer be required for separately evaluating tax returns. Instead, they will be responsible in future for supplementing the fiscal knowledge bank and keeping it up to date. This knowledge bank might also be made accessible to the tax consultancy profession, but that entails a political decision.

VI. TAX AUDITING IN A COMPUTERIZED ENVIRONMENT

A. General

Operating in a computerized environment creates its own set of problems for the tax auditor. It is obvious that he has to ensure that the data carriers and the data on them will not be changed, distorted, lost or destroyed. In a "paper" environment no special arrangements are required to ensure the integrity of the data in addition to the usual care. This is different in a computerized environment since a mistake at the keyboard or an erroneous manipulation may result in the data of the taxpayer being altered or erased.

1. As is the time and effort of the external chartered accountant.
2. I.e. VAT export fraud.

To avoid problems we recommend that the auditor uses only copies of the files and databases he has requested when he works on his own personal computer within the premises of the company being audited. The copies should be provided on diskettes, tapes or other data carriers which are accessible to him. With and on these copies he can then make his analyses and calculations. Note that the tax auditor is not allowed to carry out operations or tests in or with the administrative system which is used by the company being audited.

The tax auditor is not authorized to link his own PC directly to the computer of the taxpayer without first obtaining the advice and support of the EDP auditor. Only then can he consult or copy a specific database. In practice, the taxpayer is asked for his consent and cooperation. Of course the tax auditor has to take into account all reasonable interests of the taxpayer.

B. Converting data

We are on the eve of the total digitization of all corporate files and records. Paper documentation will gradually retreat to the background and in most instances probably disappear. Companies will want to convert their data from one carrier to another. However, conversion must not harm the auditability of data and the converted data must be reproducible within a specific period. It is therefore important that certain conditions for converting data are established and adhered to. If a taxpayer complies with these conditions, he is no longer obliged to preserve the original document.

Possible conditions for conversion include:

- The taxpayer must make technical and organizational provisions that ensure that the conversion of data is correct and complete.
- In principle the "new" data carriers must be available and accessible during the entire retention period.
- During the retention period the data must be capable of being reproduced in a readable format within a reasonable time. If these conditions are met, old systems (hardware and software) need not be retained.
- The data must be made available to the tax auditor in such a way that the audit can be completed within a reasonable period of time. The cooperation of the taxpayer being audited is essential.
- The taxpayer is responsible for the technology and methods used to convert the data.
- After conversion digitally recorded data may be preserved in digital form or in other forms, provided that they can be made accessible within a reasonable period of time and that an audit can be carried out within an equally reasonable period of time.

This last condition implies that it is not acceptable for the taxpayer merely to print large quantities of electronically recorded data on paper and then hand these over to the auditor. The amounts of data that may be retained on paper is limited by the criterion of auditability. As long as auditing the data is possible within a reasonable time frame, data may be transferred to paper.

As a general rule it may be stipulated that digital data should almost entirely stay digital. However, provided the data remain correct and complete, the taxpayer must be allowed to record data on back-up tapes/diskettes/cartridges so enabling the freeing-up of system resources. To prevent problems or disputes it is advisable to come to an agreement beforehand.

C. Forms of conversion

Data can be converted to another medium in various ways. Examples are converting data from paper to microfiche/microfilm or scanning and recording data on a digital data carrier. The data may also be converted within the same medium. An example of this is recording data from a computerized accounting system to a diskette or tape – frequently used for making back-ups – or to an optically readable disc, i.e. a Write Once, Read Many disc (a so-called WORM disc). A typical feature of a WORM disc is that data on it cannot be changed.

D. Globalization and digitization

It is to be expected that affiliated corporations established in foreign countries may not use the same accounting processes and procedures as the domestic company. It seems realistic to expect that in future the tax auditor will increasingly have to deal with the globalization of digital accounting systems. Within an international context this may have implications for the tax auditing of these digital accounting systems. There are four options regarding the maintenance and retention of a multinational company's accounting records:

- the "books, records and other documents"[3] are updated and retained in the country in which the company is established;
- the "books, records and other documents" are updated in the country in which the company is located, but retained in a foreign country;
- the "books, records and other documents" are kept in a foreign country, but stored domestically;
- the "books, records and other documents" are updated and retained in a foreign country.

The first case is a strictly domestic issue and the "standard" case for an audit. In the second situation we are confronted with a problem if an accounting system in a foreign country is stored entirely in a digital form. The tax auditor can establish whether or not the books are kept up to date. However an audit of the rest of the accounting system can only be carried out within a reasonable period of time if the tax auditor gets access to the recorded data through the computer system. If there is no direct and continuously open connection with the foreign country in which the books and records are retained, problems may arise with regard to time and communication. The tax auditor must therefore know in advance which data may be recorded and stored abroad. This requires an examination of the description of the AO/IC[4] structure and of the

3. I.e. the accounting system.
4. Administrative Organization/Internal Control

data processing system. A problem may arise in that the retention period of the books and records in that country may be shorter than is required in the country in which the company being audited is located. A similar problem may occur in respect of the requirements concerning physically safeguarding the data in another country. It may be difficult for the auditor to check these. Furthermore, the conversion of data in a foreign country may cause problems. If the original documents have been converted and then destroyed, the company will have to prove that both procedural and technical measures not only were taken during the retention period, but also that these measures were effective. It is not yet clear how the tax auditor could test this.

In the third case the company updates its books and records in a foreign country and retains these in the country in which it is established. If there is no direct and open link with that foreign country, the tax auditor is not able to verify whether the books are kept up to date. Still an audit can be carried out within a reasonable period of time, because the tax auditor has access to the books and records. Nevertheless, a major problem exists because an examination into the existence and functioning of the AO/IC system is not possible. There also may be problems if the company converts the original documents in the other country. The retention period though does not present any difficulties in this case.

In the fourth and final case the company updates and retains the books, records and other documents in a foreign country. This is to the tax auditor the most difficult situation, as he will be confronted with most of the problems we have just described in the other cases. For instance, where there is no open connection with the country concerned, the tax auditor can not establish or verify anything without having first requested assistance from the foreign tax administration. An additional problem might be the auditor's lack of knowledge of the language in which the company keeps its books and records.

Where an examination of the AO/IC system of a foreign company is not possible, the solution might be that the tax auditor calls upon the public auditor of that company to carry out such an audit.

VII. WORLDWIDE AUDITING

A. Coordination

One possible solution to the above problems and difficulties is to coordinate at European level the auditing of multinational corporations that operate in Europe. In a later stage this cooperative effort could be extended to a global level. However, numerous sensitivities have to be reckoned with. Optimally the entire audit of a particular multinational company should be managed and coordinated by the tax administration of one country.

In the field of customs audits of multinational companies some experience has been gained within the *Mattheus project*. Section 8 of the new "Convention on mutual administrative assistance in tax matters" regulates simultaneous audits of accounting records. This type of assistance may be used for instance to conduct an investigation into internal transfer prices of affiliated companies located in different countries. Section 9 of the same treaty regulates mutual participation and cooperation in audits of books and records.

In order to carry out effective audits in multinational companies, national competences must be coordinated and streamlined, alternatively tax auditors must be given European-wide competencies. In addition, it seems advisable to streamline the auditing policy. Only then can effective and efficient audits be ensured. Moreover, we expect further simplification of the data exchange procedures between the Member States of the European Union and major economies such as Japan, the United States, Canada and others.

This "electronic" exchange of information should be based upon bilateral and multilateral treaties. Individual countries can only keep abreast of the globalization of business through an intensive exchange of data.

B. Standardization of fiscal annual accounts

Standard annual accounts are a major condition for effectively auditing the returns of a multinational company electronically. Such an approach has some attractive benefits for the multinational as well, as it will be sufficient to prepare standard annual accounts which in itself should reduce the number of questions being raised by the tax administration.

C. Standard software

Another major impetus for the digitization of the auditing process within a tax administration could be given by software vendors. Companies would achieve lasting administrative cost reductions if they would incorporate standardized annual accounts in their accounting systems. Standardized annual accounts can be easily generated from computerized accounting systems. They give the tax auditor the possibility of arranging and rearranging the digitally recorded information irrespective of the accounting system. The rearranged files may then be manipulated by means of the tax administration's own software, thus greatly facilitating the analysis of such data.

The tax administration's own EDP auditors also carry out system audits into the quality of the standard software which is used by large numbers of accounting firms and companies. They establish whether a computer programme performs in accordance with the way in which it is expected to behave. The EDP auditor will also identify the specific auditing opportunities included in the programme. These may then be used in regular audits. A tax administration may also consider whether to issue a stamp of approval for selected software programmes.

VIII. NATURAL LIMITS TO TAX AUDITS

A. The "auditing impossibilities risk"

We mentioned earlier the relationship between digitization and tax fraud. However indefinite the nature of this relationship, one thing is certain: digitization reduces the so-called auditing impossibilities risk. This risk refers to the following.

After the tax auditor has assessed the fiscal risks of a company, he establishes whether there are sufficient starting points for auditing these risks. In other words, are these risks auditable. If not, auditing procedures are not very meaningful. This constitutes a natural limit to tax auditing. Sometimes the tax auditor can establish in advance that his audit will not produce sufficient auditing information.[5] An example may illustrate this. It is very difficult to audit the completeness of the reported revenues of gambling machines. Knowing the final scores of the "counter" is essential. If no information is available the tax auditor can only with great difficulty, for instance through observation on-site, verify the correctness of the scores and thus of the revenues. But this procedure is rather labour intensive.

The legal obligation to build in counters which cannot be rigged or tinkered with, greatly reduces the risk of revenue figures being manipulated. In this case digitization is a positive impetus. A legal obligation to incorporate "tamper-proof" counters in gambling machines and for instance also in taxi cabs influences the auditing impossibilities risk directly.

B. Black box

These issues occur in almost any line of business. The completeness of the sales figure, especially in smaller companies with high amounts of cash turnover is very hard to verify during audit. Until a black box is invented which digitally records sufficient facts regarding turnover to facilitate a tax audit, the tax auditor has to face a very high level of auditing impossibilities risk.

In the future when "cash" has virtually been replaced by "electronic cash", the tax auditor will have many more possibilities for carrying out his work. Cash sales will thus disappear and be replaced by bank sales. The digital information system linked to the bank operates in fact like a "black box". Big Brother from George Orwell's novel 1984 seems to have evolved from fiction to reality.

C. Barter trade

A practice, which is becoming increasingly popular, is bartering. This refers to services and goods being exchanged by companies or private persons for non-monetary consideration. The audit of these types of transactions requires a special approach from tax administrations.

IX. SOME SPECULATIONS

A. The automated audit

Sometime in the not too distant future the tax auditor may examine the accounting system of a company entirely digitally. This would enable concurrent audits to be automatically performed. To be able to do this the tax administration would have to possess computerized auditing programmes which include parameters that have been attuned precisely to the generalized client picture which applies to the company. It will thus be quite easy to establish relationships between the accounting systems and their outcomes for different companies. These audits might take place continuously, for instance at night, and electronically. It might also be possible to utilize the databases and files of various government departments.

B. Spending taxes

Through digitization and globalization it becomes not only possible, but perhaps also necessary to shift from direct taxes to indirect ones. This proposition has an increasing number of proponents. As a result of the growing internationalization of business and the number of international arrangements to avoid taxes, the basis for levying taxes is gradually diminishing. The idea of redirecting the tax burden to indirect taxes is logically sound. It may prove to be possible to adapt these developments seamlessly to the electronic flow of payments. In the case of indirect taxes tax can be levied much earlier. Of every transaction that is paid electronically the VAT part could be automatically separated and transferred to the tax administration. This payment may be accepted as the final settlement. Taxes on spending might be levied along similar lines. These too might be paid when the spending/payment takes place.

X. CONCLUSION

At the end of this address we would like to stress that any instrument man has invented can be abused. Although we just have said that digitization may innovate tax auditing, we ought not to put too much trust in what the "screen" conjures up. We used to say that paper was patient; the same can now be said of the computer monitor. We have to take care that we do not confuse what we see on the display with reality. Does what we see on the screen really represent reality? It is relatively simple, especially when using a personal computer, to switch off built-in controls or manipulate results. For a tax auditor it is not easy to detect this.

Computer print-outs usually look impeccable and give such an impression of reliability that the tax auditor is easily misled. Alterations which have been made are not visible (any

5. In similar circumstances a public accountant may invoke a technical "qualified opinion".

longer) to the tax auditor. Thus the print out does not provide any clues for further investigation.[6] A summary of the processing report does not mean that the computations have been carried out in the way stipulated. In many cases the tax auditor is not able to establish if the data in the processing report have been included correctly in the accounts. The summary handed over might just be a draft, in which additional changes have been made before the data were entered into the accounting system. In audits within a PC environment the tax auditor should not neglect to follow the same procedures to assess the reliability of the accounting system which he would have used when auditing a classic set of books and records. Samples, physical checks and observation on site are only possible if these remain within the jurisdiction of a tax administration. Ironically even though the world has shrunk so much through digitization, these procedures will become increasingly impossible.

6. In the past such clues were provided by totals checks, erasures, correction fluid, (change in) handwriting and colour of the ink.

Conference diary

For further details of the events listed below please write to the organizers at the addresses indicated.

DECEMBER 1996

Double Taxation Relief: Practice, Theory & Planning, Amsterdam, 12-13 December 1996 (English):

IBFD International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Ninth Annual Institute on Current Issues in International Taxation, J.W. Marriott Hotel, Washington, DC, 12-13 December 1996 (English):

IRS and co-sponsor the George Washington University, George Washington University, Office of Conferences and Institutes, Tel.: 1-202-973 1110.

Controlled Foreign Companies, Harrington Hall Hotel, London, 13 December 1996 (English):

The Customer Service Manager, IIR Ltd, 6th Floor, 29 Bressenden Place, London SW1E 5DR, Tel.: 44-171-915 5055, Fax: 44-171-915 5056.

The International Tax Treatment of NGOs, Danube Hotel, Rybně Namestie 1, 813 38 Bratislava, Slovak Republic, 16-17 December 1996 (English):

EUROPHIL/SAIA-SCTS, Bratislava Office, Klariska 5, P.O. Box 217, 810 00 Bratislava 1, Slovak Republic, Tel.: 42-7-533 5652, Fax: 42-7-533 5672.

Europhil, PO Box 100, F 67069 Strasbourg, Tel.: 33-88-561 646, Fax: 33-88-561 210.

JANUARY 1997

International Transfer Pricing 97, Marble Arch Marriot, London W1, 16-17 January 1997 (English):

SMI Ltd., No. 1, New Concordia Warf, Mill Street, London SE1 2BB, Tel.: 44-171-252 2222, Fax: 44-171-252 2272.

European Mergers and Acquisitions – Controlled Foreign Company Legislation, Paris, 24 January 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

FEBRUARY 1997

Principles of International Taxation, Amsterdam, 3-7 February 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

ANTI-AVOIDANCE

TRENDS IN ANTI-AVOIDANCE

REPENT WHAT'S PAST; AVOID WHAT IS TO COME[1]

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I. INTRODUCTION

This paper attempts to address issues about future trends in anti-avoidance. Attempting to predict trends is always an exercise in the art of the near-impossible, but predicting trends in the way governments react to the way taxpayers react to the way governments act has, shall we say, a certain uncertainty about it. What I have therefore attempted is a delimitation of the scope for anti-avoidance within the known and predictable context for government decisions, and a development of some thoughts on that basis. This scope depends on laws of fiscal dynamics which I present below, and the logical and other deficiencies in the systems within which those laws apply. These suggest that governments have rather fewer options than perhaps they might like to think.

II. THE LAWS OF FISCAL DYNAMICS

A. The second law: tax laws always end up in chaos

Order will inevitably degenerate into chaos.[2] This is the so-called second law of thermodynamics that, we used to be told, applies to all closed systems. Although for centuries that profound thought was regarded as infallible, Einstein and others proved that this law is not an inevitable with no alternatives – it is, in fact, avoidable. I would, however, posit a specific exception to this refutation of the law – an area where the second law of thermodynamics still prevails. The suggested reformulation is that, in any society, the *tax laws always degenerate from order to chaos*. This should perhaps be known as the second law of fiscal dynamics. It is, I would also posit, the only law about taxes that is unavoidable.

B. The first law: tax laws are always avoidable

The statement about avoidability of tax laws might better be expressed as the first law of fiscal dynamics. This is that *all tax laws are avoidable*. It is because the first law of fiscal dynamics is true that the second law is also true.

C. The zeroth law: taxes are necessary

To complete this Newtonian style of reasoning about fiscal dynamics, we must note[3] a zeroth law of fiscal dynamics: *tax laws are necessary in any society regulated by law*.[4] This reasoning demands an explanation. Why is the zeroth law inevitable? It is because a law-making society must have mechanisms that impose costs.[5]

A mechanism is therefore needed to ensure that the costs are met. That mechanism is what I refer to as a tax.[6] Of course, in some societies the form of the tax is far from the modern wage withholdings many readers will be paying. It might be paid by forced labour (and still is in states with compulsory military service or service on bodies such as juries). It might come by the appropriation by some within the society of property rights to natural resources that are otherwise available to all. Again, the mere existence of "property rights" presupposes some form of system to ensure those rights are respected (even if that is paid for out of the value of the property rights themselves).

III. A DYNAMIC FISCAL INSTABILITY

The zeroth law explains why it is impossible for the first law and second law between them to lead to the inevitable disappearance of taxes. Instead, the three laws of fiscal dynamics

1. "Confess to heaven: repent what's past; avoid what is to come": Prince Hamlet in Shakespeare, *Hamlet*, Act 3, scene iv (1601).
2. For a lively account of the science behind this bold statement, see Paul Davies, *About Time*, (1995), Penguin Science.
3. For those of scientific bent, the zeroth law is that if two systems are in thermal equilibrium with a third system, then they are in equilibrium with each other; the first law is that the total energy of a thermodynamic system remains constant, and the second is that heat never passes from a colder body to a hotter body (see *Chambers Science and Technology Dictionary*).
4. This might with justice be called Franklin's law, after Benjamin Franklin who first observed – in 1789, just before his own death – that in this life nothing is certain but death and taxes.
5. The fact that the society needs laws presupposes that not all actions in the society occur, or can be controlled, in a voluntary and spontaneous way. There is no purpose in imposing laws if those laws are not enforced. Enforcement imposes costs (as does the process of law-making). But because the society needs laws, it follows that the society cannot assume that all those who should bear a share of the costs of the society will do so.
6. More formally, taxation is the process of imposing on, and taking from, individual members of a society the costs of that society.

between them describe with a simple beauty the dynamics of the tax levying process in any society that is organized to a sufficient level to have laws. A form of perpetual motion is created. There must be taxes, but all forms of tax are inherently imperfect, and avoidance of those taxes is always possible.[7] The tax laws will therefore inevitably become less effective as time passes. The need to collect taxes will cause the society to react to offset the avoidance activity. That requires more or other laws about those taxes, which are themselves avoidable, and so forth. The process of the second law can only be halted by changing the fundamental assumption of the system as a closed system, that is, by introducing new taxes or new forms of taxes. Those new taxes, once introduced, are automatically subject from their introduction to the operation of the second law.

I suggest that these laws, and the relations between them explain fully the dynamics of anti-avoidance measures. If that is so, only three logical possibilities occur to halt the inevitable decrease in effectiveness of any set of tax laws because of the taxation dynamics in any given society. First, an unavoidable tax is identified (invalidating the first law). Second, tax laws are changed faster than they can degenerate – in other words, the system is not allowed to close and therefore degenerate (invalidating the second law). Third, taxation is abolished (and the zeroth law is invalidated).

A. Can taxes be abolished?

The third case is the extreme case. Can it occur? No. The zeroth law posits that this can only happen if law-making societies cease to exist. Marx proposed an exception in the Communist Manifesto, when arguing that after the revolution of the proletariat, the state would wither away, private property would be abolished and taxes with it, although society would remain. Despite several revolutions of the proletariat since 1848, it seems Marx was wrong.[8] The zeroth law of fiscal dynamics admits no exception. While the idea of tax-free societies haunts us, they are contradictions in terms. We merely tease ourselves with the illusion of "tax cuts".

Some states have tried to avoid the zeroth law in another way – they impose taxes, but do not call them taxes. Instead we have tolls and charges for licences to do all sorts of other things we cannot or will not avoid doing. We may sell off or give away government assets or natural resources. We may also have compulsory savings that are not, of course, taxes but cannot, of course, be left unpaid.[9] These ideas attract because they can produce things that sound like tax cuts. Semantics aside, while some of these actions may really reduce taxes, none of them abolish them.

B. Accelerating change accelerates disintegration

The second logical possibility is to create new taxes, or new tax laws, at a sufficiently fast rate that the second law of fiscal dynamics does not have time to take effect. One or two countries seem to have been attempting this in recent years, but their efforts seem, strangely, to have been counterproductive. Indeed, observation suggests that fast changes destabilize a tax system and hasten its degeneration into chaos. It might be that there is another law here: the more that taxation laws are changed, the faster they degenerate into chaos. While anecdotal evidence may be offered for this proposal, it is not susceptible to the same logical proof as the three laws. Nevertheless, if it is true, it suggests that the second law cannot be counteracted by accelerating the rate of change of the system.

C. The unavoidable tax

What other possibilities remain? It seems that some continue to look for the exception to the first law – the unavoidable tax. This is a little like hunting the Snark or the Holy Grail, and is the stuff of stories such as Don Quixote or the tales of Aesop. Unavoidable taxes do not exist. True, laws can be introduced to turn avoidance into evasion, so that people evade laws rather than avoid them.[10] But they still do not pay them. Tax laws are imposed by words, and words are faulty instruments. To misquote Wittgenstein, "Die Grenzen meiner Sprache bedeuten die Grenzen meiner Steuer" (the limit of my language means the limit of my tax).

While societies cannot abolish taxes, forms of instability do occur in the dynamics. These must be taken into account, because tax systems are no longer closed national systems. The closed system is, rather, the larger system of which individual states are but part. This introduces a disequilibrium for individual national sub-systems. Some societies create lower levels of cost than others, and therefore need lower taxes. Individuals within that system therefore pay less tax than individuals in other sub-systems, but without avoiding tax. This is part of a more general disequilibrium. Some individuals pay lower levels of taxes than others. Why does the more general disequilibrium occur? The first law tells us, of course, that the opportunity for individuals to avoid taxes is always present.

IV. THE NEW BOUNDARIES OF TAX

These instabilities point to three possible flaws in the logic of the three laws of fiscal dynamics. The first flaw is that the laws are, like all such laws, propounded only for a closed system. However, a national tax system is, in reality, never a closed system. The tax systems of states used to be closed systems, but this is no longer true. The second flaw is that in describing the combined operation of the laws I have made

7. I must interpose here a statement which I will justify later: any tax which can be avoided will be avoided.

8. In the former Soviet Union, of course, individuals and enterprises did not suffer taxation in the capitalist sense of taking away a share of the individual's property (which was what Marx saw as disappearing along with the concept of private property itself), but rather by the technique of preventing them getting that part of the property in the first place.

9. There is nothing new about this, either – medieval European kings were very good at it.

10. In the balance of this article, evasion is regarded, unless the context indicates otherwise, as a form of avoidance.

an assumption about human behaviour. It is that at least some of the members of a society will avoid its taxes. Why do we assume this?

The best answer is what appears to be a fundamental assumption of economics: people behave in a rational way. In the famous definition of Robbins, economics studies human behaviour as a relationship between ends and scarce means with alternative uses. In this context it is rational not to devote my scarce resources to pay a tax when there are preferable alternative uses. Given that I can choose the alternative uses to my better utility I will therefore act rationally by avoiding the tax. One final assumption must be made, so that this holds true. Potential avoiders must be aware of the possibility of avoidance. This is the assumption of knowledge on which so much of economic thinking rests. It is inherently improbable that societies exist where no one in that society is aware of the potential to avoid its tax laws.

There is a third flaw in the logic when applying it to the real world – again because of the assumption of a closed system. This is the assumption that no other change occurs in the way taxes work. In practice, tax yields drop not only because of avoidance, but because for other reasons people stop behaving in the way the tax laws assume. For example, the former taxes on slaves in Europe would today yield little revenue.

The particular challenge to tax authorities in the near future lies in the rate of change in the near past in the ability to separate material objects from the potential to add value by use of those objects. The old idea that the whole value of world trade went through customs posts has become outmoded at barely credible speed. As the Economist put it recently, "An amalgamation of atoms is easier to pin down than a bevy of bits and bites. Transactions carried out over the Internet may slip away from the tax-man. It can also outwit the regulators."[11] States have seen the dematerialization of much wealth – contained in the trade marks and licences rather than the items marked and licensed. They have yet to see the full dematerialization of money so that it too becomes bits and bytes, but it is happening. Further, as marginal telecommunication costs fall to zero, the only costs of moving money will be the costs of complying with – or, more cheaply, avoiding – tax and regulation.

V. HOW TO REDUCE AVOIDANCE

A. General

I suggest that the above sets of laws and assumptions are of themselves a complete explanation of the dynamics of tax and its avoidance. If that is so, two conclusions follow. First, there is no entirely successful strategy for anti-avoidance. Second, the laws and assumptions must contain within them the only possibilities for anti-avoidance action. Any trends in forms of such action must therefore be by way of continuing or shifting patterns of action within those logical possibilities and assumptions. We can therefore list them in a definitive way.

The possibilities are:

- to find new taxes or forms of existing taxes that are less avoidable than the present laws, in particular because they tax today's activities;
- to change taxes faster than they degenerate;
- to reduce the burden of taxation within a society;
- to increase the burden of taxes in other, lower taxed societies;
- to prevent access to other, lower taxed societies;
- to persuade people to act irrationally by not avoiding taxes; or
- to conceal the extent to which taxes are avoidable.

B. Anti-avoidance in past centuries

In past centuries anti-avoidance was relatively easy. The normal forms of tax, such as customs duties and land taxes, were not readily avoidable. Overall tax burdens were low. Societies were relatively closed so there was little tax competition between them. In closed authoritarian societies, it was easier to persuade people to act irrationally by paying taxes, and to conceal the possibilities of avoidance from them. In particular, tax authorities had good access to the information necessary to levy taxes, and taxpayers had limited chance to conceal it.

C. The passing of past certainties

During this century, these past certainties have largely been abolished. Few closed societies now exist, thus giving people ready access to lower-taxed societies. The easy forms of tax such as customs duties were replaced with taxes that are inherently more avoidable such as income tax. Anyone can readily purchase knowledge about the avoidability of taxes from a tax expert. Conversely, it has become harder for tax authorities to find out what is going on. At the same time, there have been huge increases in the burden of taxation in many states, making the marginal advantages of avoidance much stronger.

Perhaps more important, there has in recent decades been a decrease in the willingness of people to behave irrationally, that is, to pay taxes that they could avoid. The tax revolution that caused Proposition 13 in California is still spreading. The church taxes of protestant Europe, the poll tax in the UK, and the high marginal rates of income tax on the wealthier worked – or were supposed to work – because people would comply with them readily. Viewed at the end of the century, this willingness to pay cannot now be assumed. There is a ratchet effect on this unwillingness. Compliance in taxation works where taxes are seen as fair – everyone is paying a fair share. The more individuals avoid tax, the more other individuals will wish to do so. Tax only becomes fair again if everyone is allowed to avoid it!

In summary, the prospects for anti-avoidance look bleak. We have tax systems that are increasingly irrelevant which

11. "Survey: The World Economy", *The Economist* 28 September 1996, at 44.

impose taxes on individuals who are increasingly inclined not to pay them. It is not surprising that tax authorities are finding collecting the spiralling tax burden imposed on their residents an ever harder task.

D. Short-termism, or goosing the taxpayer

Where do we go from here? Short-term political pressures within states always point to the easier route out of a problem. This was well summarized by Colbert centuries ago: the art of taxation is getting the largest amount of feathers from the goose with the least amount of hissing. The trouble is, as those who handle fowl know, the easiest feathers to get from a goose are the outer halves of its wing feathers. Result: a goose that cannot fly. Apply that analogy to the economy and you may be able to build Versailles, but you may not remain in it for too long!

This is a real dilemma for future anti-avoidance action. The easy short-term answers no longer work efficiently at the margin for the existing patterns of tax in the existing frameworks of societies. They can cause more damage than they cure. This is entirely predictable from our starting laws and assumptions, but the effects are accelerated rather than dampened by the way societies are opening up. Do any of the variables listed above offer ways forward for successful anti-avoidance action?

E. Adopting less avoidable taxes

1. New taxes

First, there are moves towards less avoidable taxes, such as insurance premium taxes, airport taxes, tourist taxes and telephone taxes. States cannot go back to high customs duties because of GATT, but they can re-adopt other forms of trade tax. We will have lots of little taxes. Every airport now seems to be levying some kind of charge, as do many hotels. The information needed to levy them is transparent and the collectors' desire to comply with them is high. But these are palliatives compared with the fundamental issues of income tax and the social taxes.

2. Making income tax less avoidable

How will the big taxes be made less avoidable? Is the way forward measures such as the Section 482 regulations and the limitation of benefits provisions in the US–Netherlands Double Tax Convention? No. These attempts to prevent avoidance fail because they defeat themselves through their own complexity. The laws of fiscal dynamics emphasize that even these measures are inherently faulty. They can be no better than the words used and the people who use the words. Neither can be perfect. Instead, they may just be cutting the goose's wing-tips.

At some point, it will dawn on tax authorities that income taxes work in a global economy only if we relate the way we charge the tax more closely to the way the underlying income is generated. That involves a shift from residence based taxes to source based taxes. Why? Because the desire to avoid is less intense, the information is easier to track, and the location of the taxing authority is linked to the location of the source of wealth. That source remains relevant to income generation. For many purposes, the residence of an owner of property is now irrelevant to the ability to derive profit from that property.

In addition, much of the avoidance of complicated current income taxes in the major states arises simply because they are complicated. They are complicated, because tax authorities want to collect their "fair share", and they want to spread the burden of the tax "fairly". But to cut avoidance, taxes have to be made simpler. While all taxes are avoidable, there may be some sub-rule which also says that the longer a tax law is, the more likely it is that it can be avoided. The best short-term anti-avoidance measure may therefore be a proper simplification exercise. One version of this is the alternative tax. Another is the flat-rate tax. The problem is that income tax was introduced to achieve certain fairness objectives. These variants of the tax fail to meet those objectives. This may sacrifice the tolerance of those expected to pay without direct enforcement. One solution states are now adopting is therefore to change what we mean by "fair".

F. Using constant change

The second possibility is to change taxes faster than they degenerate. Two sets of states have been doing this in recent years. The first are the emerging economies of central and eastern Europe. The other group is of states like the United States, the United Kingdom and the Netherlands. Both groups have found that changes destabilize their systems and add problems rather than solve them. Change is not of itself a way forward.

G. Lowering and raising tax burdens

The third and fourth possibilities are to reduce the burden of tax in the home state (though this is hardly anti-avoidance), and to increase that burden in other states. Both reflect on the biggest problem for the future of anti-avoidance in the nation state – states cannot close the open systems in which they now operate. It is possible that they could move to stop the attractiveness of so-called fiscal paradises. But is it likely that the United Kingdom will reverse the (largely unintended) drift of territories such as the British Virgin Islands into low tax territory status, or that it will imperil the economy of the Channel Islands by interfering with their favourable fiscal systems? At present, the reverse seems true of many states, with new special tax zones such as Trieste popping up everywhere. States that fall to the temptation of having special tax zones within their territory or of sheltering offshore low tax territories must accept the continued growth of those low tax regimes at the cost of their own tax revenue sources.

H. Redefining "local" and "foreign"

Other states that have not fallen to this temptation – and they are few – will, however, press for virtuous conduct from all. They will also press for the fifth option – to reduce the possibility of accessing low tax territories. In practice, this takes the form of reallocating funds or enterprises that were thought to be in a low tax territory back into a higher tax territory, through transfer pricing, CFC legislation and the like, or the form of exit charges on the transfer of funds to a lower tax territory. These measures aim to redefine the jurisdiction of the taxing authority, or the extent of the taxable assets within the jurisdiction. The intensity of these measures is likely to grow, partly with the aim of meeting the sixth possible means of dampening avoidance. But they are at heart pretences. The long term stability of tax laws that impose tax on what ought to be, rather than what is, must be questionable. They are also inherently inefficient laws, because they must depend on the use of fictions and discretions. Besides which, it is quite possible that over half the world's wealth is in the low tax territories already. Tax authorities are merely looking at how they tax the other half.

I. Making people pay voluntarily

How do they do that? The sixth means is that of persuading people to pay tax voluntarily. There is much scope for one aspect of this: persuading taxpayers who are committed to pay a certain level of tax that it should be paid to one state rather than another. This is prevention of avoidance not of tax as such but of *our* tax. Powerful states are likely to find this an attractive option. In truth, however, this is not so much anti-avoidance as tax diversion. Tax that should have been paid to one state is claimed instead by another state. As this may affect the taxpayer little, diversion may be accepted by them. Asking them to pay extra on a voluntary basis is, however, an entirely different proposition.

There will also be moves to taxes that people are less unwilling to pay *or* to taxes imposed on people who are less unwilling to pay. The latter of these choices is socially divisive in its long-term implications, but is happening, as is the former shift. It leads to higher social taxes on the employees who cannot move, and to such taxes as compulsory savings schemes and private pension premiums (often not called a tax). But it also leads to those taxes being imposed on those less well placed to save as compared with others who have investment income from which they can save. It also leads to something not foreseen a few decades back. Free movement of workers can be prevented. Free movement of jobs cannot. At the margin, employment therefore shifts to lower tax territories. It is for this reason that even the "reliable" milch cow of revenue authorities, the ordinary employee, cannot always be relied on. The ones who really don't move are probably the ones who are net beneficiaries from the state.

J. Let them know you know

The final option is to make taxes *seem* less avoidable. A key way of doing this is to ensure that tax authorities know what taxpayers are doing. This requires a high level of interstate cooperation. It will happen only if governments realize that they are increasingly helpless if they try and act in isolation. Increased cooperation between authorities is inevitable if taxes are to be collected. That will be easier in regional blocs like that of the EU or NAFTA. However, it will take some time for the British and Luxembourg governments in the EU to find they gain more by cooperating than vetoing. Indeed, some smaller states may never find that to be the case unless other states offset their actions by offering them compensating advantages.

VI. IS THERE AN ANSWER?

A. Toleration?

I suspect the answers to the problems of avoidance – which must be drawn from the list set out in this article – are unpalatable. States will have to tolerate higher levels of avoidance. They will have to be content in taxing the immobile parts of a wealth that is increasingly mobile, and taxing the jobs that do not migrate. They will be unable to raise the taxes they have been used to raising, and to impose the fairness that some of them assume is part of a tax system. This will force states to continue the process already started of cutting the marginal rates of taxes, and of looking for second-best solutions to issues of fairness.

This process stops only if enough people actually want to pay more taxes. For that to happen, the current approach to rationality of payment of taxes must change. Governments and politicians must sell their taxes to their people. They must show people that taxes have benefits. Tied to this, they must ensure that taxes do have those benefits. Those states that do not succeed in this will see taxpayers voting with both their ballots and their feet for lower tax. It is noticeable that a shift of governments and tax authorities from confrontation to cooperation with taxpayers is clearly present. It might seem an odd form of anti-avoidance, but it may prove an effective one.

For all this, the laws of fiscal dynamics will prevail. In particular, the progress from order to chaos within the tax collection machines of individual states will continue and probably accelerate. States will, of course, look to adopt a radical new taxing approach. What new taxes should they use? Unfortunately for those looking for a new `major' tax, it probably doesn't exist. We have only old taxes in new forms. However, there is still scope to juggle the pack. In particular, if states stop trying to do too much by way of redistribution and fiscal engineering through their tax systems, they will find the taxes they need are simpler to impose and collect. For example, an origin-based value-added tax and a source-based income tax might be a better combination than at present for tax collectors in the more developed states.

B. Taxing half of the other half?

It is a sobering thought for governments that perhaps over half the world's wealth is now in low tax territories.[12] Further, everything points to that share of world wealth growing. Existing information technology is already sufficient to ensure that future information technology will be more powerful. Wealth will be increasingly mobile. In the last resort, all that a taxing authority can do with regard to mobile resources is to make its territory a desirable place for a taxpayer and the taxpayer's property to be, and then persuade the taxpayer that paying tax to that authority is rational behaviour. Of course, that is exactly how tax havens came to accumulate half the world's wealth. Anti-avoidance measures start to become serious when wealth is either forced or priced out of these havens. Neither the modalities nor the political will currently exits to do this.

Absent such measures, states must content themselves with trying to tax efficiently – if not fairly – a declining share of the other half of the world's wealth. Or, as Shakespeare put it: "throw away the worser part of it, and live the purer with the other half".[13] Whether that is a problem depends on whether that regime is one that can handle the polarization it involves.[14]

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12. A. Johns, "Not tax havens, havens for transnational invisible trade enterprise". *Intereconomics*, 29, (1994), at 32.

13. See title and footnote 1. This line appears 7 lines further down the script.

14. The writer acknowledges the valuable help he has derived from two compendiums of essays about future developments. Both books also have extensive bibliographies. *Geographies of global change* (1995), (ed. Johnston, Taylor and Watts, Blackwell Publishers) presents a sober analysis by geographers of several states of how current trends will force geo-social and geo-economic change on everyone, noting starkly in their conclusion that "an interconnected world is an easily sabotaged world (at 385)". *The Global Economy in Transition* (1996), (ed. Daniels and Lever, Addison Wesley Longman) is a multi-disciplinary study with some authors common to the previous study. Its closing papers study, in particular, why offshore production is so important, and why the financial centres of London, New York and Tokyo have grown so powerful. It is worth commenting that these papers spend little time in examining trends in the effects of taxation. In their view the regulatory climate – or lack of it – is more important. "*If a major centre of international finance reimposed the rules of the past, it would quickly become a minor centre or a former centre.*" (Drennan, at 396). That, presumably, also applies to taxes.

SIMPLIFICATION

SIMPLIFICATION OF TAX LEGISLATION

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I. INTRODUCTION

Over recent years there has been a popular demand to make tax legislation more understandable. However, in Anglo-Saxon countries there is a belief that any effort to make tax legislation less complex will result in increased uncertainty. This article examines in the context of the proposals currently being debated in the United Kingdom, the problems inherent in achieving simplification[2] of tax legislation.

II. THE PRESENT POSITION IN THE UNITED KINGDOM

All tax law is the written reflection of the legislature's intent. The rule of law requires that tax legislation lays down the limits of taxation in a way which is certain and not arbitrary. In the United Kingdom, Parliament sets out to achieve certainty in tax legislation by dealing comprehensively with every possible situation. But that, of course, is impossible because nobody can foresee every possible case and deal with it in advance. This is apparent from reading the cases where disputes have subsequently arisen. Anyone who has written about new tax provisions and tried to think of the effect of them will have had the experience that the first case one sees in practice is something which one had never thought about. As an Australian, Professor Richard Vann, has pointed out: "We suffer from tax rule madness, a disease that affects the advanced Anglo-Saxon countries generally with Australia having a particularly virulent form,"[3] and I do not think that the United Kingdom is far behind. To illustrate the effect of the present method, the last three annual Finance Acts, all of which merely tinker with the tax system rather than make major changes, contained 463, 380 and 463 A4 size pages respectively, and that is just primary legislation; there are other sources of tax law including secondary legislation. I believe that the total tax legislation of some European countries is no larger than just one of those Acts. The length and complexity of tax legislation has become much worse recently. Since this is the fiftieth anniversary of the *Bulletin* it is interesting to compare this with the equivalent figures 50 years ago. The three Acts ending in 1946 were 46, 79[4] and 62 pages long, and at that time the pages were smaller as well.

The result of the present system is certainly not simplicity, but that might not matter too much so long as it achieved certainty. It fails on that count too. If something is covered by the detail, the result is, of course, certain when one has found one's way through the detail. But what if the point is not covered? The more detail there is, the less one is able to determine what the legislation was trying to achieve, and so the less certainty there is. What would be the position if legislation in the United Kingdom made it clear what it was trying to achieve instead of trying to cover everything in detail? It would certainly be simpler. Would it not be more certain as well? The question is not whether it will be absolutely certain; as I have said, that can never be achieved. The question is only whether legislation could be more certain in total; one might accept some increased uncertainty at the edges if the major part was more certain.

III. THE CAUSES OF COMPLEXITY

Sadly, as the Renton Committee on the Preparation of Legislation,[5] concluded in 1975, the real reason why the mass of words has increased is because the judges could not be trusted to give effect to the ideas behind them, and so less and less leeway is given to them: "The real problem is one of confidence. Would Parliament be prepared to trust the courts?"[6] It is clear from the increase in size of tax legislation since the committee reported in 1975 that the answer to Renton's question "Would Parliament be prepared to trust the courts?" (which I suggest really means "Would the Revenue be prepared to trust the courts?") is no. In the United Kingdom we are therefore witnessing this ever-increasing spiral of legislation which is completely and obviously doomed to failure.

Traditionally the courts in the United Kingdom construed tax legislation as a matter of words and Parliament's concerns may once have been justified. Until recently the United Kingdom courts have not been able to use anything other than the legislation itself to interpret it, which certainly cannot have helped purposive interpretation. Consequently, as the Privy

1. This paper includes some of the suggestions put forward in the Institute for Fiscal Studies annual lecture, *Tax Law–Rules or Principles?* published in Vol. 17 *Fiscal Studies*, No. 3 (August 1996), at 63.
2. Simplification is a relative concept, which can only be understood by reference to the targeted readership of the legislation.
3. Improving Tax Law Improvement: an International Perspective, Australian Tax Forum 1995 at 193, and 222.
4. In 1945 there was also an Act of 67 pages rewriting the capital allowances code.
5. Cmnd. 6053.
6. Para. 19.41.

Council said in a recent appeal: "Quite often the benefits of a 'purposive' approach are illusory, since the purpose which is used as a point of reference merely reflects the contention of one or other of the parties about what the words ought to mean."[7] The lack of any external materials from which the courts might find the purpose of legislation has changed, although only slightly, with the decision of the House of Lords in *Pepper v. Hart*.[8] The courts may now refer to ministerial statements in Hansard[9] in cases of ambiguity or obscurity, but that is a rule which is confined as far as possible. In a recent case[10] the House of Lords refused to use Ministerial statements relating to other provisions of the same Act which might have given guidance on the construction of the provision in question, even though they agreed that it was ambiguous and obscure. On the other hand, the courts have been willing to relax the rule further when it comes to construing a statute based on European legislation in order to ascertain its purpose.[11]

It is very doubtful if the criticism, that the courts in the United Kingdom construe legislation literally as a matter of words, is true today. For example, in a recent case, the first question Lord Nolan posed in the House of Lords after setting out the legislation and the taxpayer's contention was: "Was this the purpose that Parliament intended to achieve by the words used?"[12] Whether or not they are saying it, this is much more the approach being adopted by judges today. Unfortunately just as the courts have become much more interested in the idea behind the words, the words have increased in number, and it is more and more difficult to see any ideas behind the words. Parliament and the courts are now seriously out of step.

IV. REWRITING LEGISLATION IN SIMPLER LANGUAGE

Faced with complexity there is a move by common law states to rewrite their tax legislation in more comprehensible English. It started in Australia and New Zealand and the United Kingdom has now followed suit. This proposal has been put forward in the United Kingdom both by an independent committee, the Tax Law Review Committee,[13] set up by the Institute for Fiscal Studies, and by the Inland Revenue.[14] I suggest that, although rewriting is a good thing in itself, it is rather an irrelevancy in the discussion of simplification. At the end of five years of rewriting the result will be exactly the same degree of complexity but more simply expressed.[15] I do not think that anyone will be satisfied with that or that the result will be described as simplicity.[16] The best that can be said of rewriting is that it may draw attention to things which should be done to improve the legislation when rewriting has finished and which are not clear now because of the obscurity of the legislation. For the amount of resources which will go into rewriting, there must surely be more efficient ways of doing this. *Rewriting is really an acceptance that nothing can be done to simplify tax legislation, while at the same time giving the impression that something is being done.* It enables discussions to take place about not very important details, such as how to renumber the sections so that new sections can be inserted in the future. During the five years or so that rewriting will take there will be a lot of new legislation, not written in easy-to-read form because of the time pressure under which it is produced. The best that can be said is that the easier-to-read method may indirectly influence the new legislation.

V. OTHER SUGGESTED SOLUTIONS

The Tax Law Review Committee's recommendation favouring the use of explanatory memoranda[17] seems to me to be a logical extension of *Pepper v. Hart* and a far more important recommendation than rewriting the legislation. What is in written form prepared in advance (which obviously must exist today), is surely more reliable than what the Minister says while on his feet in Parliament when he may depart from his notes. We also have the odd situation today that, if the Opposition do not ask for any explanation of a clause, in order to get through the day's business more quickly, the Minister will not even read out his prepared speech so we are all deprived for ever of this potential guidance. Publishing the memoranda and allowing their use by courts, and therefore by the rest of us, is a minor extension to *Pepper v. Hart* and is another way in which we can discover the statutory purpose. The Revenue's Report seemed much less favourable to explanatory statements, but the Government has now come round to favouring them.[18]

The Tax Law Review Committee's Final Report puts forward the interesting suggestion of a two tier system consisting of primary legislation expressed in general principles, supplemented by secondary legislation setting out the details.[19] This proposal is coupled with proposed changes in Parliamentary procedure enabling amendments to be made to statutory instruments during debate, and having a standing consultative committee of tax practitioners to comment on the drafts. Unfortunately this proposal is not put forward for the rewrit-

7. *Chan Chi-hung v. R* [1996] 1 All ER 914, 922b.
8. [1992] STC 898.
9. The report of proceedings of Parliament.
10. *Melluish v. BMI* (No.3) Limited [1995] STC 964, 978. See [1996] BTR 195, 200.
11. *Three Rivers District Council v. Bank of England* [1996] 2 All ER 363.
12. *ICI v. Colmer* [1996] STC 352, 358b.
13. Interim Report on Tax Legislation, November 1995, and Final Report on Tax Legislation, June 1996.
14. *The Path to Tax Simplification*, Report and Background Paper, December 1995, and *Tax Law Rewrite*, July 1996.
15. Here it is interesting to note the experience of the Australians. The targeted readership for their rewriting project was initially the 'taxpayer', this quickly became 'tax professionals' it is now the 'suburban tax agent'. Thus what initially started out as a project to make the tax legislation less complex and thus more easily understandable to a layman, became a project to make the legislation more easy to follow for a sophisticated tax professional. See *supra* note 16. I.e. the rewritten legislation in Australia is likely to contain the 'same degree of complexity but be more simply expressed'.
16. See M. Burton and M. Dirkis, *"The Income Tax Simplification Experience to Date"* 50 *Bulletin for International Fiscal Documentation* 2 (1996), at 67 in which this point was made in relation to the Australian rewriting.
17. Interim Report, chapter 6, and Final Report, chapter 5.
18. See the comments in the debate in the House of Lords on 27 March 1996 quoted in the TLRC's Final Report para. 2.8.
19. Final Report, para. 3.12.

ing of the existing legislation because of the need for these new Parliamentary procedures. The following benefits are claimed:

- The primary legislation would be much shorter and more comprehensible and, consequently, it would be easier to see the right answers to cases at the margins where the application of the detailed rules is unclear, frequently a problem at present.
- Less elaboration would frequently be required than at present so that the total package of primary and secondary legislation would be smaller than the primary legislation typically is at present.
- Parliament would be able to concentrate on the policy merits of the primary legislation without the detail obscuring these.
- The legislation would be less cast in stone; the secondary legislation could more easily be amended if this became necessary.[20]

I fully agree with the first (more comprehensible primary legislation), third (Parliament concentrating on the policy) and fourth (ease of change)[21] of these, particularly the first, as it must help the court to see the wood from the trees, and I therefore see great merit in the proposal. But I am concerned about whether the proposal really would achieve the second benefit and result in shorter overall legislation. With more time for consultation there could be more demand for detail in the secondary legislation, and a continuation of the current tax rule madness. This proposal is essentially the United States solution and the experience there does not instil confidence that simplification will be achieved.

VI. WHAT ELSE COULD BE DONE?

I suggest that the United Kingdom is in a unique position to experiment. So far it has adopted the usual common law approach which ends up with a mass of detail and little in the way of explanatory material about what the legislation is trying to achieve. At the same time, the United Kingdom is part of Europe and has to cope with Community legislation based on a different philosophy. VAT is based on Directives containing far less detail than is usual in the United Kingdom. The main difference from internal law is that aids to interpretation are used by the European Court, such as the preamble to the Directives and other general principles. Would adoption of the Tax Law Review Committee's proposals on explanatory memoranda enable the United Kingdom to adopt a more European approach with less detail but achieving more certainty than the present system? There is a considerable body of law in the European Court on the interpretation of the VAT Directives. Courts in the United Kingdom have had to apply different methods of interpretation to European legislation and have become accustomed to doing so. There are therefore two bodies of law standing side by side. The experiment I should like to suggest is that the United Kingdom and European Community methods of legislating and interpreting legislation should be compared with each other, and hopefully also compared with the internal tax law of some other EC countries to see which approach achieves more certainty. The comparison would have to cover not only the legislation itself but the surrounding legal culture, for example how any increased discretion given to tax authorities was controlled. The issue, as I have said, is whether the other methods result in more overall certainty than the United Kingdom's current method, even if there is less certainty in some cases.

20. Final Report, para. 3.6.
21. Although too much change would make it difficult to find the law.

FLAT TAX

INTERNATIONAL IMPLICATIONS OF THE FLAT TAX

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I. INTRODUCTION

In recent years there has been substantial interest in the United States in replacing the existing income tax with a new form of direct taxation, one based on consumption, rather than income. The best known proposal is for the "flat tax", developed by Robert Hall and Alvin Rabushka and given substantial exposure by presidential candidate Steve Forbes.[1] Enactment of the flat tax could have important international implications.[2] The next section describes the salient features of the flat tax. The section that follows summarizes international implications of adoption of the flat tax.

II. KEY FEATURES OF THE FLAT TAX

A. The flat tax

The flat tax contains an ingenious combination of four features: separate taxes on the labour income of individuals and the cash-flow of businesses (levied without regard to the organizational form of the business), cash-flow treatment of income from business and capital, elimination of personal deductions, and application of a single tax rate of about 20 per cent to the taxable "income" of both individuals (to the extent it exceeds a tax threshold created by personal exemptions and a standard deduction) and businesses. For present purposes the interesting feature of the flat tax is its treatment of income from business and capital.

In calculating the business tax base an immediate deduction is allowed for wages and salaries and for all purchases, including depreciable assets and additions to inventories. Interest income is exempt, and no deduction is allowed for interest expense. Because of the exemption of interest income, this approach is sometimes called "yield-exemption treatment". The business portion of the flat tax is thus equivalent to that under a substraction-method tax on value added, except that labour costs are deductible. Since labour income in excess of the tax threshold is taxed at the same rate as business cash-flow, the combination of individual and business taxes is equivalent to the combination of a subtraction-method value added tax and a particular form of demogrant. Some of the analysis of the next section assumes this equivalence; that is, it treats the flat tax as a form of value added tax. Unlike the present US income tax, the flat tax would be levied on a territorial basis. That is, tax would not be levied on income earned abroad. (And, of course, there would be no credit for income tax paid abroad.)

Tax would be collected on export earnings, and the value of imports would be allowed as a deduction. Thus, the flat tax would be levied according to the origin principle, rather than the destination principle, which is the predominant rule applied to VAT on international trade.[3]

B. Other consumption-based direct taxes

The yield-exemption provided by the flat tax is one "pure" form of consumption-based tax, in the sense that yield-exemption is provided to both individuals and businesses. The other pure form of consumption-based tax treats debt and interest quite differently. Under it, interest income is taxed and interest expense is deductible, as under the income tax. But, in contrast to the income tax, the proceeds of borrowing (and the receipt of repayment of debt) are included in taxable income, and lending (and repayment of debt) is deductible. Thus, at the individual level, only income that is consumed is

* The present paper draws on his paper "The US. Debate on Consumption-based Taxes: Implications for the Americas" (McLure, 1996).

1. See Hall and Rabushka (1983), (1985), and (1995). The only proposal for a consumption-based tax to have been converted to detailed legislative language is that for the Unlimited Savings Account (USA) tax proposed by Senators Sam Nunn (D-Georgia) and Pete Domenici (R-New Mexico). The proposal for the USA tax is contained in "Unlimited Savings Allowance (USA) Tax System" (1995) and is summarized in Weidenbaum (1996). For other American proposals for consumption-based direct taxes, see US Department of the Treasury (1977), Aaron and Galper (1985), Bradford (1986), and McLure and Zodrow (1996). US Congress, Joint Committee on Taxation (1995) describes various tax reform schemes, some of which are (at least loosely) based on the consumption tax model. Institute for Fiscal Studies (1978) and Lodin (1978) contain influential European proposals for consumption-based direct taxes.
2. Even serious consideration of such proposals by the United States could have important intellectual "ripple" effects in other countries, since it would give such proposals added respectability. For this aspect of the influence of US consideration of consumption-based direct taxes, see McLure (1996). Tanzi (1988) and Whalley (1990) examine the international influence of the American Tax Reform Act of 1986.
3. To implement a destination-based VAT, it is necessary to tax imports (or allow no deduction for imports under a credit-method tax) and apply a zero rate to exports (allowing credit for taxes paid on production for export). The primary exception to this rule is application of the origin principle to trade between republics of the former Soviet Union.

subject to tax. For this reason, this pure version is sometimes called a "consumed-income tax".

There is currently no proposal in the US debate for a tax on consumed income, presumably because this pure form is more complicated than its yield-exemption cousin.[4] There have, however, been two hybrid proposals combining aspects of both yield-exemption and consumed income tax approaches. One would apply consumed income tax treatment to corporations and yield-exemption treatment to households.[5] Because the international implications of this hybrid are essentially the same as those of the more familiar flat tax, the discussion of the two is combined in what follows.

The proposal for an "unlimited savings account" (USA) tax resembles a hybrid that combines consumed income tax treatment of individuals with yield-exemption treatment of business. Under it, there would be a substraction method tax on the value added of businesses and a tax on individuals that resembles a consumed income tax. As in the consumed income tax, individuals would be allowed a deduction for saving and reductions in saving would be subject to tax. In addition, a refundable credit would be allowed for the employee portion of the social security payroll taxes in calculating the tax liability of individuals.

Like the flat tax, the USA tax would be levied on a territorial basis. But border tax adjustments would be allowed; thus the business portion of the USA tax would be a destination-principle tax on value added. Moreover, credit would be allowed for the employer share of payroll taxes. Unlike the situation under most value added taxes, losses would be carried forward; they would not result in refunds, even for exporters.

The USA tax is not included in the analysis that follows because preliminary analysis suggests that it is so complicated that it would not, or at least should not, be adopted.[6] Complexity occurs in part because the USA tax would provide a deduction for net saving for individuals, rather than following the standard prescription under the consumed income tax (taxation of interest income and the proceeds of borrowing and deduction of interest expense and the repayment of the principal amount of lending).[7]

III. INTERNATIONAL IMPLICATIONS

In discussing the international implications of adoption of a consumption-based tax, it is convenient to distinguish several effects, notably those on trade, those on the location of economic activity, tax-induced shifting of income, and the need to renegotiate foreign tax treaties and creditability of a flat tax. These are considered in turn.

A. Effects on trade

To examine the trade effects of substituting a consumption-based tax for the income tax, we proceed in stages, employing a line of reasoning that is familiar from the discussion of the balance of payments effects of substituting a value added tax for the US income tax that has occurred over the past quarter century.[8] First, we consider how elimination of a uniform income tax and introduction of a uniform tax on consumption would affect nominal prices and wages, assuming the most likely reaction of monetary authorities. Then, where relevant, we consider introduction of border tax adjustments (export rebates and compensating import taxes). In the first stage we concentrate on effects on changes in nominal wages before and after tax, product prices, and real wages. In the second stage we consider effects on import prices and export prices, as well as effects on domestic prices, and deduce from these changes the effect on trade and the exchange rate.

1. Price effects of tax substitutions

Substitute VAT for income tax. It is unlikely that elimination of the income tax would greatly effect before-tax wages or product prices; it would simply increase after-tax wages by the amount of the tax reduction. By comparison, imposition of a VAT would probably raise product prices, but leave wages unchanged; thus real wages would fall. These two effects are shown in the first two lines of Table 1. As shown in the fourth line, the net effect would be no change in nominal wages, an increase in after-tax wages and product prices, and no change in real wages.

Substitute flat tax for income tax. Introduction of the flat tax would have effects that would be similar, but opposite in sign, to those of a reduction in the income tax: No effect on nominal wages or product prices, but a drop in after-tax wages and real wages. Thus the net effect of replacing the income tax with a flat tax would be minor, as shown in the last line of Table 1.

Table 1
Probable Effects of Tax Reform on Wages and Product Prices

	Nominal Wages	After-tax Wages	Product Prices	Real Wages
Eliminate income tax	0	+	0	+
Introduce another tax				
VAT	0	0	+	-
Flat tax	0	-	0	-
Net effect				
VAT	0	+	+	0
Flat tax	0	0	0	0

4. For earlier American proposals for a consumed income tax, see US Department of the Treasury (1979) and Aaron and Galper (1985). On the relative complexity of the two, see McLure and Zodrow (1990). Inclusion of the proceeds of borrowing in the tax base might also pose political and constitutional problems (the latter since the tax base would not be income, as required by the constitution).
5. See McLure and Zodrow (1996) and related references cited there.
6. On the complexity of the USA tax, see Ginsburg (1995), Kaplow (1995), and Warren (1995). Ginsburg writes, "The legislation seems unlikely of enactment, surely unlikely of enactment in the form introduced...."
7. Warren (1995) concludes, "It would be much simpler to implement the standard cash flow taxation of personal consumption."
8. See, for example, Harberger (1974) and McLure (1972) or (1973). Hall (1995) follows a similar approach.

2. Treatment of international trade

A classic theorem in the theory of international trade is that under certain conditions the choice between origin and destination-principle is irrelevant.[9] Since the trade effects of the destination-principle are equivalent to those of the origin principle, plus a currency devaluation, shifting from one principle to the other would, in the long run, be offset by movements in exchange rates or domestic price levels. However, during the period of transition between principles, the destination-principle would be more favourable to trade than the origin principle.

Substitute VAT for income tax. As noted earlier, substitution of a VAT for the income tax would probably increase product prices. Since border tax adjustments are allowed for VAT, but not for the income tax, import prices would rise in line with domestic prices, but export prices would remain unchanged, because of the rebate of VAT on export prices. Because domestic products and imports would be treated the same and export prices would be unaffected, there would be no effect on exchange rates or international trade; see the first line of Table 2.

Substitute flat tax for income tax. Substitution of the flat tax for the income tax would leave domestic prices unaffected. Being levied on the origin principle, flat tax would also leave import prices and export prices unaffected. This combination would thus also have no effect on international trade and exchange rates.

Table 2
Probable Effects of Tax Reform and Border Tax Adjustments on Prices and Exchange Rates

	Effect on Domestic Prices	Effect on Import Prices	Effect on Export Prices	Effect on Exchange Rate
Income tax replaced by				
VAT	+	+	0	0
Flat tax	0	0	0	0

B. Incentives for investment

Substitution of a consumption-based tax for the income tax would affect incentives for both outbound US investment and inbound investment by foreigners in the United States. These are considered in turn.

Outbound investment. Because the flat tax would be levied on a territorial basis, some believe that this would create incentives for investment to shift from the United States to other countries. For example, Gary Hufbauer describes this "runaway plant" phenomenon as "a near fatal objection".[10] This view seems wrong, or at least incomplete.[11] The flat tax, like other consumption-based direct taxes, is a tax on economic rents; that is, it exempts the normal return to capital, but applies to above-normal returns. This being the case, the United States would not be less attractive than a foreign country imposing a positive income tax, for a project yielding only a normal rate of return. The relative attractiveness of US and foreign sites for investments yielding above-normal returns would depend on the relation between tax rates in the two countries and the fraction of total returns represented by above-normal returns. A US flat tax would impose a lower total tax burden than a foreign income tax if the fraction of total profits represented by above-normal profits were less than the ratio of the foreign to US tax rates. Thus, for example, if one half of the return to capital in a potential investment were expected to constitute above-normal returns, the US tax would not discourage domestic investment, unless the US tax rate were at least twice as high as the foreign tax rate. Given the proposal to reduce the tax rate to about 20 per cent, the problem of runaway plants does not seem likely to be serious.

Inbound investment. Countries employing worldwide taxation of their residents should notice little effect on locational decisions of their multinational corporations that repatriate profits currently and do not have excess credits, provided they allowed credit for the consumption-based tax levied by the United States, an issue to be considered below. A change in taxes paid to the United States would simply result in correspondingly higher or lower foreign tax credits at home, and no net change in tax liability of such corporations. The analysis of the previous paragraph is applicable in the case of foreigners subject to territorial taxation in their home countries and to firms subject to worldwide taxation that do not repatriate profits currently or that have excess foreign tax credits.

Interest on passive investments in the United States is largely exempt from US tax. If interest deductions were eliminated, as under the flat tax, US interest rates would presumably fall. This would reduce the benefits currently enjoyed by foreign lenders. This should make investment at home relatively more attractive than investment in the United States.

C. Income shifting

Adoption of the flat tax would create substantial incentives for the restructuring of financial arrangements by multinational corporations. Since interest expense would not be deductible and interest income would not be taxable, there would be an incentive to shift borrowing to other countries, where it would generally be deductible, and to shift interest income to the United States. This could have dramatic revenue consequences for foreign countries. There would be substantial pressure on provisions intended to counteract income shifting, such as thin capitalization rules.

D. Foreign tax treaties and foreign tax credit

The United States has treaties with many countries. These are intended to prevent or reduce the double taxation of income flowing across national borders. If the United States were to adopt a flat tax as a replacement for the income tax, it would

9. This proposition goes back at least to a 1953 report of the European Iron and Steel Commission. For more sophisticated analyses, see Johnson and Krauss (1970), Harberger (1974), and Feldstein and Krugman (1990).
10. See Hufbauer (1995), at 68.
11. For a more complete analysis, see Grubert and Mutti (1995).

be necessary to renegotiate these treaties. In itself, this is a daunting prospect, given the relatively small size of the US staff devoted to treaty negotiations, the average length of such negotiations, and the small number of treaties that can be negotiated during any given time period. Prospects are even more unsettling, considering that it is not obvious how one would attempt to mesh a consumption-based system with a system based on taxation of income.

Countries that tax the worldwide income of their residents commonly allow credits for income tax paid to foreign governments, whether or not they have concluded a treaty with such governments. In the absence of such credits, there would be double taxation of income from foreign investments. A crucial question, then, is whether governments that allow foreign tax credits for income taxes would also allow such credits for a consumption-based tax. This depends, of course, on the law of each country. Despite the overwhelming case for creditability,[12] countries with restrictive eligibility requirements for the credit might not allow credits.[13]

While creditability is important, it should not be overemphasized. First, it is of no relevance for countries employing the territorial system. Second, most countries tax foreign-source income only when repatriated; creditability is relatively unimportant for income that is retained. Finally, most countries impose limits on the amount of foreign taxes that can be claimed as credits. Where foreign taxes exceed the domestic taxes that would be paid on the same income, corporations have excess foreign tax credits. For such companies, creditability is a secondary issue, since there is no credit in any event. Having said this, one must not be cavalier. Eligibility for foreign tax credits confers a kind of imprimatur, at least in the minds of some.

IV. CONCLUDING REMARKS

The flat tax has important potential benefits, especially simplicity (and, of course, perhaps the economic benefits that economists stress). But US adoption of a flat tax also would have unsettling effects in the international sphere. These international ramifications which were on occasion overlooked in the income tax field must be fully taken into account in the debate on the flat tax.[14]

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12. McLure and Zodrow (1995) present this case.
13. They might, for example, argue that credit should not be allowed for a tax that allows no deduction for interest (the flat tax) or that includes the proceeds of borrowing in the tax base (the consumed-income tax). Seen in this light, the USA tax might have a better chance of achieving creditability. The US government has expressed this view unofficially; see McLure and Zodrow (1996).
14. See, for example, McLure (1990) and (1992).

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INTERNET

TAX AND THE WEB: NEW TECHNOLOGY, OLD PROBLEMS

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I. INTRODUCTION

A quick stroke of a key, and she places her order to purchase some fabulous new household furniture. The lucky buyer discovered the speciality furniture company while browsing the Internet, hoping to find just the perfect room additions, unavailable in the retail stores to which her well-meaning spouse had dragged her. The best part of the purchase: the "custom" design. She had engaged in an on-line "conversation" with one of the company's marketing representatives. He had used his own Internet connection to convey her wishes to a designer, who just happened to be sitting on a beach in a remote Caribbean location. He would spend some time reflecting upon the buyer's dream room, and using his talent and the inspiration of the sunset would draw up sketches and specifications to suit her needs. As he worked he accessed a large computer mainframe in Pittsburgh. The furniture design software on the mainframe was quite remarkable, designed specifically for this business by an employee living in Australia (where none of the company's business had ever been done).

In fact, the computer itself did a lot of the work the designer would have done himself some years back, like assessing potential design flaws, automatically calculating material requirements, and determining the proper architectural aspects for safety and durability. The designer, happily, was left to his art. But some of his ideas were refined by accessing a large database of furniture design reports and patent filings, part of which he downloaded from the Pittsburgh computer for reference. When finished with his work, the designer would communicate his plans electronically to craftsmen in the European country-side, who through their laptops, and tying into the mainframe computer services, would serve as consultants to workers at a large factory in an Asian city, where the furniture would be produced. The craftsmen might even have a videoconference from time to time. The customer paid for the purchase by a charge to her "e-money" account – and all the other cross-border transfers were paid for in the same way, even among the related companies involved in the transaction.

Welcome to the communications revolution: the convenience and advantage of personal service, global consultation, and interaction, fast and without leaving your home. It's enough to make a good tax administrator shudder. But why? What's all the fuss about taxation and the Internet? And what does it have to do with transfer pricing?

II. AN OLD PROBLEM REVISITED: MAIL-ORDER BUSINESS

Many of the transactions in the above tale could have been accomplished through the regular mail and the telephone, along with the distribution of some catalogues here and there. In essence, the use of the Internet in cross-border sales raises much the same issues that tax administrators have grappled with for years when faced with mail-order business. Income is flowing out of one jurisdiction (the jurisdiction of the buyer) to another jurisdiction, and the income recipient has not established a physical presence in the buyer's country. What level of activity will permit the country of the buyer to impose a tax on the transaction? The question is not a new one. And the traditional answers still apply: tax can be imposed where the seller has a sufficient nexus to the buyer's country, a nexus that is referred to in the OECD Model Tax Treaty as a permanent establishment.

While the transactions could have taken place using the old-fashioned routes, in fact they most likely would not have happened that way. The two most important differences made by the Internet or private communication networks is speed: the near-simultaneous transmission of information and the increased mobility of activities: the effective removal of physical boundaries. The speed of communication allows individuals as well as companies and assets to be more mobile, less tied to any particular jurisdiction. Employees do not need to share office space or interact in person; design consultants do not have to visit the customer's country. With the Internet, cross-border transactions are easier to execute, and so they are likely to proliferate. While from the viewpoint of execution the transactions are easier, from the tax administrator's perspective they are harder: harder to identify, harder to trace, and harder to quantify. And with much of the work being done by a computer, there are difficult questions about where functions are being performed, and by whom. These questions are not completely new either, though the fact patterns may be innovative. But the speed, multiplicity, and decentralization of the cross-border exchanges/transmissions that are involved put pressure on traditional concepts of taxation. In an area where pundits question whether existing cables and band-widths are sufficient to carry the traffic on the information superhighway, the fiscal questions are most apt: are traditional concepts of taxation sufficient to deal with transactions of this volume and complexity, or will they break down under the strain? Are new frameworks needed?

As these questions are pondered, it should be noted that the new technologies do not pose only threats for tax administrations; they also open up new opportunities to improve the operations of tax systems. This paper addresses both the challenges and the new opportunities.

III. PROBLEMS WITH TRADITIONAL PRINCIPLES OF INTERNATIONAL INCOME TAXATION

Traditional principles of international income tax are closely tied to the question of physical presence. In developed countries, the default tax regime is usually "residency based"; that is, the tax base includes the income of any persons (whether individuals or corporations) who are considered present in the country on a sufficiently regular basis to be considered residents. The default in favour of a residency-based system of tax jurisdiction is particularly evident in the structure and operation of the OECD Model Tax Treaty. For instance, Article 21 of the OECD Model provides generally that income items not specifically dealt with in other Articles of the Model shall be taxable only in the recipient's country of residence. There are a few specific exceptions to the residency-based approach, most notably for dividends and interest, which may be taxed at source irrespective of residence of the recipient, although usually at a reduced rate. See OECD Model Tax Treaty Articles 10, 11.

In assigning taxing rights over business operations, the OECD Model's residency approach does not consider only an enterprise's juridical residency, i.e. country of incorporation. Rather, a concept of business presence is used to determine whether the enterprise has brought itself within any particular taxing jurisdiction. This is the concept of the permanent establishment. Under Article 7 of the OECD Model Treaty, a country can tax an enterprise's business profits attributable to a permanent establishment located in that country, regardless of the enterprise's country of juridical residence. Whether operations rise to the level of a permanent establishment is often a subjective determination. Article 5 of the OECD Model Treaty gives a definition and some guidance – a permanent establishment is a "fixed place of business through which the business of an enterprise is wholly or partly carried on" – but certain types of limited presence are not sufficient to draw an enterprise within the taxing jurisdiction of a country. For instance, a permanent establishment does not include "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise". (Paragraph 4 a) of Article 5 of the OECD Model Tax Treaty.)

These concepts are elementary, but their application can be quite difficult and contentious. Fundamentally, the concepts are grounded on a philosophy that taxing rights should be linked to a certain level of physical presence, where physical presence can mean assets, or personnel, or both.

The principle of physical presence comes under pressure where a business is able to exploit a market in a country without establishing a significant physical presence there. The mail-order business is a classic example of this strategy. Through mail solicitations and perhaps even telephone contact, a manufacturer might be able to sell its products rather effectively without setting a foot across a border. But there are drawbacks to this strategy. A competitor might decide to have some on-site representation to make its company and its product well-known within the confines of the specific geographic region. Or perhaps customers want to be able to sign up to a purchase contract on-site, in their own location, and want to deal with a party who has the authority to execute the contract. Companies with rapidly changing product lines might find catalogue representations too limiting. The OECD Model Tax Treaty would permit (without finding a permanent establishment) the maintenance of a stock of goods for display purposes, but this stock will do no good if customers are unaware of it. So a mail order business taking steps to avoid a permanent establishment would have to bear with the shortcomings of a limited physical presence. For years tax administrators have thought this to be a reasonably fair trade-off: no jurisdiction to tax by a country means no right to the business advantages of presence there for the company.

With Internet transactions, one encounters the same type of pressure on the physical presence test as in the mail-order business, but with two striking differences. First, the disadvantages brought about by lack of presence in the country are greatly diminished. Second, there is a real ambiguity about what presence actually means when a computer network is involved.

As to the first point, the interactive nature of the Internet (and the potential for dramatic increases in interactivity and speed in coming years) can give the customer the feel of the seller's presence, and both the customer and the seller can realize many of the advantages that presence usually brings, without company representatives or company products being within the country's boundaries. A paper catalogue, sent through the mail, is replaced by an on-line catalogue, which can be modified and updated daily, with possible changes in price lists. Advertisements might be targeted to Internet users of a particular profile, and personal solicitations, through e-mail could be made for large customers. Contracts could be agreed electronically. In the aforementioned furniture design example, our customer received personal service and attention. None of this would require physical presence.

As to the second point, perhaps the "presence" that should be relevant is that of the information being transmitted. The OECD Model Treaty already makes clear in its Commentary that a permanent establishment may exist "if the business of the enterprise is carried on mainly through automatic equipment." [Commentaries to Article 5, paragraph 10 of the OECD Model Treaty.] In such a case, the location of the automatic equipment is the main determinant of presence. The communications revolution may lead some tax administrators to go even further. For instance, they may take into consideration the location of intangible assets in assessing whether a permanent establishment has arisen in the source country.

Reflecting again on the furniture design example above, the MNE has a page on the World Wide Web that accepts customer orders. This page appears on computer screens around the world, including the country of this particular buyer. Is the mere availability of information enough to constitute presence? For years, the answer to that question has been "no". Subparagraph (e) of Article 5 excludes from the definition of "permanent establishment" the maintenance of a fixed place of business for carrying on an activity of a "preparatory or auxiliary" character, and this would normally include the supply of information. [See Commentaries to Article 5, paragraph 23.] Could the Web page nonetheless be considered a form of presence of the company in that country, on the theory that it acts as a type of dependent agent that can conclude contracts on behalf of the company? Almost surely not. The Web page itself, while perhaps an asset, cannot itself accept orders. The order acceptance would be done by an executive in some other location, albeit over the Internet. And in any event, a Web page might not be considered a *fixed* place of business. How many times would a Web page need to be accessed in a particular country for its presence to be considered habitual, rather than temporary? It would seem that the permanent establishment concepts of the Model Convention would not be able to turn a Web site into a permanent establishment.

Yet there are other possibilities. Again referring to the furniture example, how should the information being accessed by the Caribbean designer and the European craftsmen be treated? Perhaps the computer server in Pittsburgh is a fixed place of business for the company, in which case the United States might want to claim some taxing rights over a portion of the profits attributable to the intangible property represented by the furniture design. But the provision of the information stored on the computer might be considered merely auxiliary (subparagraph (e) of Article 5), or a place for the mere storage of goods (e.g. the information) belonging to the enterprise (subparagraph (a) of Article 5). Of course Australia might feel legitimately entitled to some taxing rights over the profits attributable to the design software, but then Australia might never find out that the anonymous developer of this software is in fact Australian, particularly if the entire transaction of transferring the software to the computer server was accomplished electronically.

Beyond the permanent establishment issues, there are difficult questions about the source of income. The source of income can be an important factor in judging just how much income should be attributed to a permanent establishment, should one be found to exist. General sourcing principles were developed for the physical world, not the electronic one, and so there is not always a clear answer for transactions undertaken over the Internet. Income from the sale of goods, for example, may be sourced based on the place of manufacture, the place of title passage, or some combination of the two. It is unclear how such principles would apply to the sale of information or assets like computer software that are transmitted electronically. Should a portion of the income attributable to the European craftsmen's activities be sourced in the United States, because the craftsmen have used information from the Pittsburgh computer?

Another difficult area is the proper treatment of services. Under the OECD Model Treaty, income from the performance of services is typically taxed (and in most countries is sourced) in the place where the services are performed. This rule has always referred to the physical presence of the service provider, but the rule was developed at a time when there was a close and almost necessary connection between the place where a service provider would be physically present and the place in which the services would be received. With videoconferencing, e-mail linkages, and worldwide computer networks for specific companies, this connection has become less obvious. Our furniture designer, whom we might call a "virtual employee", provides his services from a tax friendly jurisdiction, but his services are received at various locations throughout the world. Yet only his Caribbean paradise would have the right to tax the designer's compensation, no doubt a premium compensation reflecting his talents and skills. So, with no change in traditional tax concepts, a company might locate all its skilled personnel in a tax haven, and provide consulting services to high-tax European countries, without ever creating a permanent establishment. Once again, the communications revolution can be seen as putting pressure on the traditional concept of residence-based taxation.

The potential explosion in the number of cross-border transactions that will occur as a result of the Internet and private networks will require that tax administrations will have to handle effectively those cross-border transactions which generate tax consequences. One example is withholding taxes on royalty payments. With the Internet not only is it possible to carry out the buying and selling of goods and services but digitization opens up the potential for a number of types of goods to be delivered electronically (computer software, books, films, music, etc.).

Any information than can be digitized, such as books, music, computer programmes and images, can be transferred and sold electronically. A buyer's right in such electronic information may vary depending on the contract between the parties. For example, the buyer of a digitized photograph could obtain the right to use a single copy of the photograph, the right to reproduce ten copies for special purposes, or the right to reproduce the photograph in a mass-circulation magazine. Some of these transactions may be equivalent to the purchase of a physical copy of the photograph, which would result in *business profits*, others would rather result in *royalty income*, which may be subject to withholding tax in the source country.

Article 12(2) of the Model Convention defines royalties as "payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films..." It is not clear how this definition applies to the sale of digitized information.

Digitized information presents unique issues because it can be perfectly and easily reproduced. Someone desiring to purchase ten copies of an electronic book may simply purchase one copy and further acquire the right to make nine additional copies. This transaction might be seen to create royalty income, at least in part, since the right to make reproductions is a right reserved to the copyright holder. By allowing a buyer to make reproductions, the payment is, at least in part, in consideration for the use of the copyright. However, the transaction could also be viewed as being simply a substitute for the purchase of ten copies from the publisher. The buyer merely having undertaken himself to make the copies of the book.

The subject of taxation and electronic commerce is currently in vogue, and articles and conferences are proliferating to ask many of the same questions that are found here. At this stage in the debate, seldom are answers to the questions offered. For the sake of provoking a discussion we set out some possible outcomes. With regard to the traditional principle of residency and physical presence, it would seem unlikely that developed countries would embrace a change to taxation based on source. Countries that are net capital exporters could lose substantial tax revenues under such a system. Short of such a radical approach, there might be other options. One possibility is to reconsider the meaning of "presence" for transactions executed through the Internet or indeed through other real-time communications vehicles. Consulting and marketing services might be good candidates for a changed definition of presence. If a person is habitually present through videoconferencing or an interactive Internet link, he might be considered present for tax purposes. One other possibility is to simply accept the risk of base erosion inherent in the traditional approach, and retain the definition of presence in its current form.

With regard to digitized information, given its unique characteristics and the difficulties of characterization that could arise in this context, it may be necessary to reconsider the definition of royalties in the Model Convention.

IV. TRANSFER PRICING: A NEGLECTED ISSUE

Issues of permanent establishment and source of income are the most commonly raised substantive tax concerns identified with the communications revolution. These issues are concerned most directly with determining whether there is a sufficient nexus with a tax jurisdiction to subject a foreign company to tax on the profits it earns from dealing with a third party in that jurisdiction. But perhaps an equally important question is whether these activities should be taxed in each of the interested countries. That question, though often overlooked in this context, is a key issue, at least under current forms of doing business, because of the historical preference in multinational groups to prefer local country subsidiaries to branches. In using local country subsidiaries many MNEs have in essence admitted the existence of a sufficient nexus to tax, so that the more pertinent inquiry is how much income to attribute to each of these subsidiaries, very much a transfer pricing issue.

Before considering this issue in the context of the communications revolution, a few observations are in order. First, the transfer pricing issue is not confined to situations in which subsidiaries are used. Where a permanent establishment exists, the amount of income allocated to the permanent establishment would normally be determined under the same rules that govern transfer pricing between related companies. Article 9 of the OECD Model Treaty, applicable to associated enterprises, requires the application of the arm's length principle to determine transfer pricing. Article 7 of the OECD Model Treaty, addressing the allocation of business profits to a permanent establishment, generally follows the same principle. See Commentary on Article 7, paragraph 11. In some special cases, i.e. where customary in a country, the permanent establishment's profits can be determined on the basis of apportionment, but even then the result must accord with the arm's length principle.

A second observation is that the historical preference for subsidiaries may not last. That preference was formed in part from the experience that income allocation issues were less likely to arise with subsidiaries than with permanent establishments, and that where they would arise, they could be more readily resolved in the subsidiary context. Also MNEs were reluctant to divulge information about their worldwide operations to the tax authority of any one country. Now the considerations may be different. With the increased attention to transfer pricing issues, indeed with the development of a consensus position at the OECD, income allocation issues are probably at least as likely to arise with subsidiaries as with branches. Moreover, with a new emphasis on documentation and bilateral exchanges of information, MNEs can no longer count on separate incorporation to be an effective shield against divulging worldwide financial data. As the tax considerations begin to balance the choice between branch and subsidiary form, businesses may find themselves attracted to the greater flexibility from a management perspective that branches can provide. Thus, there may be an increase in the incidence with which permanent establishments will face transfer pricing inquiries.

Returning to the implications of the communications revolution for transfer pricing, the crux of the matter is the same as that in the discussion of permanent establishments and source of income. The communications revolution presents no new problems, no fundamentally or categorically different dimensions, for transfer pricing. The communications revolution just presents all the old problems more quickly. Everything is more mobile, faster, more complex. In the discussion of permanent establishments, the speed and complexity of electronic commerce was seen to put pressure on the traditional residency-based approach to taxation and the concept of physical presence, two concepts that are fundamental to the construct of international tax systems. Likewise, in the area of transfer pricing, electronic commerce and the development of internal private networks within multinationals puts pressure on the traditional approach – and all this even though the basic nature of the problems in both areas has not changed.

The traditional transfer pricing approach has two fundamental characteristics elaborated by the OECD's 1995 consensus on transfer pricing: to require a transactional approach, and to refine and improve comparability analysis. Some history is instructive. The OECD's project to revise its earlier report on transfer pricing, published in 1979, was prompted by a number of factors, not the least of which were the increase in the number and complexity of cross-border transactions, the proliferation of MNEs, and the difficulty in finding comparable market transactions to price controlled transfers involving non-routine intangible property. Academics and other interested parties began to argue that the arm's length principle was unworkable, and should be discarded in favour of a system of worldwide income apportionment according to a predetermined multi-factor formula (a system referred to as global formulary apportionment (GFA)). This system was seen by most tax administrators as producing an arbitrary allocation of the tax base, and there was little chance of obtaining agreement on the formula to be used. Without such an agreement, GFA would result in serious double taxation.

In the meantime, new methods were introduced in an effort to handle more complex cases, including those with intangible property. The United States introduced its comparable profits method (CPM), and along with other countries began to experiment with various profit split approaches. The traditional methods of comparable uncontrolled price (CUP), cost plus and resale price (the latter two based upon gross profit margins) were said to be insufficient to handle all cases, because they relied heavily on transactional similarity.

The profit-based methods were heavily criticized as not being within the ambit of the arm's length principle. Opponents claimed that countries using the methods would be able to claim an excessive share of the tax base from cross-border transactions. So, the arm's length principle was challenged on two sides: those who would discard it completely in favour of GFA, and those who would defend it so staunchly that they would permit only the three traditional methods, a narrow interpretation that threatened to make the principle itself obsolete.

The OECD solution was a balanced one: to preserve the arm's length principle, as the most effective means for dealing with transfer pricing, but to interpret it broadly enough so as to permit the use of non-traditional methods in last resort cases, but with strict limitations. The non-traditional methods would have to be applied in a manner that would safeguard the integrity of the arm's length principle. The insistence on a transactional approach and a more thorough comparability analysis followed naturally from this reasoning.

A transactional approach was considered particularly important to a net profit method because global profits could be influenced by many factors wholly unrelated to particular transactions between related companies. The arm's length principle under Article 9 of the OECD Model Treaty permits only adjustments to reach the profits that would have accrued *but for* special conditions established in the relation between the parties. To isolate these special conditions and so satisfy the foregoing "but-for" test, only the profits of the controlled transaction should be taken into account.

The thorough comparability analysis was needed to ensure that any adjustment would achieve the same results that would have been realized by independent enterprises in comparable circumstances. Without an adequate comparability analysis a transfer price established through utilizing third party data might not represent a true market price because of differences in the circumstances for the third party relative to the taxpayer. A particular emphasis was placed on a thorough comparability analysis for the OECD's net profit margin method (the transactional net margin method or TNMM), because of the variety of circumstances that can influence operating expenses and hence net profits. Net profit margin methods are sometimes used when third party data are not sufficiently similar in the transactional elements (e.g. the product being transferred, the functions being performed); net profit can factor out some of these differences. The danger was that the decreased importance of transactional comparability would cause other comparability issues, in particular the comparability of the business enterprises themselves, to be overlooked.

The OECD Guidelines describe a number of characteristics about the enterprises being compared that could influence net profits, such as market position and management efficiency. Only with these factors taken properly into account were all the OECD countries prepared to accept the use of the TNMM.

In the OECD Guidelines, the profit split method was made subject to the transactional limitation, but the focus on comparability is less significant. Comparability is less emphasized because the profit split method does not rely heavily on external data. While the OECD Guidelines do request tax examiners to seek external data that are informative of how independent parties would have divided the profit from a comparable transaction, in practice internal data are the most significant factor in setting the profit split percentages. Conformity with the arm's length principle is achieved not so much by using comparable external data as by using the approach of dividing profits that independent parties would have found acceptable. The Guidelines instruct that this approach normally involves valuing the relative value of the contributions made by each participant, possibly taking into account relative costs and expenditures e.g. for research and development.

With this background in mind, it is easy to see why any challenge to the transactional approach and comparability analysis could be precarious. It is equally easy to see why the communications revolution sets up that challenge. The speed, frequency and integration of exchanges over the Internet and the development of private networks within MNEs will require an innovative approach in applying a separate transaction analysis. In terms of comparability, it becomes more difficult to determine what the transaction actually is, and even greater difficulties apply to finding a third party transaction about which enough is known to conclude that it is comparable. And transactions can be hard to discover and trace, particularly those which take place in private networks. The OECD Guidelines direct a functional analysis to assess comparability, but with electronic commerce and private networks it can be difficult to know who is doing what. Transfer pricing will increase in complexity, particularly if the MNE is purposefully attempting to shift income among related parties.

To illustrate, in the furniture design example, can the designer's work be analysed separately from the computer server transaction, from the development of the remarkable computer software, from the participation of the craftsmen, even from the manufacture itself? Perhaps, but as transactions become more and more complex with a myriad of back and forth flows all around the MNE group, separate identification and analysis of transactions could become burdensome, indeed unattractive to taxpayers as well as tax collectors. An early version of this problem has been seen outside the world of electronic commerce, when members of an MNE group engage in cross-licensing through the device of a "grant-back" clause for the results of research and development. The cross-flows usually cannot be handled separately, and the group's research and development function may need to be considered globally.

The other concern is whether the standard of comparability can be met. The standard likely would not permit application of a traditional method to determine the computer server's revenues, based upon profit margins or prices from third party information providers, unless those third parties, like the MNE, also had developed the information database and equally reliable software. The functional analysis supporting a comparability assessment is also in trouble. When the Caribbean designer accesses the Pittsburgh mainframe in order to have potential design flaws assessed and for other structural aid, there is a question about who should be credited with the activity. The computer server might be seen as providing only information. On the other hand, perhaps the computer server is engaged in a limited form of design work that would have been carried on by a human being some years ago. For the functional analysis, the world of electronic commerce poses a nearly theological question: how much credit should be given to a computer for its processing functions, even though the functions are being directed by a human.

In short, the communications revolution stands to put great pressure on the transactional and comparability principles that are the bedrock of the arm's length principle as now interpreted by the OECD. What might result from this pressure? One possibility is a greater use of the profit split method, where external comparable data is less important. And furthermore, there could be a softening of the transactional principle when applying the profit split, on the grounds of practicality. The aggregation rules in Chapter I of the Guidelines would permit such aggregation where the transactions are "so closely linked or continuous that they cannot be evaluated adequately on a separate basis". The Guidelines are perhaps a bit prescient in seeing "continuous" transactions as eligible for aggregation – electronic commerce could often present the case of continuous exchanges, possibly even around the clock. Such continuity is most familiar in the area of innovative financial transactions, e.g. global trading, where the profit split method is often advanced as the most fitting solution.

Tax administrators may find some relief to the extent that Multinational Groups will develop their own private communication networks, as well as accessing the Internet. MNEs will likely prefer these private networks for a number of reasons. With the transfer of highly valuable intangibles (e.g. trade secrets, know-how) MNEs may not have sufficient confidence in the security arrangements under the Internet. Also, under private networks MNEs can use new advanced technologies, permitting, for example, our furniture designers to work together in three dimensions and in real time. The use of these private global networks is already well advanced, as can be seen by the development of global trading.

If private networks become the "norm" for communications and cooperation on high value projects between related parties, tax administrations may be able to avoid some of the problems referred to in this section, at least insofar as they have adequate information requirements. Nevertheless, even related parties may find it more convenient to use the Internet for low value routine transactions.

V. PROBLEMS WITH THE TRADITIONAL PRINCIPLES UNDERLYING VALUE ADDED TAXES (VAT)

The communications revolution also poses challenges for the traditional concepts underlying VAT systems. Tax administrations and others are concerned with the ways in which supplies of telecommunication services, Internet fees, satellite broadcasting and supplies of computer software and related computer services will be treated under the VAT.

Apart from services related to the financial sector (which presents a whole new set of problems), the vast majority of the services in question are normally taxable at a positive rate of VAT when supplied for domestic consumption and taxable at a zero rate of VAT when qualifying as exported services. Consequently, it is the VAT rules governing the accountability of international services that have always posed problems for tax administrations. These problems are amplified manyfold when considering services based upon these new communication technologies, particularly in respect of the time, place and value of the supplies.

The initial problem involves the *place of supply* and the difficulty in determining the identity and place of establishment of the supplier. For example with modern telecommunications techniques there is no need for the supplier to be established in the country of supply as in the case of the "call-back" system operated by many American companies in Europe. The problems associated with the *time of supply* (chargeable event) are a natural follow-on to the initial problem and equally difficult to solve due to the difficulty in determining the source of the supplies. The problems associated with the *value of the supply* (tax base) underline the overall significance of the situation in dealing with intangible products where values are extremely difficult to estimate – but undoubtedly of a very high magnitude.

VI. PROBLEMS WITH AUDITING AND ENFORCEMENT

Beyond the technical issues described above, electronic commerce transactions and the development of Internet networks will challenge even the most efficient tax collection and enforcement regime, both under direct and indirect taxation. The Internet allows significant anonymity. The use of an Internet site can be untraceable to the actual user or even to the user's country. In our example, the United States may have difficulty in discovering that the Pittsburgh mainframe has been used by the Caribbean designer. Even where some electronic traffic has been discovered, encryption keys may prevent a tax administration from knowing the content of the message or communication. For either reason, Internet transactions may leave no "audit trail". The sites also can be shifted very quickly, so that tax administrations may have difficulty keeping up with the trail even if it can be found.

Perhaps the most significant audit concern derives from the potential for significant use of e-money arrangements for transactions. Through e-money, the Internet can take bank secrecy to an extreme. The untraceability of Internet transactions means that e-money could function essentially like cash that is kept at home rather than put on deposit at a bank. The tax authorities may never know about such sums. However, e-money would not have many of the disadvantages that would be present in holding cash outside a banking institution. Holding large amounts of cash presents a security risk, and normally cash would only be transferred in person. With e-money, there are no physical bank notes and the security could be assured by the provider of the e-account. E-money is also readily transferable. The account provider would be the electronic equivalent of a bank, albeit one located juridically in cyberspace – an "e-bank".

Physical banks generally are required to report on cash issue and deposits, particularly in the OECD area where bank secrecy is generally discouraged. Such requirements do not yet extend to e-banks. In some cases, useful information might be taken from the e-bank about, e.g. an account established to allow a potential consumer to make purchases, and about transfers processed to the e-account of a seller. However, in other cases, particularly involving transactions between related companies, the e-accounts may be less formal, and not involve a third party acting as an electronic bank. As mentioned before, the tax administration may not be aware of the transaction between the Caribbean designer and the United States computer server. But further, the United States may be unaware of any payments made to the Caribbean designer from the United States, if these are made through e-money accounts.

The e-money accounts might even be turned into purchasing power outside cyberspace through the use of "smart cards", a plastic card similar to a credit card and which contains digitized information encoded on a microchip. The smart card could possibly function as a type of bearer instrument credit or debit card, and would present the same tax compliance challenge as must be confronted with any bearer instrument. In this case, it may be more difficult to enforce any reporting requirements that might be proposed.

VII. THE CHALLENGE FOR TAX ADMINISTRATIONS

New information technologies will open up new ways for tax administrations to carry out their business. This section discusses those approaches that tax administrations are exploring.

Electronic data interchange and electronic transmission of data is being used increasingly by businesses in their dealings. Electronic communication may also be used by financial institutions and employers to provide data to the tax administrations on taxpayers. Electronic filing allows taxpayers to file their tax return using the telephone and personal computers and is already available in an increasing number of OECD Member countries (Canada, the Netherlands, New Zealand, the United States). This process allows assessment notices and refund credits to be made much faster. The objective is also to reduce paper work and eliminate the necessity to key information, thereby reducing the risk of error and the costs for both the tax administration and the taxpayer. Some estimates suggest that the time required to obtain a refund may be reduced by half. (The system may, however, be more vulnerable to fraudulent refund claims). Electronic transmission can also be used for automatic exchange of information and an EDI standard is presently being designed by the OECD for these types of exchanges, with due respect for confidentiality.

Imaging: Imaging allows a tax administration to capture information from paper tax returns and convert this information into an electronic format. This process increases accuracy and speed and reduces the number of staff involved in data entry. Digital storage allows for instant indexing, retrieval, and automated responses to taxpayers. Imaging technology may also be used by taxpayers to keep books and records for tax purposes and this is accepted for instance by certain countries (e.g. Canada).

Use of the Internet: Tax administrations have with the Internet a tool to provide easy access for taxpayers to a wide range of information (tax forms and publications, newsletters, tax statistics, on-line filing, and possibilities to provide feedback or comments on proposed regulations). The Internet may also be used for electronic filing of tax returns once a secure system has been developed.

Technological innovations such as those described above are already having an impact on and will increasingly change the operation of tax administrations. The changes are likely to allow taxpayers to receive better services and to reduce costs for governments at a time of resource constraints as well as to reduce the burden and compliance costs for taxpayers. In the longer term, these new technologies may enable the complexity of the tax system to be reduced: a goal set for many of the tax reforms of the 1980/90s but so far with little success. If this potential is to be fully exploited, countries will need to engage in a process of strategic planning, especially if the pace of technological innovations accelerates. This new environment will require tax administrations to anticipate change in order to prepare and adjust the organization of the tax administration and train staff to respond to the demands of taxpayers who will increasingly want to use electronic transmission in their dealings with the tax administration. The tax administration will need to explore direct links to private information systems providing third party information (from employers, financial institutions etc.) and to information systems of other public departments and eventually foreign tax administrations especially via automatic exchanges of tax information. There will also need to be greater cooperation between tax administrations and financial and other regulatory bodies.

VIII. HOW THE OECD IS ADDRESSING THESE ISSUES

The OECD's Committee on Fiscal Affairs has decided to address the taxation issues raised by the communications revolution through a multi-disciplinary approach that will involve all its existing Working Parties. Working Party No. 1 on Double Taxation will consider the questions relating to permanent establishments and other issues arising under the OECD Model Treaty. Working Party No. 6 on Multinational Enterprises will consider the transfer pricing implications. Working Party No. 8 on Tax Avoidance and Evasion will consider the bank secrecy and compliance aspects. The Committee itself will be examining the strategic management issues raised by these technologies. This work will be carried forward in a non-traditional manner appropriate to the subject matter: rather than having delegates come together in Paris, it is intended to coordinate the multi-disciplinary work through a "virtual" group of delegates – that is, through electronic conferencing facilities.

The OECD's Special Sessions on Innovative Financial Instruments is also doing some work relevant to the communications revolution. That group is working on a paper for publication on global trading, a business activity that relies heavily on cross-border electronic communications. The Steering Group on Transfer Pricing is currently working on a new chapter to the OECD Transfer Pricing Guidelines on the subject of permanent establishments, where the interaction of Articles 7 and 9, as well as other special issues such as the treatment of intra-branch payments, will be discussed in more detail. This work could inform the more specific Internet discussion that will occur in the virtual group, in which Working Party No. 6 delegates will take part. (Until the new chapter on permanent establishments is completed, relevant guidance can be found in a 1984 OECD Report entitled "Three Taxation Issues").

The Committee's Group on Consumption Taxes is currently examining the ways in which these new technologies can be used to deliver international services and the implications for VAT and sales taxes.

Aside from the specifics, the most important role for the OECD is to help the Member countries find mutually agreed approaches for taxing electronic commerce. In this way, the risk of double taxation will be minimized, and legitimate electronic transactions will not be impeded by tax considerations. At the same time, fair and consistent rules will discourage abuses and help provide a level playing field for all businesses operating in this domain. And who knows, from what this project teaches the OECD about the Internet and virtual working groups, we may one day find the organization's headquarters on a remote Caribbean beach frequented by furniture designers.

INTERNET

The Impact of the Internet on the Taxation of International Transactions

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The existing body of international tax rules, as reflected both in national law and in treaties, is based in large part on the supposition that international trade consists of the physical shipment of tangible goods or the physical movement of persons to perform services at different locations. The challenge posed by the development of the Internet and related means of communication is that in many cases this is simply no longer true.

More and more of the products which people buy are not physical, in the traditional sense of the word. It is reported that in the United States today, more than half of all capital expenditures are for information technology – and that does not include software.[1] A large number of transactions which used to involve the delivery of physical goods no longer does. Any reader with a computer, a modem and suitable software, for example, can browse a magazine by simply dialling in. No physical product moves from one place to another.

Even when a customer buys physical goods, the purchasing process has radically changed. The customer can often order goods by going on-line. He or she can engage in a detailed dialogue concerning quality, price, availability and delivery terms simply by "chatting" on the computer with the seller's representative, wherever that person may be located. In addition, it may be difficult or impossible to trace the location of the computer facility which the seller employed to deal with the customer. The server, the facility used to accept a customer's incoming call, may be located anywhere; and many enterprises may have multiple servers at a variety of locations. The customer has no way of knowing which server is handling a transaction, and the server itself may not be able to tell where the customer is located.[2]

It has equally become much harder to ascertain where services are performed. Less and less often is it necessary for the service provider to go physically to the customer; and often a single service may be performed by a combination of people in a variety of locations. To take a simple example, a customer seeking to "debug" a software system which it has purchased may secure "hot line" assistance by calling a local telephone number; the caller is immediately put in touch with a specialist, who may be located anywhere in the world, depending upon the expertise required or simply the time of day. If an on-going consultation is required, several specialists located in several countries may participate over a period of time. When the problem is solved, any delivery of services is provided by simply downloading further programming onto the customer's system.

The examples could be multiplied, but the theme is the same: traditional suppositions of the way in which commerce is carried out do not reflect what actually happens in the Internet era.

A somewhat more subtle change has occurred in the way in which we would characterize what is being sold in commerce. We have always thought of a book as an item of tangible personal property and therefore the income from its sale as income from the sale of goods. Now, however, we realize that the delivery of the book (or the fax, for that matter) is only one way of providing the recipient with information. The Internet is another. And that makes us wonder whether we were really right in the way we characterized the book transaction in the first place.

All modern tax systems and tax treaties make distinctions among three basic categories of income (as well as others, of course): the sale of personal property, the provision of services, and the furnishing of intangibles, including intellectual property rights.[3] In the era of the Internet, these distinctions are blurring. When an enterprise provides me with information, is it selling me property (the paper on which statistics are recorded)? Is it providing a service (because it has gathered the information for me)? Or am I paying for the use of intellectual property (because the provider has developed a unique composition)? Is the provision of software, technically a license of intellectual property, really a license or a sale?[4] Does the answer vary from case to case? Does this mean that we must discard the traditional concepts, or does it merely

1. See Chase Manhattan Bank, *Private Client Advantages*, Summer, 1996, at 3.
2. See Glicklich, Goldberg and Levine, (1996), "Internet Sales Pose International Tax Challenges," 84 *Journal of Taxation* June (1996) at 325, (hereafter cited as "Internet Sales").
3. See, e.g. Sec. 861(a) United States Internal Code of 1986; *Vogel, Double Taxation Conventions* (1990), at 706-7 (discussing differences between treatment of royalties and personal services under income tax conventions).
4. See discussion of this issue in the analysis of the application of the royalty article of US treaties appearing in United States Treasury Department, *Technical Explanation of the U.S. Model Income Tax Convention* at 179 (1996), reproduced in *Tax Notes Today*, 23 September 1996, at 38.

mean that we must focus more sharply on exactly what it is that each of us is paying for when we make our purchases?

This poses much more than an intellectual question. The conventional tax rules assume that taxing jurisdiction, and therefore revenue, will be divided between the country in which income is derived (the "source country") and the country in which the recipient of the income is resident (the "residence country").[5] In the most general terms, income from business activities physically carried on in the source country will be taxable there as if carried on by a resident enterprise,[6] while income from intangibles and investment income derived from the source country will be subject to withholding tax, if not exempt.[7] All other income is taxable only in the country of residence, which will exempt, or grant a foreign tax credit for taxes imposed on, income taxed in the source country.[8] To these very general rules there are obviously many exceptions, the most significant of which in the present context is that in addition to taxing services performed by a non-resident enterprise within its borders, a source country in many cases imposes a withholding tax on services utilized in the country by a resident enterprise even though such services are physically performed abroad by a non-resident.[9]

The changes wrought by the Internet and parallel developments in communications (such as satellite systems), which drastically reduce the need for a seller or a service provider to have a physical presence in the country where its customer is located, threaten fundamentally to alter this division of revenue by shifting the balance of taxing jurisdiction, and revenue, decisively in favour of the country of residence. Since income flows between countries are not necessarily balanced and in the case of flows between developing and developed countries are often severely imbalanced,[10] such a shift could have profound revenue consequences.

The broadest question raised by these considerations is whether existing tax concepts can be adapted to the new technology or whether the technological changes require us to abandon traditional concepts and devise entirely new ones.[11] Perhaps the most obvious example is the permanent establishment article embodied in most income tax treaties.

Under treaties patterned on the OECD Model Convention, the business profits of a non-resident enterprise may be taxed by a Contracting State only if the enterprise maintains a permanent establishment in that country and if the profits are attributed to that permanent establishment.[12] Basically, a permanent establishment may consist either of a physical facility ("fixed place of business")[13] or an agent that has and habitually exercises the authority to enter into contracts on behalf of the enterprise.[14]

To focus first on the existence of a physical facility, take the case of a non-resident enterprise that maintains in a taxing country a "host server" – that is, a computer which is programmed with information concerning its products. Customers dial in to obtain product information and also may place orders through that facility. In one sense, this is the modern version of a catalogue store. There seems to be little question that this equipment could be considered a "particular site" and therefore a fixed place of business.[15] A more difficult issue, however, is whether this facility would be excluded as a permanent establishment under the carve-out provided for a facility maintained solely for the purpose of storage, display or delivery of goods or merchandise.[16] In addition, if a customer can place a binding order simply by conversing with the server, could the equipment be deemed to give rise to an "agency" which has the authority to enter into contracts on behalf of the enterprise? Does it make any difference if sales or credit approval is given by someone located outside the source country? A number of additional interpretative questions arise.[17]

Beyond this, is there any practical reason why a seller cannot simply serve customers in a country through a server located in another country, presumably a tax haven? If this is feasible, what basis would the source country have for claiming that a permanent establishment exists? Does this mean that, in order to preserve source country taxing jurisdiction, the permanent establishment concept needs to be modified, or discarded?

With respect to the provision of information or other intangible goods, the issues are different but hardly less troubling. If the resulting income is characterized as income from the provision of services, it will not be taxable at the source, under OECD-type treaties, unless the service provider is physically present in the source country – perhaps for an extended period of time.[18] As indicated above, this may not be true in a rapidly increasing number of cases.

Under the domestic law of a number of countries, income from the provision of services is considered to be domestically sourced and therefore subject to tax if the services are utilized in the country.[19] At least in the case of some Latin American countries, the right to impose a withholding tax is reserved in these circumstances, even under a treaty having provisions otherwise conforming to the OECD Model.[20] In such a case, the right to impose tax will be preserved. As a practical matter, however, it is not clear how the tax will be enforced. This will depend upon the ability of the tax authorities to monitor payments. In light of the rapidly expanding

5. See e.g. American Law Institute, *International Aspects of United States Income Taxation* II-Income Tax Treaties 1-11 (1991).
6. See OECD Model Tax Convention on Income and Capital (1992), Arts. 5 and 7 (hereafter "OECD Model")
7. See OECD Model Arts. 10, 11 and 12.
8. Id. Art. 23.
9. See Tillinghast, (1996), "Tax Treaty Issues", 50 *U. Miami L.* Rev. 455, 477-80.
10. Id. at 474 et seq.
11. See e.g. Statement of Glen A. Kohl, Deputy Assistant Secretary of the Treasury for Tax Policy, 18 October 1996 (espousing the adaptation of existing concepts), reported in *BNA, Daily Tax Report*, 21 October 1996 at G-3.
12. See OECD Model Arts. 5 and 7.
13. See OECD Model Art. 5, para. 2.
14. Id. Art. 5, paras. 6 and 7.
15. See Internet Sales at 326.
16. Id. at 327.
17. Id. at 328.
18. See OECD Model Arts. 14 and 15.
19. See Tillinghast, *supra* note 9, at 478.
20. See e.g. item 4 of the Protocol entered into by Brazil and Luxembourg in connection with the conclusion of the income tax treaty between those countries, treating technical assistance fees as royalties subject to withholding tax under para. 3 of Art. 12 of the treaty, reproduced in III *Taxation in Latin America* Section D, Brazil–Luxembourg, at 10 (Amsterdam: IBFD).

ability of private parties to clear payment balances through the Internet, rather than through the balancing system, this may prove difficult. In a recent seminar conducted by the International Fiscal Association,[21] Mervyn King, the chief economist of the Bank of England, predicted that in order to maintain their ability to regulate money supply, central banks will seek to exercise supervision over Internet payments; and this may provide the taxing authorities with access to information.

If income from the provision of information or other intangible goods is considered income from the licensing of intangible property, rather than from the provision of services, similar issues arise. Under many income tax treaties, the source country is permitted to impose a limited rate of withholding tax on royalties; (under other treaties, royalties are exempt).[22] If so, the source country will be permitted to tax if the use of the intangible property is in that country or, in some cases, if payment is made from that country.[23]

So far, this discussion of the provision of services has focused on taxation by the country in which the customer is located. Additional issues arise with respect to the taxation of services where they are performed. To revert to the example presented above, suppose that, to "debug" the software system of a customer located in Argentina, "hot line" services are performed in Germany, the United States and Japan. There is no certain way to determine to what extent the specialists located in each of these three countries contributed to the ultimate resolution of the customer's problem. This presents a problem analogous in some respects to that raised by global securities trading operations.[24] These have been the subject of innovative "Advance Pricing Agreements", which have used formulary factors to apportion income among the countries in which activities are carried on.[25]

There are no clear or simple answers to the issues raised by the Internet. The tax systems of the world will be required to go through a period of readjustment which is only really just beginning. Countries will have to decide whether to rely on existing taxes or to adopt wholly new ones. If they choose to retain the existing systems, they will need to decide how the traditional concepts are to be applied to the Internet world.

In this process, there is a crying need for a concerted approach. If individual countries or blocs of countries run off in different directions, the result will be chaos. If, for example, some countries respond by introducing non-income taxes on computer use, while another group responds by retaining reliance on the income tax but redefining the basis for imposing tax at source, while still another group sticks very close to the existing rules, a dramatic increase in the double taxation of international income flows will be inevitable.

Initial steps are being taken to try to develop a consensus response. The Committee on Fiscal Affairs of the OECD is known to be studying these questions, as are several individual governments. The International Fiscal Association has initiated an independent research study of the issues. No doubt, other groups and commentators will add their own input. There is no guarantee, of course, that these efforts will be successful or that any suggested solutions will be agreed upon by governments. But the effort must be made, since the alternative could be a fundamental breakdown of the international tax system – which, despite its many faults and inadequacies, has served the world economy well.

21. Seminar entitled "Visions of Tax Systems in the Twenty-First Century," held at the fiftieth Congress of the International Fiscal Association in Geneva on 5 September 1996.
22. See OECD Model Art. 12 and Reservations on the Article appearing in the Commentary on Art. 12, beginning at paragraph 32.
23. The source of royalty income is not dealt with in the OECD Model but is dealt with in some conventions. See e.g. Income Tax Convention between the United States and the People's Republic of China, Art. 11, para. 5.
24. See e.g. Plambeck, "The Taxation Implications of Global Trading",48 *Tax Notes*, 27 August (1990) at 1143.
25. See US Internal Revenue Service Notice 94-40, 1994-1 C.B. 351.

OECD MODEL CONVENTION

Reflections on the Future of the OECD Model Convention and Commentary

Prof. Dr Klaus Vogel

I. INTRODUCTION

The history of the OECD Model Convention is a history of success. Though not strictly binding, not even to OECD Member countries[1] the Model has been adopted worldwide by both member and non-member countries as a basis for Double Taxation Conventions. Although the objectives of treaty negotiators may vary, which is reflected by specific clauses in individual treaties, the treaties practically always espouse the structure of the Model and, to the extent that the Model conforms to the negotiators' intentions, they follow its wording. So also does the UN Model and no institution to date wants to change the structure or content of the Model substantially. Similarly, the OECD Commentary has been consulted by courts all over the world and is considered by them, as Vinelott, J., put it, "a guide to the interpretation of the treaty".[2]

Will this success story continue into the 21st century? Very probably, provided that the members and staff of the Committee on Fiscal Affairs, or more precisely of its Working Party No. 1, succeed in adapting the Model to the changes to tax structures that must be expected, even if those changes turn out to be radical ones. It will also be necessary for them to mitigate certain risks to the influence of the Model and Commentary which they themselves have created when they introduced a new procedure and a new mode of publication. The ultimate success, of course, would be a development of the Model into a Multilateral Convention for the Avoidance of Double Taxation. But this is less likely, because the changes just mentioned, if they should materialize, would make universal distributive rules even more difficult to agree upon than before.

II. ADAPTATION TO CHANGING TAX STRUCTURES

When the League of Nations adopted and published its first treaty models in 1928 schedular income taxes still prevailed in Europe. This is even today reflected in the current treaty system of distributive rules. Types of income are classified, mostly such which were subject to separate taxes under the schedular system, and are assigned for taxation either to the source state or to the residence state. Income not falling under one of those classifications is assigned to the state of residence.[3] This system although tailored to schedular taxes was capable of being satisfactorily applied to comprehensive income tax regimes.[4]

The same is not true for the application of the traditional rules on dividend taxation to an integrated corporate income tax. Under the original and still current version of the OECD Model, income taxation at the corporate level is governed by Article 7, i.e. corporate income is taxed by the state of residence of the corporation unless the corporation has a permanent establishment in the other contracting state. Further, dividends distributed by the corporation may be taxed by the state of the corporation under Article 10 up to a certain percentage, whereupon the state of the shareholder will give credit for this tax according to Article 23. In other words these rules presume corporate income being subject to tax on two different levels as is the case under the so-called "classical" system of corporate income taxation. In contrast, under integration, taxation at the corporate level is meant to be only provisional. Its underlying approach is that corporate income should, at least in principle, not be taxed differently from partnership income, which applied to treaties would mean that dividends would be tax-free like partnership withdrawals. It is evident that states will not easily consent to such a solution and that particular problems exist between states which have introduced imputation systems and those which have not. But until now states have preferred muddling through, in other words to find solutions on a treaty-by-treaty basis instead of looking for a new set of rules based on universal principles.[5]

A transition from our traditional income tax to a consumption-based system of direct taxation (expenditure tax, cash-flow tax or a similar charge) as is advocated and even predicted today by some leading economists[6] would present an

1. According to Art. 18(c) of the OECD's procedural rules a Council recommendation obliges the Member countries only to examine whether the measures recommended are "opportune".
2. *Sun Life Assurance v. Pearson*, Simon's Tax Cases 461, (1984), at 513.
3. Such income was under the schedular system often subject to a supplementary tax on overall income.
4. Comprehensive income tax systems only existed in a few states in the 1920s.
5. Alternative solutions were discussed by a combined OECD-IFA panel at the Toronto IFA Congress 1994, panellists: R. Aguirre Pangburn, R. Doernberg, J. Sasseville, K. van Raad, D. Williams, moderation: the author. See: *International Taxation of Dividends Reconsidered in Light of Corporate Tax Integration*, IFA Congress Seminar Series, vol. 19 a, 1995, and the authors cited there at 2 note 1. Further: R. Doernberg and K. van Raad, *Intertax* 1995, 3, at 15.
6. See, among many others, M. Rose (ed.), (1990), *Heidelberg Congress on taxing consumption*, with contributions of prominent economists and ample references.

even more drastic challenge to treaty drafters. For example: *Kaldor*'s expenditure tax which would exempt investment and certain qualified savings from the income tax base would, in an international context, require a particular treaty regime for disinvestments. On the one hand, it is hardly conceivable that a taxpayer could change the treaty classification of certain receipts by putting them on the shelf in one year and disinvesting (i.e. consuming) them in the next. On the other hand, if all the money that was earned long ago and that was finally disinvested were to be taxed under the treaty rules applicable to the original earning, this would necessitate huge accounting complications and administrative costs. Moreover, first legislators and then negotiators would have to decide whether investment abroad, in the other contracting state, should be deductible like domestic investment and which state should tax the withdrawal of such investment. Further difficulties would be raised by the timing element as it would not be certain that in the year of a disinvestment sufficient tax credit would be available in the residence state.[7]

It seems easier at first sight to apply the current Model Convention to another type of consumption-based income tax which is at present practised in Croatia and which has been called the "interest-exclusive" income tax.[8] Under this system portfolio interest is tax-free and the interest element included in business income is deductible from that income according to a formula. But if an OECD type tax treaty is applied to this tax as it is at present, it turns out that (a) a non-resident receiving interest from Croatia is taxed at full rates by his home country, (b) the same applies to the interest element in business income from a permanent establishment in Croatia if the credit method applies, (c) a Croatian receiving interest from a contracting state is subject there to withholding tax and will receive no tax credit in Croatia if the interest is his only foreign income, (d) again the same may apply to the interest element in foreign permanent establishment income. In other words, the systematic approach of the Croatian "interest-exclusive" income tax is cancelled in an international context when the other contracting state continues to levy a traditional income tax.

One solution to this problem would be to provide for a credit for notional taxes, i.e. for Croatia's treaty partners to grant the taxpayer a credit *as if* the interest income and the interest element in business income had been taxed at ordinary rates. But it should be clear that such credit would be no tax sparing credit in the usual meaning of this term, that is to say it would be no tax subsidy.[9] Rather, it would be a recognition that Croatia's income tax is systematically different from classical income tax, since it is based on its own distinct precepts. In other words, a credit for notional taxes would be in this case an act of respect towards Croatia's legislature which has chosen to levy a direct tax on consumption by exempting interest income.

It is clear that it would not be easy for the OECD Fiscal Committee, a body of administrators from countries following very different legislative approaches, to arrive at a consensus on how to resolve the aforementioned problems. And absorbed by day-to-day problems as they probably are, they may be averse to discuss situations which at the moment are, with one exception, still hypothetical. Further, the Croatian legislation may seem to them to be just an isolated occurrence which neither requires nor justifies considerations of a general nature. Yet if tax reforms of the type discussed start to occur on a significant scale, negotiators will have to quickly react to them. They will not be in a position to wait for the OECD Fiscal Committee to discuss the different aspects and finally arrive at recommendations. This will mean that countries will have to adopt their own approaches which will not be coordinated by an underlying consensus.[10]

In other words, they will have to depart from the Model Convention. And as a consumption-based income tax may affect several types of income they may have to depart from the Model in several ways. The overall impact of the OECD Model would be weakened by such deviation. The harmonization at present achieved would be diminished and to a far greater extent than just by varying rules on dividend taxation. The persuasion emanating from common observance to the Model would be reduced. It would not be unwise, therefore, for the Fiscal Committee to discuss in advance the appropriate response in the form of new treaty rules to such far-reaching reforms. The Committee's members may be reluctant, it is true, to agree in advance on recommendations when they do not yet know what will be in their own country's interest. On the other hand this "veil of ignorance" may promote equitable results, as Rawls believes[11] and even accelerate agreement. Such agreement, though it would not give negotiators support in their current work, may be all the more helpful to them when sooner or later reforms of the type discussed above occur. The topic may, therefore, deserve more of the Committee's attention than other, certainly not unimportant questions that are currently being discussed like the elimination of a special provision on independent personal services (Article 14 of the Model) or even the consequences of modern communication technologies.

III. CERTAINTY REGARDING THE TEXT OF MODEL AND COMMENTARY

Another risk to the authority of the Model and Commentary may arise from a new mode of amending and publishing them which was introduced in 1992. Both documents were first published in 1963 and were republished in a revised form in 1977, on both occasions based on Recommendations of the OECD Council. If I remember correctly, I have seen the Council Recommendation of 1977 in the form of a copy of a typescript to which at least the text of the new Model was added as an annex. Later, the 1963 as well as the 1977 Model and Commentary were published as paperbacks. Thus there could be no doubt about the content of both versions and about the date at which the revised texts replaced the originals.

7. These and more questions were raised by the students of a seminar which I chaired in 1990. See, in detail: S. Joseph and H.-J. Vollrath, (1991), *Anwendbarkeit des Internationalen Steuerrechts bei Einführung einer Ausgabensteuer*.
8. M. Rose, loc. cit. *supra* note 6, at 7.
9. The United States Senate in particular refuses to grant tax sparing credits to its treaty partners.
10. Just as they have done (or are doing) with respect to corporate tax integration.
11. J. Rawls, *A Theory of Justice*, 1971, at 136.

In contrast, starting from 1992 both Model and Commentary are amended in intervals of one or two years (to date 1992, 1994 and 1995) and published as loose-leafs. This mode is intended to be continued. In addition, the 1992 and 1995 editions were published as paperbacks, but not the 1994 one. Annexed to each article of the Model and Commentary the loose-leaf publication contains a section called "History" intended to inform the reader of all changes which the text has undergone since 1963 and the Commentary since 1977. This section is not reproduced in the paperbacks. In 1994 I tried to see the original Council Recommendation (because the new Model was not yet published), but I did not succeed; maybe I did not try hard enough.[12] At any rate the OECD has no "Official Journal" or "Gazette Officielle" to publish its Recommendations and other documents, and it is not clear whether and to whom these Recommendations are distributed or indeed whether they are distributed in a regular way or only upon request.

There is no doubt that the new mode of changing the Model and Commentary in short intervals has advantages. Working Party No. 1 can thus react to new problems that may be urgent by amending the central documents; previously it had been confined to publishing separate reports that readers might put away and not find when they needed them. Taxpayers, administrators and judges if they hold an edition of the loose-leaf volume which has been diligently cared for and which includes the most recent instalments, can be sure, (at least this is the idea) that they find in this single volume all the information on the Model and Commentary that they need. Thus in theory the Model has become more topical, more dynamic, and easier to work with.

On the other hand, this dynamic development may not be seen as beneficial by everyone. Let us take the government officials of new states, e.g. the successor states of the former USSR. They have just recently become acquainted with the works of the OECD, they have learnt about the merits of its Treaty Model and how to apply its provisions. (The OECD has taken a lot of trouble to instruct the Civil Servants of those new states,) now they learn that this Model which they have been told was excellent, has been changed. Maybe their instructors explained to them the rationale of Article 14, a provision which the former USSR did not accept in its Double Taxation Conventions for ideological reasons.[13] What will those Civil Servants think if the OECD now deletes the article? Will they still be convinced that in their negotiations they should follow as far as possible the OECD Model? Is it unrealistic to assume that the persuasive power of the Treaty Model may be considerably impaired by such experiences?

Further, for the proper application of the Model and Commentary by the courts it is of paramount importance to be able to reliably determine what was their text at a given date or dates in the past. With regard to the administrative officials of OECD member countries we may reasonably assume that they are bound to observe the current version of the Commentary at any time, unless the courts of their country have decided against it. In contrast, the courts will determine the relevant version by reference to the legal grounds for consulting the Commentary. In most states it will not be possible to construe the assignment of ministers or government officials to the OECD Council as a delegation of legislative power to that body, nor can such delegation be inferred from the founding documents of the OECD. Therefore, the only convincing justification for consulting the Commentary when interpreting tax treaties is the presumption[14] that in choosing terms from the Model the contracting parties intended to give them the same meaning as in the Model, i.e. the meaning which is set out in the Commentary. This is the "ordinary meaning" (Article 31(1) Vienna Convention on the Law of Treaties) of a treaty term derived from the Model[15] or, if the readers of this paper do not agree, it is a "special meaning" (Article 31 (4)) attributed to the term by the Commentary.[16] However, if this is the reasoning on which reference to the Commentary must be based, then the version referred to can only be that which was in force at the time of the conclusion of the treaty as was correctly decided in *Sun Life Assurance*.[17]

Now everybody who has ever worked with loose-leafs knows that their reliability has a tendency to decrease, very often after only a few instalments. Even the most scrupulous person makes mistakes sometimes when inserting pages and persons to whom the updating of loose-leaf instalments is entrusted are seldom very scrupulous.[18] Moreover, even the OECD instalments are not absolutely reliable. At least one of them contained severe printing errors, e.g. sentences had been omitted etc. These faults may have since been removed, but the fact that they occurred shows that a loose-leaf has inherent problems. There are even more of them when a former version of Model and Commentary must be referred to. It is true, that for determining former versions the loose-leaf publication has its "History" section which, as mentioned before, is not contained in the paperbacks. But this "History" is lacking in lucidity and hence is not very easy to read. In addition, not all changes to the text will be found under "History". At least in the 1994 version of the Model a considerable number of changes were made that were thought to be stylistic ones (exchanges of "if" for "when"; "that" for "which"; etc.) and were not documented. But who will know in advance whether a correction meant to be stylistic may not be considered to be substantive by a court?

In short: whereas the 1963 and 1977 versions of the Model and Commentary continue to exist in paperback form and may be consulted at any time, it is rather difficult to reliably establish what was the 1994 version. And where a library only subscribed to the loose-leaf and did not acquire the

12. However, the Recommendation was published later, in connection with the update to the Model and Commentary.

13. F. Hacker, Die Doppelbesteuerungsabkommen Rußlands und der anderen GUS-Staaten, (1992), in: *Münchener Schriften zum Internationalen Steuerrecht*, Heft 15, at 140 and 173.

14. See for the justification of such presumption: K. Vogel, *K. Vogel, On Double Taxation Conventions*, 3rd ed. 1997, Introduction m. no. 80.

15. R. Prokisch, "Fragen der Auslegung von Doppelbesteuerungsabkommen", (1994) in: *Steuer und Wirtschaft International*, 4 at 52.

16. H.G. Ault, (1993), "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", in: *Essays on International Taxation, To Sidney I. Roberts*, at 61, and reprinted in *Intertax* 1994, at 144.

17. *Supra* note 2.

18. Unfortunately, this is very often true in particular of libraries of courts, administrative bodies and universities. I know that there are countries where this is different, but they are exceptions.

paperbacks (e.g. for budgetary reasons) the same would apply to both the 1992 and the 1995 versions. In consequence, if the present procedure is not rectified, such difficulties may make courts unwilling to look at the Commentary at all. We have a saying in Germany: "to saw off the branch on which one sits". Unfortunately the OECD may fall into this trap with its loose-leaf publication.

We should by no means forget how important it is that the law can be ascertained beyond doubt and without incurring too much difficulty. Clarity and publicity of law were achievements of the enlightenment age. Secret laws as they had existed under absolutism were from now on considered unacceptable. Official journals were founded to publish legislation and thus to make it accessible to every citizen. This was not just done to promote political rights. Publicity of law gave commerce a legal basis which everybody could look up at its proper place of publication and on which the businessman could, therefore, rely. This reliability was of paramount importance for the development and growth of market economies. Compared to such legislation the OECD Model and Commentary may be just "soft law", but their publicity is no less important.

Consequently, if the success story mentioned above is to continue, the OECD should seriously consider how to create a continuous and reliable documentation at least of all Council Recommendations affecting the Model and Commentary. The best solution for this would be the creation of an "Official Journal", but there may not be enough material for this mode of publication, in which case another effective means of publication should be sought. Anyway, such publication must ensure that all relevant recommendations including their annexes (Model and Commentary) are made accessible immediately after they have been approved and that they can easily be collected by libraries, public archives, and private subscribers. There is no objection whatever against a loose-leaf collection, but this collection should be an additional one, it must not be the only means of publication.

Ceterum censeo: As I have mentioned before on other occasions, in most countries official documents like statutes, treaties etc. are not protected by copyright. By asserting copyright for its Model and Commentary the OECD seems to maintain that they are private publications, a collection of private opinions of the members of the OECD Fiscal Committee. If they were, they would have no official authority whatsoever. Of course, this is not what the OECD means, but it should be aware that its insistence on copyright might be interpreted in this way.

EUROPEAN UNION

THE EUROPEAN TAX PARADOX: HOW LESS BEGETS MORE

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I. INTRODUCTION

This paper deals with fiscal sovereignty. The issue of the fiscal sovereignty of the Member States of the European Union has been on the front pages of tax journals and magazines for more than a decade now, since the European Court of Justice (ECJ) made its first decision on income tax.[1]

The question is usually framed in terms of a stark choice. Either fiscal sovereignty is transferred from the Member States to the Union thus facilitating progress towards tax harmonization and European Monetary Union, or Member States retain their full sovereignty in tax matters meaning that the road to further tax integration remains blocked. Moreover fiscal sovereignty, together with monetary power and defense are considered the ultimate levers of national sovereignty "tout court".

The trouble with putting things this way is that then fiscal sovereignty is considered a monolithic rock standing either in the camp of the defenders of the nation-state, or in the camp of the European federalists. Any lawyer or indeed monetary economist, will tell you that the reality is not nearly so clear cut.

This paper submits that it is possible to transfer fiscal sovereignty in a methodological fashion from one level of government to another and that in doing so all levels of government will increase their taxing power. This thesis will be buttressed on the analysis of reputed tax lawyers outside the context of European integration, and on the basis of historical experience in the United States.

II. THE TAX POSITION OF THE EUROPEAN COURT OF JUSTICE

Since its first decision in income tax cases the ECJ has made more than a dozen decisions, gradually clarifying its position on the relationship between the non-discrimination provisions of the Treaty and the rules of the national tax systems of the Member States.[2] The core of these decisions can be summarized as follows.

Although the national tax systems of the Member States are justified in making different rules for resident and non-resident taxpayers, because in principle both categories of taxpayers are in different positions, such differences can only be justified (a) when there is an objective legal ground to justify the different tax treatment and (b) when the factual position with respect to the exercise of an economic activity is indeed different. Even when there are objective reasons for different tax treatment, such different treatment has been rejected by the ECJ when, considering the economic activity, the factual positions of the resident and non-resident taxpayer are equivalent.[3]

The ECJ has taken this position in tax cases, because it applies the Treaty rules to tax cases, in exactly the same way as it does to other areas of law, such as labour law, social security and competition law. It therefore effectively denies national governments the right to make their own rules necessary for the operation of their individual tax systems. In insisting on a factually equal tax treatment between resident and non-resident taxpayers, the ECJ's position should be contrasted with the position taken by most national tax courts, which accept a reasonable or objective legal justification for differentiation, even when the resulting distribution of the tax burdens among resident and non-resident taxpayers will be unequal. The ECJ does not accept an unequal distribution of tax burdens, when such unequal distribution affects the intra-state movement of people, services, or capital, or the right of establishment in another Member State.[4]

Because of this position of principle the ECJ held that a Belgian resident working in Germany, and earning all or most of his income in the latter country, should be treated in exactly the same way as a German resident also working in Germany.[5] The practical objection (difficulties in collecting information on non-residents) against this equal treatment, which most national tax courts would accept as constituting objective grounds for differentiation, was rejected by the ECJ. In the same vein the ECJ held that a Belgian resident, working as a company director in the Netherlands and earning all or most of his income there, was entitled to the same deduction for pension allowances as Dutch residents. The argument by the Dutch tax administration, that the pension benefits would only be taxable in the country of residence (Belgium) and not the country of source (the Netherlands)

1. *Commission v. France*, 270/83, 28 January 1986, 1986 ECR 273.
2. *Biehl*, C., 175/88, ECR 1990, 1-1779; *Commerzbank AG*, C-330/91, ECR 1993, 1-4017, *Finanzamt Köln-Altstadt v. Roland Schumacker*, C-279/93, ECR 1995, 1-225.
3. *Wielockx v. Inspecteur der Belastingen*, C-80/94, ECR 1995, I-2493, *Asscher v. Staatssecretaris van Financiën*, C-107/94 (not yet released).
4. Vanistendael, Frans, The role of the European Court of Justice as the supreme judge in tax cases, *E.C. Tax Review*, 1996/3, at 114-119.
5. *Finanzamt Köln-Altstadt v. Roland Schumacker*, C-279/93, ECR 1995, I-225.

was rejected by the ECJ, because it held that the Netherlands voluntarily abdicated its power to tax such pensions in an international tax treaty. Any national tax court however, would have accepted the Dutch argument as a sound reason for differentiation between resident and non-resident taxpayers.

Because of these decisions the ECJ has been subject to mounting criticism.[6] Some people have even criticized the ECJ for possessing an inadequate technical knowledge of national tax systems and for destroying and dismantling these tax systems. A call has been made to restrict the decision making power of the ECJ in tax cases.[7] This criticism is in my view unjustified, because the ECJ is merely the victim of a system that is not of its own making.

III. THE DILEMMA OF THE INCOME TAX IN THE EUROPEAN LEGAL ORDER

The cause of all this pain and suffering is the fact that the European legal order deals with questions that are quite different from the common problems of any income tax system.

The first question in any income tax system is one of equitable distribution of burdens. In order to achieve this equitable distribution of tax burdens the tax system makes all kinds of distinctions and differentiations between different categories of taxpayers; professionals, businessmen, employees, private individuals, legal entities, non-profit organizations, residents and non-residents etc. All these infringements against the principle of neutrality are accepted, provided the differentiation has some "objective" base. In the name of equity a lot of infringements are made against the neutral income tax treatment of all factors of production.

Neutrality let alone international neutrality of the flows of goods, people, capital and services is not a major concern of any given tax system. Indeed the essence of the tax system is not to be neutral because its aim is to change the primary (neutral) distribution of income and wealth that emerges from the production and distribution process "in its natural state" into a more equitable secondary distribution of income and wealth.

Under the Treaty however the ECJ has only one single guideline to decide its cases, i.e. the principle of non-discrimination or the principle of neutrality. The ECJ has no choice but to apply this principle to the questions submitted to it. It cannot act as a legislator and invoke all kinds of criteria for the equitable distribution of tax burdens, which one can find in the national tax laws, but not in the Treaty. The final result of this set-up is not in doubt. If nothing changes the ECJ is set for a massive conflict with national tax laws, in which large parts of the national tax law will be obliterated in the name of non-discrimination and neutrality. This has already been widely predicted. The question is what to do about it. The historic experience of the United States can teach us something.

IV. THE LIMITS OF THE INTERSTATE COMMERCE CLAUSE IN THE UNITED STATES

The historic tax experience of the United States bears in many ways a resemblance to the situation in the European Union today.[8] The US states had full taxing power, with the exception of taxes on imports and exports. Although the constitution provided that "Congress shall have power to lay and collect taxes", the Union did not have a federal income tax, until the adoption of the sixteenth amendment of the Constitution in 1913. The regulation of foreign commerce was reserved to the federal government. The commerce clause[9] gave full powers to Congress to regulate commerce among the states, and the import-export clause[10] prohibited the states from taxing international and interstate commerce. The interstate commerce clause had the same effect as Article 95 of the Treaty has with respect to indirect taxation and the basic freedoms have with respect to direct taxation.

During the 19th century and opening decades of the 20th century, the US Supreme Court took the view that any tax burden on interstate commerce would violate the interstate commerce clause: "Interstate commerce cannot be taxed at all, even though the same amount of tax should be laid on domestic commerce, or that which is carried on solely within the state".[11] The position is very similar to that of the ECJ, which takes the view that any infringement of the basic freedoms by the income tax rules of a Member State should be abolished.[12]

Like the ECJ which provided an exception to the automatic application of the basic freedoms on the basis of the "coherence" of the national tax system[13] the US Supreme Court sought a way out by allowing states to tax "local" activities, which had only an "indirect" effect on interstate commerce.[14] In order to protect the autonomy of state taxation the case law became so confused that the distinction between local and interstate commerce became almost meaningless.

In 1938, however the US Supreme Court initiated a major change in its reasoning, by holding that states were permitted to impose a fair share of the tax burden on interstate commerce.[15] This doctrine evolved gradually and the criteria to allow direct state taxes on interstate commerce were further developed in *Complete Auto Transit Inc. v. Brady*.[16] These criteria are:

6. Wattel P., The E.C. Court's attempts to reconcile Treaty freedoms with international tax law, CLR 33, 1996, at 223-254; Vermeend W., The Court of Justice of the European Communities and direct taxes; "Est-ce que la justice est de ce monde?", *E.C. Tax Review*, 1996/2, at 54.
7. J.F. Avery Jones, "Carry on Discriminating", 36 *European Taxation* 2 (1996), at 46.
8. This part of the paper is based on seminar A: Taxation issues in a Federal State and Economic Groupings with Concurrent Taxing Authorities, The United States of America, by Stephen L. Gordon, presented at the IFA conference in Geneva, September 1996.
9. Art. 1 Sec. 8, cl. 3.
10. Art. 1 Sec. 10, cl. 2.
11. *Robbins v. Shelby County Taxing District*, 120 US 489, 497 (1887)
12. *Commerzbank A.G.*, C-370/91, ECR 1993, I-4017.
13. *Bachmann*, C-204/90, ECR 1992, I-249.
14. *Adams Express Co. v. Ohio*, 165 US 194 (1897).
15. *Western Livestock v. Bureau of Revenue*, 303 US 250 (1938).
16. 430 US 274 (1977).

- is there a sufficient "nexus" between the taxed activity and the taxing state?;
- can the tax be fairly apportioned among the states? and
- does the tax discriminate against interstate commerce?

At the time that this new court doctrine was developed, two relevant factors had changed compared to the 19th century: (1) the United States now had a federal income tax which provided substantial revenue and (2) economically all the states were firmly integrated into the Union.[17] These two conditions made it possible for the US Supreme Court to desist from its strict interpretation of the interstate commerce clause in state tax matters.

In Europe today economic integration is as well developed as it was in the United States during the beginning of the New Deal. The difference is that the European Union does not have a unified income tax. In order to create the conditions for the ECJ to adopt a more relaxed attitude with respect to the four basic freedoms in income tax matters, it is necessary to transfer some taxing power in the area of income tax to the European Union. This limited transfer of taxing power, together with the introduction of the single European currency will free the ECJ from its narrow view on the basic freedoms. The ECJ will be put in a position very similar to that of the US Supreme Court in the late thirties, in which it can choose among a variety of standards to decide a case. Of course this requires a major political decision. However this political decision is not tantamount to the transfer of full fiscal sovereignty to the European Union. By agreeing to a limited transfer of fiscal sovereignty as described below, the Member States will in fact regain the effective taxing power, which they are currently in the process of losing because of the decisions of the ECJ.

V. THE VARIOUS BUILDING BLOCKS OF FISCAL SOVEREIGNTY

The next step to the solution is the demonstration that taxing powers consist of many separate elements which can be dealt with as individual components of fiscal sovereignty. This part of the paper is not very original, and any tax lawyer in a federal or confederal system will be willing to confirm its accuracy.[18] To tax practitioners and politicians in centralized tax systems like those of the United Kingdom, France, the Netherlands or Denmark this division of fiscal sovereignty may sound like a fairy tale.

Fiscal sovereignty, or the power of the purse has two main features: the power to tax and the power to spend. The power to raise revenue is not necessarily exercised at the same level of government as the power to spend. Even in centralized tax systems, this is very clear at the municipal level. Cities and townships do not raise all their revenue themselves. A substantial part of their revenue will consist in subsidies that have their origin in taxes imposed by the central government. This is also true of federal or confederal states: most of the revenue of the regions in Belgium is derived from allowances received from the central government, paid for by federal taxes. This even happens in the European Union. Part of the common resources consists of the proceeds from VAT that are transferred from the Member States to the Union.

The power to levy taxes can itself be divided into: the power to legislate and the power to administrate. The power to legislate can be further differentiated:
- the power to determine the scope of the tax and the tax base;
- the power to fix the tax rates and deductions and credits;
- the power to determine the procedural rules for tax collection, litigation and penalties for non-compliance.

In a customs union the power to determine the scope, the tax base and the rates are all transferred to the common customs authority. The procedural rules for payment, collection, litigation and sanctioning stay with the national legislator. Yet fiscal sovereignty remains largely unaffected by this transfer of taxing powers. To the contrary the collective negotiating power of all the members of the customs union, has much more weight than the unfettered fiscal sovereignty of each individual country.

VI. THE SOLUTION OF THE TAX PARADOX

One way to solve the tax paradox and to restore fiscal sovereignty to the Member States is to return to full control by the national legislature over all tax laws, except perhaps for customs duties. This would mean the end of the European Economic and Monetary Union and above all the end of the single European currency.

Member Sates would formally and legally be restored to full fiscal sovereignty, but it is clear that from an economic and budgetary point of view their taxing power would be diminished and become more subject to international pressure. Some Member States would certainly try to regain some of their lost power at the international level by forming smaller regional economic alliances, like the Scandinavian countries did before they entered the European Union. Very probably a new alliance would emerge with Germany at its centre and Austria, the Benelux and possibly Switzerland, France and later Poland, the Czech Republic and Hungary as its partners. Within these new regional alliances tax systems would be adapted and approximated (as in the defunct European Union) so as to permit economic and monetary union, and perhaps even a single currency or the equivalent thereof in the form of fixed exchange rates. Staunch defenders of national sovereignty like the United Kingdom would be permitted to stick it out on their own. Smaller countries like Greece, Ireland and Portugal would have to attempt to find new allies.

Another way to solve the tax paradox is to learn from the United States and to make use of the subdivisions of taxing power.

17. I.e. the danger of the economic disintegration of the United States, if states had been allowed to tax interstate commerce, had receded.
18. This part of the paper is based on the discussion of the concept of taxing power (Steuerhoheit) in Tipke K. & Lang J., *Steuerrecht*, at 67-79, Otto Schmidt, Cologne (1991).

The ECJ should be supported by more substantive rules of income tax law, e.g. minimum tax rules that should be observed by all the Member States in addition to the four basic freedoms of the Treaty. The example lies in VAT. Due to the existence of substantive rules of VAT, the ECJ does not have to rely on the non-discrimination Article 95 as the exclusive touchstone for its decisions. In some cases substantive VAT rules have been upheld without regard to non-discrimination provisions to the disadvantage of foreign taxpayers, simply because the minimum requirements for foreign taxpayers set in Community legislation happened to be less advantageous than the rules for domestic taxpayers.[19]

These substantive rules should be minimum or maximum rules, as suggested in the Ruding report on the harmonization of corporate income tax.[20] These common minimum or maximum rules should certainly be less ambitious than those which were proposed by the Ruding Committee. Nevertheless they should contain (1) a minimum corporate tax rate, (2) maximum rates for depreciation, (3) ceilings for tax-free reserves and deductions, (4) common rules for the valuation of assets and (5) maximum rules with respect to tax incentives and special tax regimes. The main purpose of this common core of tax rules would be to limit tax competition among Member States, and in this way to restore their taxing power. All the other tax rules would remain fully subject to the national tax legislator. The power to determine the maximum tax rates, the power to determine the actual rate of depreciation and the actual volume of tax-free reserves, the rules of procedure, collection and administration and last but not least the penalties. Above all the Member States would remain free to determine the actual amount of corporate income tax, as they remain free to determine the actual rates of VAT. With the support of a Europe-wide minimum tax rate, their taxing power may actually increase.

In this way the ECJ would be able to choose from among a variety of criteria when judging the conformity of national tax rules with European tax law. Like the Supreme Court in the United States it would be in a position to judge when and where intra-community trade or services would have to bear their fair share of the tax burden. Not every violation of the basic freedoms in the Treaty would give rise to the destruction of national tax rules. When the differences would be permitted by secondary tax legislation the ECJ would have a legal basis to uphold the different tax treatment. It would not be automatically obliged to use the jack knife of the basic freedoms against any tax obstacle in the way of free trade and services.

These minimal and maximal tax rules should be applied in the area of corporate income tax, the taxation of private investment income and the area of social security contributions on wages, because these are the three areas in which the establishment of economic and monetary union would cause the biggest distortions because of substantial differences in tax rules. There is much less need for tax harmonization in the area of personal income tax. Large population migrations because of differences in personal income tax are highly unlikely. Only a small segment of the professionally active population would move solely for tax reasons. Tax differentials do have an impact however on the location of business investments. Therefore corporate income tax, together with social security burdens should be subject to minimal common rules. Because of the volatility of flows of personal investment income, this part of the personal income tax should also be included.

The final problem is a procedural one: how to reach a decision of substance in all these areas. It is clear that the unanimous voting requirement in tax matters has blocked decisions for many years, even though most Member States are convinced of the necessity of these reforms. In the name of democracy a rather small minority is blocking a large majority. Therefore taxes in the European Union should also become subject to majority rule. However, because of the basic rule "No taxation without representation", these common tax rules should be decided by an elected European parliament and not by the Council of the Ministers of Finance and even less by the European Commission. Therefore the key to unlocking the European tax paradox lies with constitutional reform in the Union, and the political decision to build a Union with effective power to issue a common currency and to determine the basic framework of taxation for the Member States.

The transfer of some minimal taxing powers to the European Union will in the end restore the taxing powers of the Member States and shelter national tax systems from surprise decisions by the ECJ and from international tax competition among themselves. In this sense less apparent fiscal sovereignty in fact means more effective fiscal sovereignty, or how less begets more.

19. This is for instance the case for the time limits for the repayment of tax set under Art.7 of the Eighth VAT Directive. See VAT Tribunal London 4 July 1991, Gongerius Hanco BV: *Common Market Law Reports* 1992, at 302. See also VAT Tribunal London 16 February 1993, Max Thimm GmbH: *Common Market Law Reports* 1993, at 964.

20. Report of the Committee of Independent Experts on Company Taxation (Ruding Report): Chapter 10, at 193-219, Brussels (1992).

TRANSFER PRICING

THE FUTURE OF TRANSFER PRICING

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I. INTRODUCTION

About 50 per cent of world trade is carried out between related companies. Their share is likely to rise substantially with increased globalization. This is because the "big players" which drive the globalization process forward, accompanied by an increasing number of medium-sized companies, establish foreign subsidiaries or participate in cross-border joint ventures.[1] It is therefore reasonable to expect that cross-border trade between related companies will increase both in absolute terms and as a percentage of world trade.

Trade between related companies need not solely be influenced by market conditions, the group's policy decisions may also have a substantial impact on the transfer prices charged. Transfer pricing is not only of significance for the profit centres of the group but also for the tax bases of the countries hosting the group companies. Therefore from the perspectives of both the companies and countries concerned, there will be an increase in the importance of transactions subject to transfer pricing.

II. THE REACTION OF THE COUNTRIES

The world economy is stagnating, indeed the economies of some countries are even contracting. Social and labour costs have increased to an extent that they impede economic progress. The adverse economic conditions, when combined with lower income from taxes, exert a lot of pressure on the states. Therefore, the tax climate has become tough. These changes focus the attention of many countries on their tax base, which may be affected by transfer prices determined outside their jurisdictions as well as by domestic transactions.

As a consequence, the significance of transfer prices for the tax base has been recognized by almost all countries. This has led to the intensification of the struggle for a higher share in the profit connected with international trade. States try to achieve this higher share in two ways.

The field tax audit. This audit focuses more and more on transfer prices. In Germany, practically all tax audits check transfer prices. This is due not only to international trade but also to the relationship between corporation and shareholder which may result in hidden distributions of profit, or in hidden contributions of capital.

Legislation. More and more countries are becoming aware that they either have no legislation to adjust inadequate transfer prices, or that the legislation they do have is ineffective. Therefore, new rules are increasingly introduced.

III. NEW RULES ARE THE TREND

All over the world new rules on transfer pricing can be found. These rules are normally influenced by the United States, Japan, Australia and the OECD, see Section IV below. France has just recently amended its law, while Britain is in the process of doing likewise. In Germany discussions have started between the tax authorities and industry in order to review the existing Administrative Principles. Korea revises its transfer pricing law. Brazil has just published a first law on transfer pricing. These examples are merely indicative of a worldwide trend.

IV. THE TRENDSETTERS OF THE WORLD

The United States has become the most important trendsetter in the area of international taxation. What is considered and regulated in the United States necessarily influences the thinking and the rules in other countries. Japan is one of the world's most important trade nations. Therefore, its policies and actions affect international trade. The Asia-Pacific region becomes more and more important and Australia, as one of the most developed countries in that part of the world, strongly influences the region. The OECD is an association of the world's major industrialized nations. Its opinions and recommendations are highly persuasive not only to its Member countries, but also to the rest of the world. Therefore, these nations, together with the OECD, play a key role in setting international transfer pricing standards.

A. The United States

The United States has sophisticated rules on transfer pricing. These include regulations on tangibles and intangibles[2] as

1. Of course, a lot of national and independent enterprises will be established, too, or will increase their activities. However, the impact of these companies on cross-border trade is unlikely to be very significant.
2. Regs. to Sec. 482 IRC as of July 1994.

well as on cost sharing.[3] The provision of documentation by the taxpayer is extensively regulated and secured by strict penalties.[4] In order to give a degree of certainty to the taxpayer, Advanced Transfer Pricing Agreements (APAs) based on detailed rules can be concluded.[5] One area, however, is still based on old regulations. This is the area of administrative services within a group of companies (i.e. management fees etc.). Apart from that, new rules on financial instruments are under consideration. Global or 24-hour trading as well as derivatives require the attention of the tax authorities.

B. Japan

Japan established laws and additional rules in 1957.[6] These were amended in 1986.[7] A preconfirming system, a kind of APA, was introduced by a circular of the Ministry of Finance in April 1987. This has been extended by a basic rule in 1995 on bilateral agreements. An extensive rule on bilateral APAs is expected soon.

A group of some 20 tax experts within the Ministry of Finance studied transfer pricing for several years. About five years ago the tax authorities issued the first assessments which adjusted transfer prices set by multinational enterprises. Since then, there has been an increasing number of assessments raised, where the adjustments made to transfer prices have been greater than USD 100 million.

C. Australia

Since 1992, the National Tax Office of Australia (NTO) has been very active in the transfer-pricing field. Regulations have been issued on financial services, basic considerations, documentation, profit allocation, etc.[8]

D. OECD

The OECD first published a detailed report on transfer pricing in 1979 which was followed by additional reports in 1984 and 1987. On 27 June 1995, the Committee on Fiscal Affairs approved of new Transfer Pricing Guidelines which were published with the unanimous consent of the OECD Council on 13 July 1995. These guidelines represent a revision and extension of the 1979 report. The guidelines are now published in a loose-leaf edition and they will be amended and reviewed from time to time. The rules provided by the guidelines are subject to an ongoing monitoring to which industry and taxpayers are invited to contribute.

The first edition of the guidelines comprised five chapters discussing the arm's length principle, traditional transaction based methods, other methods based on profit elements, administrative rules and documentation. A first supplement as of March 1996, deals with intangibles and intra-group services. Cost contribution arrangements/cost-sharing rules are under consideration and future editions will deal with the profit allocation between head office and permanent establishments as well as with thin capitalization.

V. AREAS OF CONFLICT

All OECD Member countries and most of the other states apply the arm's length principle which represents a broadly accepted basis. This, however, does not mean that all rules adopted by the various countries and based on that principle are congruent. On the contrary, there are a lot of different rules and some of these represent serious problems potentially leading to double taxation of profits and a struggle between the countries to get their fair share of the tax resulting from international trade.

It might appear that these conflicts are solved by the OECD Guidelines. But this impression is deceptive. Beneath the surface the conflict still remains. It is not impossible that this conflict will eventually result in an economic war.

The major players in the conflict are, on one side, the United States supported to a certain extent by Australia and – somewhat less – by Japan and, on the other side, some of the European States and Canada. The battle focuses mainly on transfer pricing methods and penalties.

VI. TRANSFER PRICING METHODS

Everybody agrees that the comparable uncontrolled price method (CUP) is the best method, provided that comparables are available. However, the conditions that must be met to qualify as a comparable in the United States are rather strict; those of many other countries and the OECD Guidelines are more flexible.

If CUP cannot be applied, the conflict starts in earnest. In the United States the comparable profits method (CPM) is in practice becoming predominant for the simple reason that sufficient data usually exist to implement this method and it therefore becomes a "best method" under the US rules. Other

3. Regs. to Sec. 482 IRC as of December 1995.
4. Regs. to Sec. 6662 IRC as of February 1996.
5. Revenue Procedure 91-22, 1991 - 1 C.B. 526 (March 1991).
6. Art. 66-4 of law no. 26/1957, cabinet order no. 43/1957 and decree of the Minister of Finance no. 15/1957.
7. Law no. 13/1986, cabinet order no. 81/1986 and decree no. 11/1986.
8. The following list provides an overview of expected, draft and final regulations.

Subject of the Regulations	Drafts published or expected	Final Regulations
Financial Services		1992, TR 92/11
Basic Considerations		31 May 1994, TR 94/14
Advanced Pricing Agreements		22 June 1995, TR 95/23
Profit Allocation	20 April 1995	March 1996
Permanent Establishment	TR 95/D 11	
Transfer Pricing Methods	29 September 1995 TR 95/D 22	September 1996
Documentation	29 September 1995 TR 95/D 23	September 1996
Penalties	29 September 1995 TR 95/D 24	June 1996
Management fees	September 1995*	September 1996
Problems concerning Art. 9 OECD-MC	March 1996*	December 1996
Assessments	March 1996*	December 1996

* Not yet published

states reject that method. The OECD has also disqualified CPM. Nevertheless, the United States still applies it.

The conflict becomes apparent if the first adjustments based on a CPM are applied in the United States and corresponding adjustments in other countries are refused in a competent authority procedure. It also seems that the transactional net margin method (TNMM), developed by the OECD – which has some similarities with the CPM on one side, and the resale price method and the cost plus method on the other side – does not provide a good basis for a compromise. The CPM determines prices for a single transaction as far as possible starting from an overall result (profit or loss). The TNMM, however, starts from the other side with the individual transactions, aggregates them, and reaches an overall result. However, the results are not congruent. Indeed, there is a great risk that these methods will produce very different results. These differences may lead to serious conflicts which might also spill over into other areas of international interest.

VII. PENALTIES

Penalties too, may result in serious conflicts. This can be demonstrated by considering an adjustment of 100 million dollars (such an adjustment could easily arise in the case of a major multinational: indeed larger adjustments have already been made). In the United States this will result in a tax liability of about USD 35 million and a penalty on that tax of 40 per cent or USD 14 million. If the same situation arose in Germany – enough equity assumed – the total amount of corporate income tax and dividend withholding tax levied will be about the same as in the United States. However, there are no penalties in Germany. A "Bußgeld" which is a fine and requires proof of negligence is limited to DEM 100,000 – only. Clearly these differences are tremendous. Moreover, the conflict will become exacerbated due to the fact that the documentation requirements in the United States are very extensive and strict, whereas in the OECD Guidelines documentation is described as useful and helpful only. Furthermore, in the United States the burden of proof lies with the taxpayer. In most of the other countries it lies with the authorities.

All these differences represent an incentive to shift profits to the United States, possibly contrary to the underlying economic realities. This, of course, will not be accepted by other countries which look upon the US penalty regulations as being overly harsh and unfair. Therefore, serious conflicts can be predicted.

VIII. CAN THE CONFLICT BE SETTLED?

Most countries have established an APA system to provide the taxpayer with certainty. However, not all countries have such a system. For example, although Germany theoretically is prepared to review a transfer pricing system in advance, the practice is different. Indeed, Germany has officially announced that it is very restrictive with APAs. In other countries APAs can be concluded. Most, however, are domestic APAs not dealing with the situation in the other country and therefore do not provide cross border certainty. Even if a taxpayer asks for a bi- or multilateral APA and the states involved try to achieve it, conflicts are only avoided to a certain extent: penalties can be circumvented, but preference for the application of different pricing methods may remain. As states are not obliged to come to an agreement under mutual agreement procedures, the potential for conflict still exists.

The OECD assumes that Member countries should change their transfer pricing rules to become congruent with the OECD Guidelines. However, publications of United States experts who have formerly held senior positions within the IRS reveal that they still believe that CPM is in accordance with the arm's length principle and Article 9 of the OECD-Model Tax Convention. Up to now there are no indications that the US regulations will be changed. Therefore, the potential for conflict persists.

Unanimous approval of the OECD Guidelines by the Member countries should result in adherence to those guidelines by these countries. This should as a consequence influence the national rules and practices of these countries. Indeed, several experts, among them Professor Klaus Vogel, attribute a certain significance to the OECD Guidelines under international law.[9] It is therefore hoped that the OECD Guidelines will help to resolve the above conflicts. However, at present, it can only be stated that transfer pricing is becoming increasingly significant and for that reason the lack of a unified approach is very worrying. Stormy waters lie ahead for transfer pricing in the opening decade of the 21st century!

9. I.e. since the Guidelines meet some of the requirements under the Vienna Convention on the Law of Treaties.

TAX REFORM

TAX REFORM FOR THE 21ST CENTURY

Jeffrey Owens and Edward Whitehouse

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I. INTRODUCTION

Tax systems in the latter half of the nineties look very different from the mid-eighties as fundamental tax reforms were implemented across the OECD. This paper aims to describe some common themes in these tax reforms. By examining the shape of the tax reform agenda, it seeks to assess how tax systems are likely to look in ten years' time.

II. COMPLEXITY REMAINS A PROBLEM

Some of the more serious problems with OECD countries' tax systems were resolved by tax reforms. But some remain. Perhaps the most common criticism is the complexity of taxation. Systems are difficult for taxpayers to understand and for tax authorities to administer. This broadens the scope for sophisticated tax avoidance schemes and increases the cost of raising revenues to governments and the costs of compliance for taxpayers. And ever more sophisticated tax avoidance schemes also contribute to complexity, as detailed legislation is required to close loopholes. In the United Kingdom, total administrative and compliance costs are estimated to be 1.5 per cent of GDP, with two thirds of the total relating to compliance (Sandford, 1995). As the author of the study notes, this implies taxation is an industry as large as agriculture, forestry and fishing.

Many of the critics of tax complexity fail to address its fundamental causes. If the problem lies in the complexity of the transactions we are trying to tax or in some legal, non-tax requirements then there may be little for tax-policy makers to do. But tax reform can help if complexity results from policies themselves or in the linguistic style of legislation.

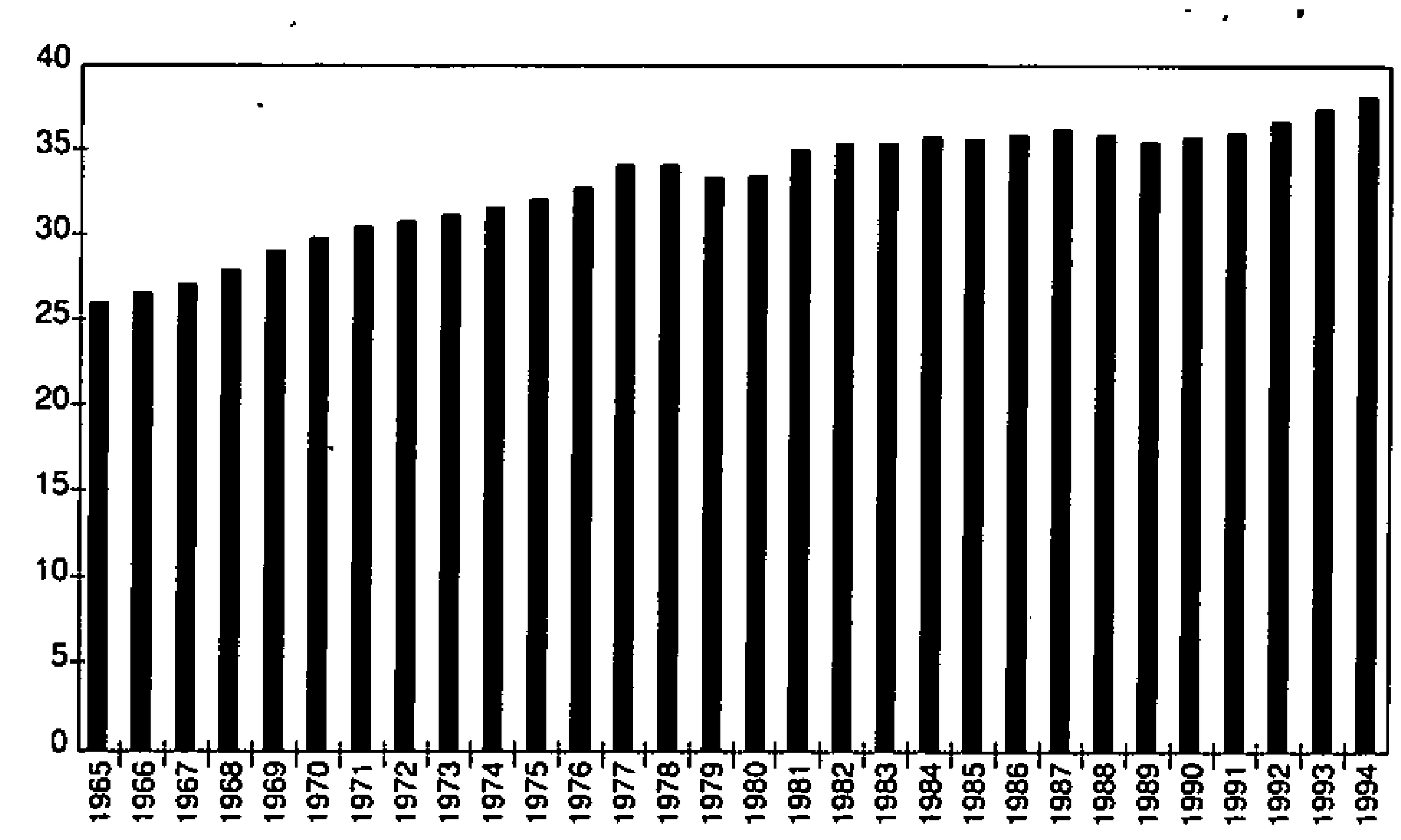
Complexity is difficult to measure, but the volume of legislation is perhaps a reasonable proxy. Since 1954, the United States Internal Revenue Code has grown by 200 per cent. In Canada, the volume of tax law trebled between 1971 and 1994 and it doubled over a similar period in the Netherlands. Only in France is this trend absent: tax legislation there is about the same length as it was 30 years ago (Tax Law Review Committee, 1996).

Some of the recent tax reforms described below have simplified tax systems, but only a few countries have attempted to address the complexity issue in a systematic way. Australia began a three-year Tax Law Improvement Programme in 1993 with the explicit aim of reducing compliance costs. Legislation is being completely re-written in clearer language. So far, 50 per cent cuts in the volume of legislation have been achieved despite the addition of further explanations. In New Zealand, a similar project to rewrite income tax legislation has begun and in Ireland the first consolidation of tax legislation since 1967 is under way. In the United States, the vogue (and often vague) solution is the introduction of a "flat tax". It is difficult to judge whether the benefits of a simpler tax code after the rewrite outweigh the cost of the exercise and the loss of familiarity with existing law.

III. THE TAX BURDEN CONTINUES TO GROW

A second common complaint is about the size of the tax burden. Despite efforts in many countries to halt or reverse the long-term increase in the tax burden, total taxes rose from 34 per cent of GDP in 1980 to 37 per cent in 1990 and to 38.5 per cent in 1994. The rate of increase of the tax burden during the eighties and nineties was half that of the seventies. The tax burden fell between 1980 and 1994 only in Luxembourg, Norway and the United Kingdom. Although the continuing growth of the tax take is common across OECD countries, there remain nonetheless significant differences between countries. In Belgium, the Czech Republic, Denmark, Finland the Netherlands and Sweden, the tax burden exceeds 45 per cent of GDP. In contrast, in Australia, Japan, Mexico, Turkey and the United States taxes are less than 30 per cent of GDP.

Figure 1.
Taxes as a percentage of GDP in OECD countries, 1965-94



Source: OECD Revenue Statistics

IV. TOP INCOME TAX RATES COME TUMBLING DOWN

One particular aspect of the growing tax burden that has been addressed was the upward creep in the top marginal rates of the personal income tax. Many analysts pointed out that these caused economic distortions, providing a disincentive to work and to save. Furthermore, high marginal rates in the income tax schedule provide an incentive to use tax loopholes, thereby reducing the marginal rate in practice. The end result is that higher tax rates may not mean correspondingly higher revenues. Table 1 shows that 20 countries – the only exception being Turkey with a very low marginal rate to start with – cut their top marginal rates in recent years, by an average of over ten percentage points. But the vast majority of these cuts were in the late eighties, and top rates have tended to remain stable in the nineties. Previous cuts have been partially reversed in Canada, Denmark, Ireland, Sweden and the United States.

Table 1.
Top marginal rates of central government personal income tax

	1986	1990	1995
Australia	57	47	47
Austria	62	50	50
Belgium	72	55	55
Canada	34	29	31.3
Denmark	45	40	34.5
Finland	51	43	39
France	65	57	56.8
Germany	56	53	53
Greece	63	50	40
Iceland	38.5	33	38.15
Ireland	58	53	48
Italy	62	50	51
Japan	70	50	50
Luxembourg	57	56	50
Netherlands	72	60	60
New Zealand	57	33	33
Norway	40	20	13.7
Portugal	61	40	40
Spain	66	56	56
Sweden	50	20	25
Switzerland	13	13	11.5
Turkey	50	50	55
United Kingdom	60	40	40
United States	50	28	39.6

Source: OECD Tax Database

Note: Canada, Finland, Iceland, Norway, Sweden, Switzerland and the United States also have personal income tax levied by sub-central government.

V. A BROADER INCOME TAX BASE

In many cases, countries financed these cuts in top marginal rates by broadening the tax base. For example, taxes on fringe benefits were increased in Australia, Finland, New Zealand and the United Kingdom and the deductibility of mortgage interest payments was limited in Finland, Ireland, and the United Kingdom. The 1986 reform in the United States removed a range of deductions. These tax concessions can distort consumption, savings and investment decisions. They may introduce complexity in the system. Because of their lack of transparency compared with government spending or regulatory measures, they can become entrenched and continue beyond the period of their usefulness. As part of the assault on these tax privileges, Australia, Belgium, Finland, France, Ireland, Italy, the Netherlands and Portugal began producing tax expenditure accounts during the eighties. These reports, estimating the revenues foregone from tax concessions have now been produced by 14 OECD countries. The shift to a broader tax base with lower top rates has meant that personal income tax revenues have not declined significantly. In 1994, they raised an average of 10.7 per cent of GDP across the OECD, compared with 11.3 per cent in 1980.

VI. A FLATTER INCOME TAX

As well as cutting top rates of income tax, many countries have restructured the income tax rate schedule to reduce the number of brackets. This is perhaps one of the only areas in which tax systems have become simpler during the eighties. Fewer marginal rates need not make the income tax less progressive (i.e. the proportion of income paid in tax increases with income). Most of the progressivity of the income tax derives from the fact that the first slice of income is free of tax. But fewer marginal rates do make taxes simpler, for example, when trying to deduct tax from different income sources. Table 2 shows that 16 countries cut the number of schedule rates in the late eighties. The average number of rates fell from over ten to below six. But during the nineties, while France, Greece, Ireland and Luxembourg have simplified their tax schedules, previous simplifications have been reversed in Iceland, the United Kingdom and the United States. Taken together, tables 1 and 2 show that in the eighties, and to a limited extent also in the nineties, the personal income tax became a flatter tax with fewer rates and smaller differences between them.

Table 2.
Number of positive rates in the personal income tax schedule, 1986, 1990 and 1995

	1986	1990	1995
Australia	5	4	4
Austria	10	5	5
Belgium	12	7	7
Canada	10	3	4
Denmark	3	3	4
Finland	11	6	6
France	12	12	6
Greece	18	9	3
Iceland	3	1	2
Ireland	3	3	2
Italy	9	7	7
Japan	15	5	5
Luxembourg	21	24	17
Netherlands	9	3	3
New Zealand	6	2	2
Norway	8	2	2
Spain	34	16	16

Sweden	10	1	1
Switzerland	6	6	13
Turkey	6	6	7
United Kingdom	6	2	3
United States	14	2	5

Source: OECD Tax Database

VII. CHANGING TAX STRUCTURES

Changing the tax mix – usually involving a shift from the personal income tax to general consumption taxes, like VAT – was much discussed in many countries in the eighties and nineties. Switching to consumption taxes may increase the incentive to save by reducing the difference between pre- and post-tax returns on savings. Consumption taxes may be less easy to avoid and evade than income taxes. It has also been argued that such a switch would improve work incentives as net earnings are increased. But this is unlikely to be true in practice: if people find that the consumption possibilities for a given wage are reduced due to higher consumption taxes, then the effect on their work incentives will be the same as when the tax was deducted directly from their earnings. There are also a number of concerns with general consumption taxes. They are usually less progressive than the personal income tax, imposing a larger tax burden on lower income taxpayers. In Australia, Canada and Japan, there has been strong taxpayer resistance to the proposal or introduction of general consumption taxes. VAT can generate inefficiency if some goods are excluded from the base or taxed at a lower or higher rate, so distorting consumer choices.

Table 3 shows that there has been a shift to general consumption taxes, but that this has mainly been at the expense of other taxes on goods and services (like excise duties), with rather smaller falls in personal and corporate income taxes. The countries which have seen the biggest changes are Greece, New Zealand and Turkey when they introduced general consumption taxes. In the last two cases, this was accompanied by substantial cuts in personal income tax. In Japan, general consumption tax revenues have risen as receipts from corporate income taxes fell sharply in the nineties. Canada saw a similar sharp decline in corporate tax revenues. Social security contributions rose there and in Finland and Japan. Spain has used general consumption taxes to reduce the role of social security contributions. Finally, the United Kingdom also increased the rate and extended the base of VAT significantly.

Table 3.
Structure of taxation in OECD countries
(Per cent of total revenue)

Type of tax	1965	1970	1975	1980	1985	1990	1994
Personal income	26	28	31	32	30	30	28
Corporate income	9	9	8	7	8	8	8
Social security	19	21	25	25	25	25	27
Property	8	7	6	5	5	5	5
General consumption	12	13	13	14	16	17	18
Other goods and services	24	22	17	17	16	15	14

Source: OECD Revenue Statistics

VIII. THE RISE OF VAT

The main reason for the growth in general consumption tax revenues has been the substitution of VAT for retail and wholesale sales taxes. Currently, Australia and the United States are the only OECD countries without a VAT-type tax. Greece, Spain and Portugal introduced VAT in the eighties when they joined the European Union (this is a condition of membership). Canada, Iceland, Japan, New Zealand and Switzerland have also recently introduced a VAT. The second reason for the growth of general consumption taxes has been the tendency for rates of VAT to rise once the tax is introduced. The average rate of VAT when countries first introduce the tax is 12.5 per cent; the average in 1996 is 17.5 per cent. Table 4 charts the rise of VAT, as more countries introduce it and rates of VAT rise.

Table 4.
VAT in OECD countries

	Year VAT introduced	Initial standard rate	Current standard rate
Austria	1973	16	20
Belgium	1971	18	21
Canada	1991	7	7
Denmark	1967	10	25
Finland	1969	11.1	22
France	1964	20	20.6
Germany	1968	10	15
Greece	1987	16	18
Iceland	1989	22	24.5
Ireland	1972	16.4	21
Italy	1973	12	19
Japan	1989	3	5
Luxembourg	1970	8	15
Mexico	1960	10	15
Netherlands	1969	12	17.5
New Zealand	1986	10	12.5
Norway	1970	20	23
Portugal	1986	16	17
Spain	1986	12	16
Sweden	1969	11.1	25
Switzerland	1995	6.5	6.5
Turkey	1985	10	15
United Kingdom	1973	10	17.5

Source: OECD Consumption Tax Trends

IX. THE VAT BASE

All countries exempt many services from VAT – including financial services, property letting, medical care, education, charities and gambling – and apply lower or zero rates to certain other goods and services, such as books and newspapers, transport, food etc. Some countries have followed the trend in the personal income tax, to shift to a broader VAT base. As noted above, this reduces the distortion to consumers' spending patterns and so improves the efficiency of the economy. By adjusting VAT revenues as a percentage of GDP to account for the differences in standard VAT rates, table 5 looks at the size of the VAT base relative to GDP in different countries. This will reflect a number of other factors – such as the weight of consumption in GDP and the extent of VAT evasion – as well as the statutory coverage of VAT. With this caveat in mind, New Zealand and Japan are found to collect disproportionately large amounts of revenues given their VAT rates, whereas revenues in Belgium, Ireland, Italy, Spain and Sweden are relatively low. In New Zealand, for example, this probably reflects the very broad coverage of VAT and in Ireland, the range of zero-rated goods.

Table 5.
VAT revenues, standard rate and estimated VAT base, 1993

	Standard VAT rate	VAT revenues (% of GDP)	VAT base (average=100)
Austria	20	8.3	102
Belgium	20.5	7.0	84
Canada	7	2.6	90
Denmark	25	9.8	96
Finland	22	8.6	96
France	18.6	7.5	99
Germany	15	6.8	111
Greece	18	8.5	116
Iceland	24.5	9.9	99
Ireland	21	7.0	82
Italy	19	5.6	72
Japan	3	1.5	123
Luxembourg	15	6.7	110
Netherlands	17.5	7.0	98
New Zealand	12.5	8.2	161
Norway	22	9.1	102
Portugal	16	6.2	95
Spain	15	5.1	83
Sweden	25	8.5	83
Switzerland	6.5	2.7	102
Turkey	15	5.7	93
United Kingdom	17.5	6.6	93

Source: OECD Consumption Tax Trends and OECD Revenue Statistics

X. SOCIAL SECURITY CONTRIBUTIONS

A second trend evident in table 3 is the growth in social security contributions, so that by 1994 they nearly raised as much as the personal income tax. In the majority of OECD countries (16), more was raised from social security than from income tax. This shift probably reflects the growing pressures on social security expenditure from higher levels of unemployment, the ageing of the population and other social changes, such as an increase in the number of lone parents. These extra benefits must be financed, either through higher social security contribution rates or through broader financing of benefits.

In some countries, increases in the value of social security benefits also added to the pressure. For example, the value of unemployment benefits increased significantly relative to earnings during the eighties in Finland, France, Greece, Norway and Portugal. Only in Belgium, New Zealand, the United Kingdom and the United States did benefit levels fall relative to earnings in the eighties (OECD, 1994, chapter 8).

XI. COMPANY TAXES FOLLOW THE PERSONAL INCOME TAX TREND

Trends in the corporate income tax have followed the personal income tax – the tax base has been broadened and rates reduced. Various incentive schemes have been limited or abolished in Australia, Austria, Finland, Germany, Iceland, Ireland, Portugal, Spain and the United States, including schemes for particular regions or sectors, investment credits and property-related tax-shelters. Depreciation for tax purposes has been brought more closely in line with economic depreciation. Table 6 shows that the cuts in central government corporate income tax since the mid eighties average around ten percentage points.

Table 6.
Basic rates of corporate income tax of central government, 1986-95

	1986	1991	1995
Australia	49	39	33
Austria	30	30	34
Belgium	45	39	39
Canada	36	29	29
Denmark	50	38	34
Finland	33	23	25
France	45	34/42	33
Germany	56	50/36	45/30
Greece	49	46	35/40
Iceland	51	45	33
Ireland	50	43	40
Italy	36	36	36
Japan	43	38	38
Luxembourg	40	33	33
Netherlands	42	35	35
New Zealand	45	33	33
Norway	28	27	19
Portugal	42/47	36	36
Spain	35	35	35
Sweden	52	30	28
Switzerland	4-10	4-10	4-10
Turkey	46	49	25
United Kingdom	35	34	33
United States	46	34	35

Source: OECD (1991) and OECD Tax Database

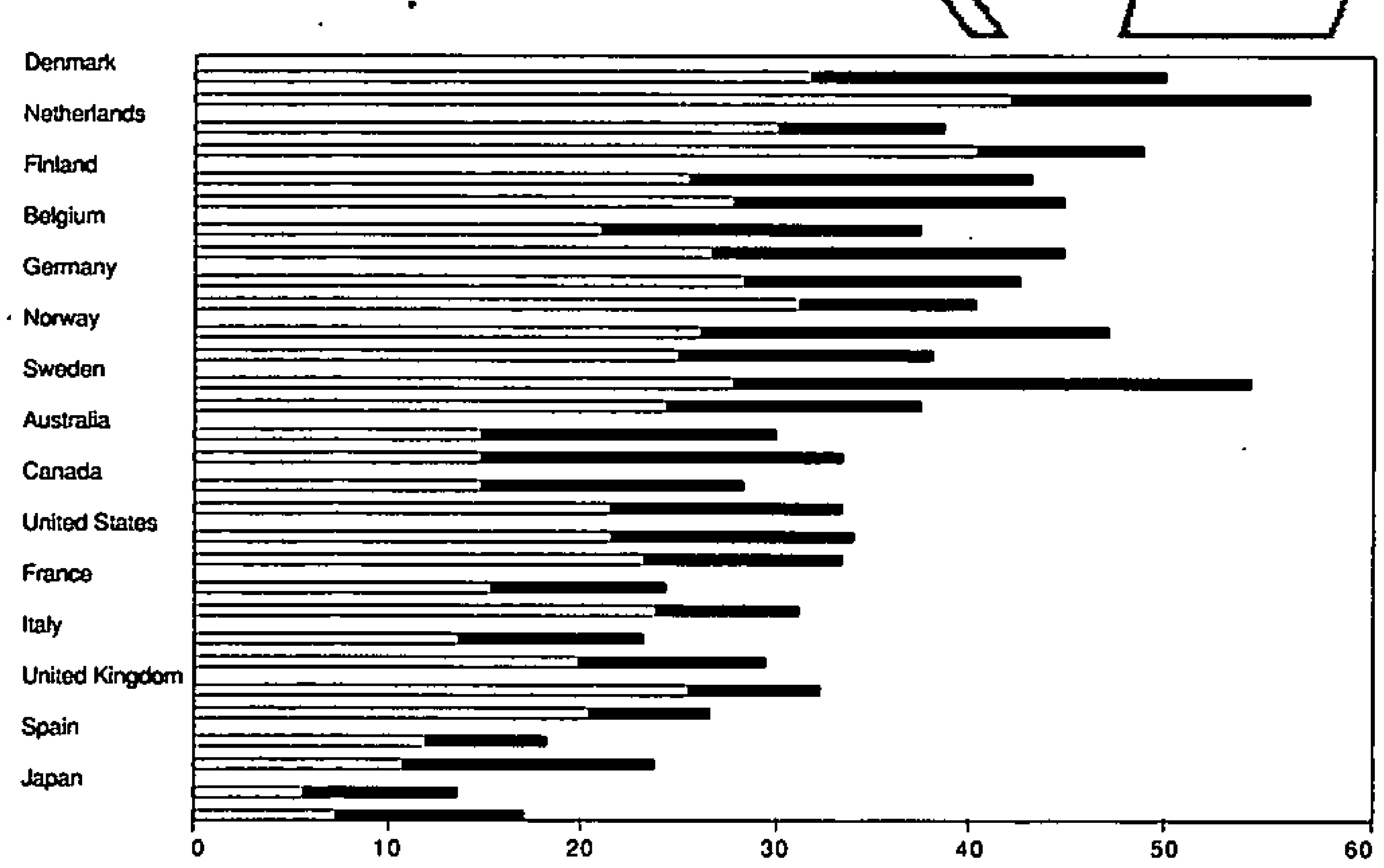
Note: Austria, Canada, Finland, Germany, Italy, Japan, Norway, Portugal, Switzerland and the United States also have sub-central corporate taxes. Rates rounded to nearest percentage point. Many countries also have special rates for firms with fewer profits and for particular sectors.

XII. PROBLEMS FOR THE 21ST CENTURY

A. The distribution of income

Figure 2 shows one reason for concern with the effect of tax reforms in the late eighties and early nineties. The white bars show the average tax rate (i.e. personal income tax and social security contributions as a percentage of earnings) at two thirds of average earnings. The grey bars show the average tax rates at double average earnings. The difference between the grey and the white bars shows how progressive the tax system is. For each country, the upper bar shows the situation in 1978, the lower in 1992. In Canada, Denmark, the Netherlands and France, taxes have risen across the board, but have risen more steeply on those with lower earnings. In Norway and Sweden, taxes have fallen for all groups, but the falls for those on lower incomes are less than for higher earners. Finally, in Germany and the United States, the tax burden on those low down the earnings' distribution has risen, but fallen for higher earners. In these countries, individual direct taxes have become less progressive.

Figure 2.
Personal income tax and employees' social security contributions as a percentage of earnings, single persons earning 67 and 200 per cent of average, 1978 and 1992



Source: The OECD Jobs Study: Taxation, Employment and Unemployment, OECD, 1995

The result of these changes is that the distribution of income is widening in a number of OECD countries. In the United Kingdom and the United States, the distribution of before tax income has been widening, partly because of higher unemployment and ageing of the population and partly because of a wider gap between low and high earnings from employment. The change in the structure of taxation, with a greater part of the burden borne by those on low incomes means that the change in the after-tax distribution of income is even greater. Table 7 shows the distribution of the tax burden. The incomes of the population have been ranked from the lowest to the highest, and the population divided into fifths, or quintiles. The first column of the table shows the percentage of the total direct tax burden (including personal income tax and employees' social security contributions) paid by the poorest fifth of the population, the last column, the proportion paid by the richest fifth. In Australia and the United States, the poorest 60 per cent of the population pay around a quarter of total taxes, followed by Canada and the United Kingdom where this portion is around 28.5 per cent. The highest figures are in Ireland, Norway, the Netherlands and Sweden, where around 36 per cent of total taxes are paid by the poorest 60 per cent. These figures probably result from the differences in the pre-tax income distribution. In North America and the United Kingdom the distribution of pre-tax incomes is much broader than the relatively equal distributions of the Nordic countries. Thus, even if taxes were equally progressive in the two groups of countries, the percentage of taxes paid by poorer groups would be lower if the income distribution is wider.

Table 7.
Percentage of total taxes paid

Income quintile:	1	2	3	4	5
Australia	0.7	7.6	16.3	24.2	51.2
Canada	3.6	8.8	16.2	24.8	46.5
Finland	4.9	11.2	17.1	23.9	42.9
Germany	5.5	10.4	17.0	23.4	43.7
Ireland	7.0	12.2	17.6	23.8	39.3
Netherlands	10.3	10.0	16.2	22.3	41.2
Norway	3.7	13.2	19.2	25.7	38.1
Sweden	6.3	12.5	17.7	23.3	40.1
United Kingdom	4.5	8.1	15.9	25.0	46.4
United States	3.8	6.9	13.9	22.6	52.7

Source: OECD (1995)

B. The environment

In the late eighties, environmental problems became an important concern. Scientific evidence emerged of the hole in the ozone layer, global warming, the health hazards posed by lead and particulates from motor fuels and the damage from acid rain. Action was demanded of policy makers. There is a range of ways in which governments can intervene – government spending, taxation and regulation – to promote environmentally-friendly behaviour, as in other policy areas. Green taxes have a number of advantages over command-and-control methods. They provide a market incentive to reduce pollution in the most efficient way. Moreover, they provide a continuing incentive to innovate, to find new ways of reducing pollution to reduce the environmental-tax burden further. Finally, unlike regulation, taxes raise revenues which can be used to cut deficits, increase spending or reduce other taxes. But despite this theory, there have been few successful examples of green tax reform. Table 8 shows the revenues from environmental taxes in three countries for 1994. They amount to less than 1 per cent of revenues in each case. Governments have instead resorted to other policy measures to achieve environmental goals than direct taxes on pollutants. In some cases they have used differentiation of existing taxes. For example, excise duties favour unleaded petrol in 19 countries and motor vehicle taxes have been differentiated to favour catalytic converters or fuel-efficient cars. Other countries have used command and control. Austria, for example, has simply banned leaded petrol and CFCs are being phased out throughout the world. Other countries have used existing taxes such as motor fuel duties. Although these have an environmental impact, they are not pure environmental taxes since the tax base is not directly related to the environmental damage caused.

The only environmental tax with the potential to raise significant revenues would be a CO_2 tax. However, there are a number of obstacles to countries wishing to introduce the tax alone, such as its likely effect on the competitiveness of domestic industry, and international consensus has not been forthcoming. It remains to be seen whether existing measures are sufficient to meet countries' obligations to stabilize CO_2 emissions or whether an international agreement to introduce a CO_2 tax will be necessary.

Table 8.
Revenues from environmental taxes

	Revenues (per cent of total, 1994)
Denmark	
CFC	0.001
CO_2	0.658
Nickel-cadmium batteries	0.002
Disposable tableware	0.011
Insecticide	0.002
Waste	0.119
Total	0.809
Netherlands	
Air pollution	0.430
Water pollution	0.007
Total	0.437
Norway	
CO_2	0.714

C. Savings

The issue of household savings raises a number of policy concerns. Some argue that the pool of savings is too small, and that higher levels of savings would boost investment and long-term rates of economic growth. But the OECD (1994b) study concluded that "there is no clear evidence that the level of taxation ... does generally affect the level of household saving". Even if tax incentives could be used to encourage *household* saving, there is no reason to expect *national* saving to increase. The tax revenue the government loses from the incentive cuts public savings and may more than offset the increase in household saving.

A second concern is the allocation of savings. In every country, different savings vehicles are taxed differently. The result is that individuals choose savings instruments not on economic grounds, like the expected return and risk, but opt for the most fiscally-privileged route. The fundamental difficulty is the definition of income, a topic that economists and accountants have discussed for many years. Hicks, for example, defined income as how much someone could consume in a year and still expect to be as well off at the end of the year. But this is not an easily implemented, precise concept.

The literature provides two benchmark tax treatments. An expenditure tax aims to tax consumption in a particular period. With respect to savings, this can be achieved in two ways. First, contributions into the savings account and the investment returns earned could be exempted from tax, with tax imposed when savings are withdrawn. Second, contributions could be made out of after-tax income, but investment returns and withdrawal of savings exempt. The second benchmark is the comprehensive income tax, which taxes both consumption and savings. This can be implemented by taxing both contributions and investment returns or both investment returns and withdrawal of savings. With regard to saving, the expenditure tax is neutral: consumption today and tomorrow is taxed at the same rate, whereas the comprehensive income tax discriminates against future consumption by taxing it more than current consumption.

Figure 3 compares the actual tax treatment of four illustrative savings vehicles – a pension, housing (bought without a loan), direct purchase of equities and bank deposits. The figure shows marginal effective tax rates (METRs) on savings. As noted previously, the expenditure tax treats savings neutrally, so the METR of an expenditure tax is zero. The comprehensive income tax taxes savings as if they were current consumption. The METR is therefore the statutory marginal rate. Figure 3 is computed for an individual paying the highest marginal tax rate.

Comparing different instruments, in four countries – Canada, France, the United Kingdom and the United States – pensions have the most generous tax treatment, followed by housing and then equity purchase, with bank deposits being the least tax-privileged. In Germany, while pensions have an expenditure tax treatment, housing receives a very large tax subsidy, but again, equities and bank deposits have a much less generous tax treatment. In Japan, pensions are taxed heavily, while equity investments have the most generous treatment.

Comparing the tax treatment with the two benchmarks, there are a number of examples of expenditure tax treatments: pensions in Canada, Germany, Italy and housing and pensions in the United States. Bank deposits are taxed on a comprehensive income tax basis in Canada, the United Kingdom and the United States.[1]

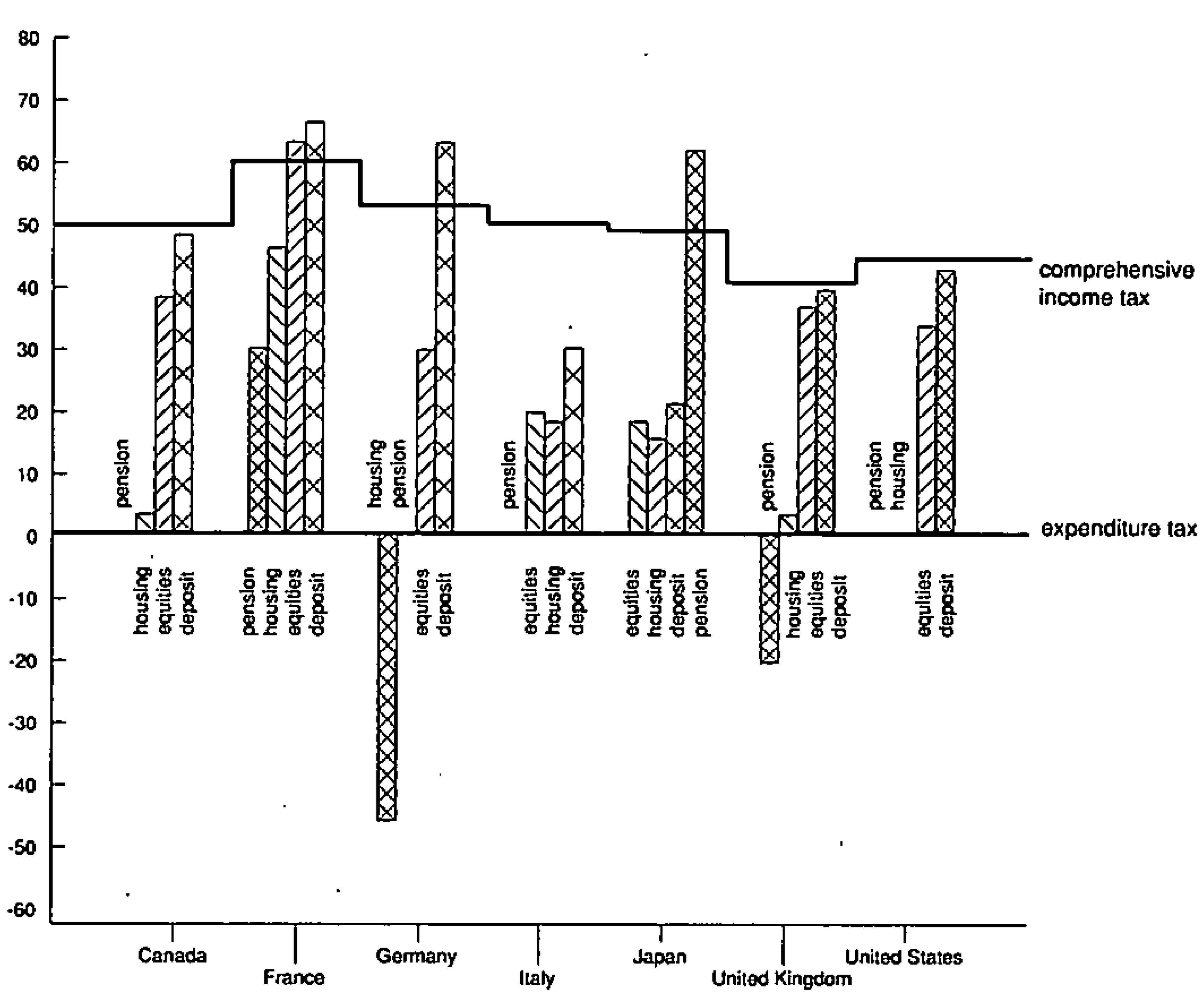
But in some cases, the tax treatment lies even outside the range of the two benchmarks. For example housing in Germany and pensions in the United Kingdom are tax subsidized. Deposits in Germany and France are taxed at a higher rate than the comprehensive income tax.

In all the countries shown, there are enormous differences between the tax treatment of different savings instruments.

1. Although in each case the tax is levied on *nominal* returns whereas a pure comprehensive income tax would tax only *real* returns. If inflation were taken into account, then the effective tax rate would be higher than a comprehensive income tax.

The effect is to divert savings into the most fiscally privileged assets and away from those which attract a tax penalty. The net result is that the taxation of savings overall tends to move towards that of the most generously-treated savings. The risk is that by choosing savings vehicles because of tax rather than economic characteristics, the market is distorted and investment misallocated.

Figure 3. Effective tax rates on savings, 1994



Source: OECD (1994b)

Some countries have moved to reduce differences between the tax treatment of different savings instruments. Denmark, Finland, Norway and Sweden have implemented the most extensive reforms, moving their tax systems towards a flat-rate tax on capital income to varying extents. In Finland, for example, a separate flat tax of 25 per cent was introduced on capital income and tax-exempt savings deposits abolished. In Norway, interest, imputed income from owner-occupation, dividends etc. are taxed at a flat 28 per cent. In Portugal, the tax reform of 1989 introduced reliefs for retirement and housing savings accounts and stock option plans.

In other countries, specific savings incentive schemes have been introduced, often with the purpose of moving towards an expenditure tax. Examples of schemes exempting the interest on deposits up to a ceiling include the *plan d'épargne populaire* (PEP) and the *Livret A* accounts in France and tax-exempt special savings accounts (TESSAs) in the United Kingdom. Germany, the Netherlands and Spain use the simpler approach of exempting a fixed amount of interest income from all sources.

Various schemes offering limited tax deduction for investment in equities are available in Austria, Belgium, Canada, France, Germany, Iceland, Ireland, Luxembourg, Norway and the United Kingdom. Personal equity plans (PEPs) in the United Kingdom and *plans d'épargne en actions* (PEA) in France offer exemption from taxation of dividend income and capital gains.

Despite recent reforms, most countries still tax different savings instruments at wildly different rates. Expect further moves towards a neutral tax regime either through flat taxes on capital income or increased use of tax-exempt savings vehicles.

D. Investment

Reforms to corporate taxation have not eliminated the disincentive to firms to invest and the distortions to the way firms finance investment and the form investment takes. The standard way of examining the effects of taxes on investment is to look at "marginal effective tax wedges". The METW shows the difference between the rate of return before and after tax. A METW of 1.2 per cent implies that a return of 11.2 per cent is required before tax to achieve a target after-tax return of 10 per cent for the firm. Table 9 shows METWs for a range of countries and different financing arrangements and types of asset.

In every country, debt is the most tax efficient form of finance. For example, the required rate of return in Germany is nearly halved due to the deduction of nominal interest payments against the relatively high corporate tax rate. Retained earnings in every case raise the required return, because there is no relief like that for interest payments. In the United States the so-called "classical" corporation tax gives no relief to shareholders against the taxes paid by the company. Retained earnings and new equity have the same tax wedge as a result. In each of the other countries, there is some compensation to shareholders. New equity is more generously treated than retained earnings. The compensation method is an "imputation" system in France and the United Kingdom, and a split-rate system in Germany, where dividend distributions and retained earnings are taxed at different rates).

Table 9 also shows the tax system favours buildings over machinery and machinery over inventories (although this pattern is not the same for all OECD countries, see OECD, 1991).

Table 9.
Marginal effective tax wedge by financing and asset

	Buildings	Plant and machinery	Inventory	Retained earnings	New equity	Debt	Average
France	1.2	-0.5	3.5	3.7	-4.0	-2.2	0.8
Germany	2.4	0.5	4.5	7.0	-3.1	-4.6	1.9
Netherlands	1.8	0.4	2.3	4.0	-0.7	-2.5	1.2
United Kingdom	2.0	0.6	3.9	4.2	0.5	-1.8	1.7
United States	4.4	0.9	3.8	5.4	5.4	-2.9	2.5
Average	2.4	0.4	3.6	4.9	-0.4	-2.8	

Source: *Griffith* (1996)

Note: Marginal effective tax wedge is the difference between the post-tax and pre-tax real rates of return. Assuming a 10 per cent post-tax target return, an METW of 1.2 implies that the pre-tax return must be 11.2 per cent. Weights, from OECD (1991): buildings 28 per cent, plant and machinery 50 per cent, inventory 22 per cent; retained earnings 55 per cent, new equity 10 per cent, debt 35 per cent. Assumes economic depreciation of 3.6 per cent for buildings, 12.25 per cent for plant and zero for inventory and inflation of 3.5 per cent.

Finally, the last column averages over the different assets and forms of financing to show the overall incentive to invest. The weightings used reflect the OECD-wide average split between assets and finance. In each country there is a disincentive to invest, equivalent to adding around 1.5 per cent to the cost of capital to firms.

There have been numerous proposals for ways in which these tax-induced biases in investment can be ameliorated or even eliminated (see, for example, IFS Capital Taxes Group, 1992). Given the concern about the impact of investment on economic growth, it would be surprising if the next decade did not see reforms in this area.

E. Taxes and unemployment

The OECD Jobs Study concluded that the high level of unemployment is the unfortunate result of societies' failure to adapt to a world of rapid change and intensified global competition. If work does not pay, people will be reluctant to work. For most people, there are clear financial incentives to work. But such incentives may be lacking for many people with low potential wages, particularly if they have children. For these groups, social and labour market goals may clash. Benefits need to be high enough to ensure an adequate income, but then taking a job may bring little or no extra income, trapping families in a cycle of dependency. Tax and benefit systems cause three types of labour-market problems:

- The "unemployment trap", where benefits are high compared with earnings. Cutting the benefits of the unemployed increases the reward for taking a job but the social costs of this solution may be unacceptable.
- The "poverty trap": low-wage workers have little immediate financial incentive to increase hours worked; to work part-time or to invest in education and training to move up the wage ladder.
- Taxes on labour may increase its cost and reduce employment.

Cutting taxes on labour, even when targeted on low-wage earners, is expensive. Such cuts will require either a switch to taxes which are not ultimately borne by labour, cuts in public spending or redistributing the tax burden onto higher earners. One area where the tax system bears particularly on low income earners is social security contributions. Ceilings to contributions mean that the marginal tax rate on high earners is zero, but positive on those with low earnings. Employers have an incentive to give overtime to existing workers, rather than employ other people. Table 10 shows ceilings relative to average earnings in those OECD countries which have them.

Table 10.
Structure of social security contributions, 1993

	Ceilings (% average earnings)	
	Employee	Employer
Austria	146	146
Canada	105	105
France	131	131
Germany	169	169
Greece	212	212
Ireland	154	164
Luxembourg	245	245
Spain	219	219
Turkey	83	–
United Kingdom	154	–
United States	229	229

Source: OECD (1995b)

A second way of using the tax system to make work pay is the use of employment-conditional tax credits or benefits, in-work benefits for short. These increase the returns to working by paying a supplement only to those in work. By withdrawing the tax credit or benefit as earnings increase, the benefits are targeted on those with low earnings. Often the schemes are limited to families with children. Since benefit systems give these groups the largest payment out of work, they are further targeted on the groups for which work incentives might be a problem. Examples of such schemes in practice include Family Credit in the United Kingdom, the Earned Income Tax Credit in the United States and Family Income Supplement in Ireland. Evidence from the United Kingdom and the United States suggests that these schemes can be effective in improving work incentives and encouraging people into employment. Denmark has recently investigated the relevance of such a scheme to its labour market (Ministry of Finance, 1995). Other countries might be expected to follow.

F. Globalization

Globalization is not new, but the pace of integration of national economies has quickened. The development of regional trading blocs, – such as the EU and NAFTA – the removal of restrictions on investment flows and improved communications technology have accentuated the trends. The implications for tax policy have been, and will continue to be enormous.

Globalization has increased the geographical mobility of capital. The benefits to the world economy are clear: the international allocation of savings and capital is improved, improving firms' incentives to invest. The tax base has become more mobile, and business decisions like investment and financing are therefore more sensitive to tax differentials between countries. This means that high tax rates on capital are no longer feasible, which is perhaps responsible for some of the cuts in corporate tax revenues shown in table 3 and the falling company tax rates in table 6. Some countries have also seen an erosion of the capital income tax base.

Economic integration could put pressure on other tax bases. Cross-border shopping puts pressure on differentials in excise and VAT rates. Denmark and Canada have been forced to cut alcohol and tobacco taxes in response. The European Union has imposed minimum excise duty and VAT rates to ameliorate this problem, but countries with particularly high rates will continue to have problems. The concern again here is that tax competition for cross-border shopping will result in lower tax rates; another example of an eroding tax base.

Perhaps the most important new development for tax policy is new communications technology. The Internet, in particular, is creating a global "information superhighway" which will revolutionize business more quickly than previous technical advances. As technological change weakens the links between economic activity and a particular location, traditional tax concepts, such as "residency" and "source" become difficult to apply. Fiscal residency is usually decided on criteria such as physical presence, incorporation and place of effective control. But management and control of services provided over the information superhighway are difficult to determine. Advances in communications now allow distant groups of people to collaborate in new ways: for example, global securities dealing and scientific projects. Allocating the profits and losses of these activities to different countries is a problem for tax authorities. The Internet also allows entrepreneurs to extend the services they can offer abroad without the need to set up a physical presence in that country.

As the Internet becomes more commercialized, a parallel banking and payment system becomes a distinct possibility. A new system is needed to allow tax authorities to identify when and where taxable activities are carried out, including access, record-keeping and reporting requirements. Anonymity and encryption built into these systems need to balance consumers' requirements of confidentiality with the needs of tax administrations.

XIII. CONCLUSIONS

This paper has set out a series of recent trends in tax reform and examined the likely topics that will drive the tax agenda in the coming years. Changes in the eighties and early nineties include:

- reductions in the top rate of personal income tax;
- reductions in the rates of corporate income tax;
- broadening of the income tax base;
- VAT spreading to more countries;
- increases in VAT rates.

The main driving forces behind these changes have been:

- globalization. This led to capital becoming more internationally mobile, and put pressure on differences in tax rates. Globalization also tends to favour taxes where the location of the tax base is readily identifiable, such as consumption or earnings, rather than tax bases which are difficult to locate, such as profits.
- developments in the technology of tax collection. I.e. computers make it easier to collect data on transactions, while the cost of tax inspectors and lawyers exercising their judgement increases.
- a widespread desire to eliminate fiscal distortions and move towards a neutral tax system.

These trends and pressures will continue to dominate tax reform in the coming years. We highlighted five main areas where changes can be expected:

- a move to a more neutral system for taxing different forms of savings;
- further efforts to introduce environmental taxes;
- concern about the impact of tax reform on the distribution of income;
- a move to a more neutral system for investment;
- concern about the impact of taxes on the labour market and unemployment.

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IFA NEWS

Press Release

INTERNATIONAL FISCAL ASSOCIATION
50TH CONGRESS

INTRODUCTION

The International Fiscal Association which was established in 1938, this year celebrated its fiftieth Congress. The 1996 Congress was hosted by the IFA Swiss branch at Geneva from 1-6 September, 1996. The Congress was attended by some 1,395 delegates from over 50 different countries made up of private practitioners as well as representatives of tax authorities, universities and other organizations. The event proved to be highly successful as reflected in the interest expressed by delegates and their enthusiastic participation in the working sessions.

The traditional IFA format was followed, with the presentation of two main subjects and four seminars. A general report had been prepared on each of the two main topics and each topic was discussed by a panel headed by a discussion leader. The two main subjects discussed over the first two days of the Congress were:

- Subject I: Principles for the determination of income and capital of permanent establishments and their application to banks, insurance companies and other financial institutions.
- Subject II: International aspects of thin capitalization.

Over the two remaining days allocated to the scientific programme of the Congress four subsidiary subjects were discussed within the framework of a seminar:

- Taxation issues in a federal state and economic groupings with concurrent taxing authorities.
- The influence of corporate law and accounting principles in determining taxable income.
- International tax aspects of economic relations with Eastern Europe.
- OECD Model Treaty – 1996 and beyond.

One of the themes arising from these subjects is the impact on international taxation of information technology and the almost effortless transferability of information. The initial focus of the Congress, however, was on financing cross-border business activities as reflected in the two main topics concerning permanent establishments (PE) and thin capitalization. Some of the issues surrounding PEs were also discussed in Seminar D: OECD Model Treaty – 1996 and beyond.

In order to mark the Jubilee celebration of IFA, the scientific programme culminated in a symposium entitled "Visions of the Tax Systems of the XXI Century". This symposium perhaps best captures one of the objectives of IFA to identify potential developments in international taxation and to sensitize members to the likely issues arising from them. Indeed it was during this Congress that the Chairman of the Permanent Scientific Committee of IFA, Mr D.R. Tillinghast, announced that IFA would sponsor and fund an independent research project in the field of international taxation. The first segment of the project would analyse the impact of the communications revolution on traditional source taxation concepts, such as the PE provision of the OECD Model and withholding tax rules. The second segment would address issues relating to financial instruments.

CROSS-BORDER FINANCING OF BUSINESS OPERATIONS

1. Allocation of income and capital to permanent establishments

Subject I addressed the issues central to the methods used in attributing income and capital to the PE of banks, insurance companies and other finance companies. The general reporter on this subject was Dr P. Athanas of Switzerland and the discussion leader Mr I.W. Harris of the United Kingdom (UK). The panel and delegates agreed that as a result of the increased functional independence of the PE, the allocation of income and capital should be governed by the direct method and not the indirect method. It was the general view of the panel that practical relationships between a head office and a branch on the one hand and between a parent and a subsidiary on the other are similar. Hence any differences in the allocation of income and capital to subsidiaries and branches seem unjustified.

The participants however recognized that there are some countries with a long tradition of applying the indirect method. The Congress therefore resolved that with respect to such countries there should be a transition period long enough to allow both the legislator and the banker or insurer to change the existing method of allocation without causing new double taxation problems. The Congress further agreed on the necessity for tax authorities to recognize and respect the capital requirements of banking and insurance industry regulatory authorities. Capitalization was determined to be a management decision which should be recognized by the tax authorities.

One further issue was that of effective risk bearing. Some delegates were of the view that in reality the branch does not bear the risk, but that the risk is borne by the bank as a whole. The majority of the members present, however, concluded that branches do bear the risk and that the OECD guidelines on income allocation resulting from loans should be revised in order to emphasize the criterion of effective risk bearing.

2. Thin capitalization

By contrast with Subject I, Subject II addressed the manner in which a subsidiary is capitalized and that it is not regarded as a purely management issue. The general reporter on this subject was Prof. Dr D.J. Piltz of Germany and the discussion leader was Avv. B. Gangemi of Italy. As discussed by the panel, concern with thin capitalization arises because of the more favourable tax treatment of interest over dividends. This treatment can result in the effective shifting of the tax base from the source country to the country of residence of the shareholder. Some revenue authorities respond by disallowing the deductibility of interest and re-characterizing interest payments as dividends.

The resolutions passed by the delegates seek to provide guidelines as to the circumstances in which the decisions of management could be challenged by revenue authorities. In addressing this issue the panel and delegates considered whether the matter of thin capitalization could be appropriately addressed by Article 9 of the OECD Model Convention and the interaction of that article with Article 24.

One delegate noted that consideration should be given to the significant effects of exchange gains and losses on financing in inflationary economies. It was also agreed through intervention from delegates that the application of thin capitalization rules should not be limited to situations where there is a tax haven involved or fraudulent planning. It was also agreed that once it is determined in a given case that the application of a thin capitalization adjustment does not conflict with the criteria set out in Article 9(1), then under the terms of Article 24(4) the non-discrimination principle would not apply.

The delegates concluded by resolving that Article 9 was appropriate for determining whether the relationship between lender and borrower is at arm's length. There was a caveat, however, that a comparison of the level of profit of borrower or lender should not be a factor in determining whether the transaction is at arm's length. The delegates and panel further agreed that once it has been found that a re-characterization of interest as dividends does not offend a double taxation agreement (DTA) in effect, then the shareholder's country of residence is obliged to apply its rules for avoiding double taxation of dividends.

There were three further points on which delegates agreed. Firstly, the taxpayer has a right to prove that its debt/equity ratio is appropriate even if it exceeds a fixed ratio. Secondly, that if the application of thin capitalization rules results in double taxation, the countries concerned should make an attempt to relieve such double taxation, even if the relief is not in accordance with the DTA. Finally, taxpayers should have the right to request a binding ruling as to whether or not a transaction triggers thin capitalization rules.

SEMINARS

1. Federal Taxation

Mr J. Hausman of Canada chaired Seminar A which dealt with issues arising in federal states and economic groupings (such as provinces or cities) where there are concurrent taxing authorities. In such situations free trade may be affected if the free movement of capital, people and goods is inhibited. The panellists considered specifically the USA, Australia, Brazil and the European Union (EU) and addressed four issues: (a) non-discrimination (b) locational neutrality (c) cross-border enforcement and collection and (d) uniform compliance with international commitments.

The United States (US) Supreme Court has adopted a four prong test to measure the constitutionality (under the commerce clause) of a state tax on interstate commerce. These are whether (i) there is a "substantial nexus" between the taxed activity and the taxing state (ii) the tax is fairly apportioned (iii) the tax discriminates against interstate commerce and (iv) the tax is fairly related to the services provided by the state. In Australia there is less concern because the six states have ceded to the federal government the right to levy taxes on income. Constitutional rules prohibit the Australian federal government from discriminating by giving preference to one state. It also prevents the federal government from levying taxes on property belonging to Australian states.

In Brazil, three basic rules apply: (i) all federal taxes must be uniform amongst states; (ii) federal, state and municipal level taxes must not hinder the free flow of goods; and (iii) member states must not discriminate. The Brazilian experience has been mainly in the area of transaction taxes, since individual and corporate income tax and the excise tax on manufactured goods have always been federal taxes in Brazil. Within the EU there are only two directives which harmonize specific aspects of direct taxation. Apart from these, the general non-discrimination principle, as laid down in the EC Treaty and developed by the European Court of Justice, may overrule national provisions.

The discussion then shifted to locational neutrality. This was described as the state's failure to use a taxing power, especially with a view towards attracting new investments to the state. In the US, states are free not to tax but a certain uniformity of taxation is achieved through the impact of market forces.

In the four territories under discussion, the question of cross-border enforcement and collection of taxes was not an area of major concern and was not addressed in any great detail. With respect to uniform compliance with international commitments the panel noted that, generally the federal governments have the power to regulate state taxes through treaties made with other countries. In the case of the EU there is no appropriate treaty-making power, but it was suggested that Member States are obliged to respect the EC Treaty in concluding treaties.

Much of the discussion emanating from the floor focused on the need for the EU to harmonize direct taxes in order to ensure monetary and political integration. The chairman in conclusion noted that the EU could consider the three possible methods which emerged from the discussion: (i) market forces as is the case in the US; (ii) legislation as is the case in Brazil; and (iii) consensus as in the case of Australia.

2. Corporate and accounting principles in determining taxable income

Seminar B was chaired by Prof. P. Thorell of Sweden and explored the differences in corporate and accounting principles in determining taxable income. The purpose of this seminar was to examine the interaction between corporate law, financial accounting and tax accounting. Introductory papers were presented on Germany, the UK and Japan. The German presentation revealed a strong relationship between financial and tax accounting, characterized by the concept of prudence. There is less conformity in the UK and the true and fair concept is regarded as the overriding principle. While the courts in the UK will follow accounting principles, they are prepared to depart from these principles if they deviate from the tax principles under review. The Japanese position is similar to that of Germany in the utilization of financial accounts for tax and accounting purposes, but the overriding principle is disclosure and not prudence. In Japan and Germany there is a level of simplicity absent in the UK because the UK does not adhere to the tax conformity principle.

The panellists noted that the accounting standards were developed in order to meet disclosure objectives, and should not be fettered for purposes of taxation. The panellists also considered whether a profit should be taxable only when distributable, and explained that there were many circumstances in which the ability to pay can be deferred by the company. It was therefore agreed that the concept of realization should be developed further.

Finally this seminar considered the effect of inflation on accounting and tax. The panellists experienced in this area were from Argentina and Uruguay. They were of the view that an income tax system must contemplate adjustments for inflation. It is therefore important that (i) financial statements adjusted for inflation should be the only financial statements for all purposes (ii) the accounting and tax regulations concerning inflation adjustments should agree and (iii) the financial statements prepared for commercial purposes should be in conformity with generally accepted accounting principles, and should be used as a starting point for the preparation of tax returns, notwithstanding the peculiarities of the specific adjustments resulting from the tax law.

3. Eastern Europe

Seminar C considered three issues (i) the experience of western investors in Eastern Europe (ii) the experience of Eastern European countries and (iii) the comparison of the tax treatment of ten selected topics in the Czech Republic, Poland and Russia. Prof. Dr A. Rädler of Germany chaired this session which proved to be very interesting from both a practical and a theoretical perspective. This topic was most relevant to persons interested in investing in Eastern Europe as well as those interested in the tax and commercial problems of a country in transition to a market economy.

The panellists observed that in the three countries there are a number of challenges for taxation authorities, with the revision of the accounting and legal framework. As delegates were able to relate, there are also considerable challenges to investors. The relevant laws are sometimes unclear and incomplete. In addition there are sometimes frequent changes to the law with little possibility of appeal if an issue becomes contentious. The experience of these countries is in many respects similar as they attempt to conform to OECD standards.

4. OECD Model Treaty Developments

Seminar D, chaired by Prof. Dr K. Vogel of Germany, is in keeping with the Congress themes of looking towards the future, the impact of information technology and the renewed concern with PEs. These issues proved to be appropriate for a joint panel of the IFA and the OECD. The representative of the OECD commented on the ongoing work of the OECD in developing the Model Convention. One of the areas of particular importance in this regard is Article 5, the PE article and Article 14, the fixed base article and their interaction with Article 24, the non-discrimination article. The issue was raised as to whether Article 14 should be deleted from the Model Convention. This prompted a discussion as to the differences between Article 14 and Article 5 of the Model. The delegates were able to identify situations where there were differences in the application of the two articles. The panel also considered the circumstances in which the home country of the company or individual and the host country of the PE or fixed base would have the right to tax.

The panellists highlighted the following issues:

- the determination of the place where services are performed and consumed;
- the review of the concepts of the PE and management and control;
- Value Added Tax and adapting to the Internet and the use of electronic cards;
- new possibilities in the collection of taxes.

TAX VISIONS OF THE XXI CENTURY

Finally, the Jubilee symposium, continued the themes raised in Seminar D above. The symposium was chaired by Professor S.O. Lodin of Sweden and had the honour of including EC Commissioner of Taxation Mr M. Monti in the panel. The questions surrounding the use of information technology were most clearly reflected in this forum. The two branches of the discussion were (i) the use of information technology in improving the efficiency of tax administration and (ii) the ability of revenue authorities to capture the increasing number of transactions which would be carried out in a dematerialized form.

The symposium considered that the following matters would become of increasing importance:

- an increase in the implementation of expenditure taxes;
- harmonization of tax bases, so that jurisdiction and enforcement would prove to be less difficult;
- introduction of the formulary approach in the allocation of tax revenues;
- introduction of a flat rate tax;
- reduction of tax rates;
- gross assets tax on corporations;
- the increasing role of supranational organizations;
- further protection of the taxpayer from double taxation and a right of audience before revenue authorities;
- rationalization of the inequitable treatment of dividends and interest.

Some of these matters are of more immediate concern than others. There was also some limited discussion as to whether legislators would seek to discover new tax bases. The question was raised as to whether environmental taxes would form the basis of such new taxes. An increase in the implementation of the Value Added Tax system is also anticipated. The chairman of this session however concluded that the variables involved in attempting to foresee international tax developments were perhaps too many to expect a high degree of accuracy in the predictions of the panellists. Despite this, however, it was acknowledged that the topic was extremely useful and a fitting close to this fiftieth Congress.

Prepared by Mrs Lynette V. Eastmond (Barbados), with substantive contributions from Dr Peter Harris (Australia), Dr Marco Lombardi (Italy), Dr Yves Noël (Switzerland) and Dr Ruud Sommerhalder (Netherlands).

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